



4491

VITA/TCE Training Guide

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

2011 RETURNS



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

How to Get Technical Updates?

Updates to the volunteer training materials will be contained in Publication 4491X, VITA/TCE Training Supplement mid-December. To access this publication, in the upper right hand corner of www.irs.gov, type in "Pub 4491X" in the search field.

During the tax season Volunteer Tax Alerts will be issued periodically. Type "volunteer alerts", in the search field to access all tax alerts.



Volunteer Standards of Conduct

VITA/TCE Programs

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

All VITA/TCE volunteers must complete the Volunteer Standards of Conduct Training and sign Form 13615, Volunteer Standards of Conduct Agreement prior to working at a VITA/TCE site. In addition, return preparers, quality reviewers, and VITA/TCE tax law instructors must certify in tax law prior to signing this form. This form is not valid until the site coordinator, sponsoring partner, instructor, or IRS contact confirms the volunteer's identity and signs the form.

As a volunteer participant in the VITA/TCE Programs, I will:

- 1) Follow the Quality Site Requirements (QSR).
- 2) Not accept payment or solicit donations for federal or state tax return preparation.
- 3) Not solicit business from taxpayers I assist or use the knowledge I gained (their information) about them for any direct or indirect personal benefit for me or any other specific individual.
- 4) Not knowingly prepare false returns.
- 5) Not engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct deemed to have a negative effect on the VITA/TCE Programs.
- 6) Treat all taxpayers in a professional, courteous, and respectful manner.

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

- Removal from the VITA/TCE Programs and inclusion on volunteer registry;
- Deactivation of your Partner's VITA/TCE EFIN (electronic ID number);
- Removal of all IRS products, supplies, loaned equipment, and taxpayer information;
- Termination of the sponsoring organizations partnership with IRS;
- Termination of sponsoring organization grant funds; and
- Subjection to criminal investigations.

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Confidentiality Statement:

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



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

WAGE AND INVESTMENT DIVISION

November 18, 2011

Greetings Volunteers,

Welcome and thank you for agreeing to give your time, talent, and support in helping to administer the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. As we prepare for the 2012 filing season, I am reminded that you are the key to the success we have achieved over the years. Each filing season brings exciting and rewarding challenges that you always endure with unwavering determination.

During last filing season, the Treasury Inspector General for Tax Administration and the IRS Stakeholder Partnerships, Education & Communication (SPEC) partners uncovered unacceptable practices at a few VITA/TCE sites. I want to assure you that we know these few do not represent the majority. In light of these issues, IRS-SPEC has enhanced the *Volunteer Standards of Conduct* by developing mandatory training and testing for all volunteers. The intent is to provide guidance and structure for regulating VITA/TCE volunteers and to protect taxpayers. Our program's longevity is founded on the trust that taxpayers have with our partners and volunteers.

I highly recommend Link & Learn Taxes to supplement your classroom training if you have Internet access. It's accessible 24 hours-a-day from www.irs.gov and is our preferred technical training tool. It is an excellent way to experience the IRS return preparation software and to obtain your program certification.

I welcome suggestions for improving your experience, as well as that of the taxpayers you serve. Please e-mail your feedback to partner@irs.gov or mail to:

Internal Revenue Service (VITA/TCE Training)
401 West Peachtree Street, NW – Stop 45 W&I
Atlanta, GA 30308

Again, welcome and thanks. Let's work together to make this our best filing season ever!

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Beebe".

Michael Beebe
Director, Stakeholder Partnerships,
Education & Communication

What's in my training kit?

Product	What's New This Year
Publication 4491, Student Training Guide	<ul style="list-style-type: none"> • New tax law content for 2011 that was available at the time this publication was approved for print. • Publication 4491 is the printed technical training guide for instructors and students. Instructors can acquire additional guidance on www.irs.gov, by searching for Publication 4555-e. • The Business Travel Expense lesson is now covered in Military Employee Business Expenses. • The scope of returns prepared at VITA/TCE sites expanded to include: <ul style="list-style-type: none"> - Lesson 14 Lump Sum Social Security Payments <p>Note: The following optional modules are available on www.irs.gov, keyword <i>Link & Learn Taxes</i>:</p> <ul style="list-style-type: none"> - Cancellation of Debt for Credit Cards and Mortgages – requires Advanced, Military, or International Certification - Health Savings Accounts (HSAs) – requires Intermediate Certification or higher
Publication 4491-W, Comprehensive Problems & Exercises Workbook	<ul style="list-style-type: none"> • Problem and practice exercises that cover new 2011 tax law and changes to what is in scope this year. • If possible, sites should wait to use the tax year 2011 tax preparation software that will be on the Software Practice Lab when Link & Learn Taxes is available on www.irs.gov in early November.
Publication 4012, Volunteer Resource Guide	<ul style="list-style-type: none"> • Additional guidance for charts and exhibits revised to reflect tax year 2011 tax law.
Form 6744, Test/Retest	<ul style="list-style-type: none"> • The test is designed for use with the software Practice Lab on Link & Learn Taxes. It is open book and can be taken and scored on Link & Learn Taxes. • The answers for the test and retest are based on 2011 values for deductions, exemptions, tax, and credits. To be a certified volunteer, the student must demonstrate competency in 2011 tax law. Only the 2011 version of the software will generate the correct answers for 2011 returns. • The new Standards of Conduct (Ethics) Training and test are included in this booklet.
Course Evaluation	<ul style="list-style-type: none"> • Share your ideas for enhancing these materials by completing the training evaluations on www.irs.gov, keyword <i>Link & Learn Taxes</i>. At the end of any online module, click the evaluation link and make the appropriate entries. • See the Director's letter in the front of this book for additional guidance.
Software Practice Lab	<ul style="list-style-type: none"> • Reinforce your training using the IRS e-learning application for volunteers – Link & Learn Taxes. The site also contains an early-release version of the IRS-provided tax preparation software.



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Certification Level Indicators/Legend

					Out of Scope	Link & Learn Taxes
Basic - A	Intermediate - B	Advanced - C	Military - D	International - E	OFS	L&LT

Form 1040		Department of the Treasury—Internal Revenue Service (99)		2011		OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
For the year Jan. 1–Dec. 31, 2011, or other tax year beginning ., 2011, ending ., 20						See separate instructions.	
Entire Section 3-All		Your first name and initial		Last name		Your social security number	
Entire Section 4-All also see lesson 7		If a joint return, spouse's first name and initial		Last name		Spouse's social security number	
Home address (number and street). If you have a P.O. box, see instructions.						Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).						Presidential Election Campaign	
Foreign country name				Foreign province/country		Foreign postal code	
Filing Status		1 <input type="checkbox"/> Single		4 <input type="checkbox"/> 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. ▶		▲ Make sure the SSN(s) above and on line 6c are correct.	
		2 <input type="checkbox"/> Married filing jointly (even if only one had income)		5 <input type="checkbox"/> Qualifying widow(er) with dependent child		Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse	
		3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶					
Exemptions		6a <input type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a				Boxes checked on 6a and 6b	
		b <input type="checkbox"/> Spouse				No. of children on 6c who:	
		c Dependents:		(2) Dependent's social security number		• lived with you	
		(1) First name Last name		(3) Dependent's relationship to you		• did not live with you due to divorce or separation (see instructions)	
				(4) <input type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)		Dependents on 6c not entered above	
		If more than four dependents, see instructions and check here ▶ <input type="checkbox"/>				Add numbers on lines above ▶ <input type="checkbox"/>	
		d Total number of exemptions claimed					
Income		7 Wages, salaries, tips, etc. Attach Form(s) W-2				7 8-All	
		8a Taxable interest. Attach Schedule B if required				8a 8-All	
		b Tax-exempt interest. Do not include on line 8a		8b 8-All			
		9a Ordinary dividends. Attach Schedule B if required				9a 8-All	
		b Qualified dividends		9b 8-All			
		10 Taxable refunds, credits, or offsets of state and local income taxes				10 8-B-E	
		11 Alimony received				11 8-B-E	
		12 Business income or (loss). Attach Schedule C or C-EZ				12 9-B-E Limited	
		13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>				13 10-C-E	
		14 Other gains or (losses). Attach Form 4797				14 OFS	
		15a IRA distributions		15a 11-B-E		b Taxable amount	
		16a Pensions and annuities		16a 11-B-E		15b 11-B-E	
		17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E				16b 11-B-E	
		18 Farm income or (loss). Attach Schedule F				17 12-C-E Limited	
		19 Unemployment compensation				18 OFS	
		20a Social security benefits		20a 14-All		19 13-All	
		b Taxable amount				20b 14-All	
		21 Other income. List type and amount				21 15-All Special Certification L&LT	
		22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶				22	
Adjusted Gross Income		23 Educator expenses		23 17-B-E			
		24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ		24 21-D			
		25 Health savings account deduction. Attach Form 8889		25 Special Certification L&LT			
		26 Moving expenses. Attach Form 3903		26 18-D			
		27 Deductible part of self-employment tax. Attach Schedule SE		27 17-B-E			
		28 Self-employed SEP, SIMPLE, and qualified plans		28 OFS			
		29 Self-employed health insurance deduction		29 OFS			
		30 Penalty on early withdrawal of savings		30 17-All			
		31a Alimony paid b Recipient's SSN ▶		31a 17-B-E			
		32 IRA deduction		32 17-B-E			
		33 Student loan interest deduction		33 17-B-E			
		34 Tuition and fees. Attach Form 8917		34 17-B-E			
		35 Domestic production activities deduction. Attach Form 8903		35 OFS			
		36 Add lines 23 through 35				36	
		37 Subtract line 36 from line 22. This is your adjusted gross income ▶				37	
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2011)							

Scope of Service - Form 1040 Line Entries by Certification Level

Certification Level Indicators/Legend



Basic - **A**



Intermediate - **B**



Advanced - **C**



Military - **D**



International - **E**

Out of Scope
OFS

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L<

Form 1040 (2011) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	
	39a	Check <input type="checkbox"/> You were born before January 2, 1947, <input type="checkbox"/> Blind. Total boxes checked 19-All if: <input type="checkbox"/> Spouse was born before January 2, 1947, <input type="checkbox"/> Blind. checked 19-B-E			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here <input type="checkbox"/> 39b			
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$5,800 Married filing jointly or Qualifying widow(er), \$11,600 Head of household, \$8,500	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)		40	19-All; Some OFS
	41	Subtract line 40 from line 38		41	
	42	Exemptions. Multiply \$3,700 by the number on line 6d.		42	5-All
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	
	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election		44	All; Some OFS
	45	Alternative minimum tax (see instructions). Attach Form 6251		45	OFS
	46	Add lines 44 and 45		46	
	47	Foreign tax credit. Attach Form 1116 if required.	47	24-B-E	
	48	Credit for child and dependent care expenses. Attach Form 2441	48	22-All	
	49	Education credits from Form 8863, line 23	49	23-B-E	
	50	Retirement savings contributions credit. Attach Form 8880	50	26-All	
	51	Child tax credit (see instructions)	51	25-All	
	52	Residential energy credits. Attach Form 5695	52	26-B-E	
	53	Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53	OFS, Except Sch R - 26-All	
	54	Add lines 47 through 53. These are your total credits		54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-		55	
Other Taxes	56	Self-employment tax. Attach Schedule SE	All	OFS	27-B-E
	57	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919			Form 4137 Only
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			27-B-E
	59a	Household employment taxes from Schedule H			OFS
	b	First-time homebuyer credit repayment. Attach Form 5405 if required			27-B-E
	60	Other taxes. Enter code(s) from instructions			HSA Only Special Certification L&LT
	61	Add lines 55 through 60. This is your total tax		61	
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62	28-All	
	63	2011 estimated tax payments and amount applied from 2010 return	63	28-All	
	64a	Earned income credit (EIC)	64a	29-All	
	b	Nontaxable combat pay election 64b 29-All			
	65	Additional child tax credit. Attach Form 8812	65	25-All	
	66	American opportunity credit from Form 8863, line 14	66	23-B-E	
	67	First-time homebuyer credit from Form 5405, line 10	67	28-B-E	
	68	Amount paid with request for extension to file	68	28-All	
	69	Excess social security and tier 1 RRTA tax withheld	69	28-All	
	70	Credit for federal tax on fuels. Attach Form 4136	70	OFS	
	71	Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> 8839 c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885	71	OFS	
	72	Add lines 62, 63, 64a, and 65 through 71. These are your total payments		72	All
Refund	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid		73	30-All
	74a	Amount of line 73 you want refunded to you. If Form 8888 is attached, check here <input type="checkbox"/>		74a	30-All
Direct deposit? See instructions.	b	Routing number	c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
	d	Account number			
	75	Amount of line 73 you want applied to your 2012 estimated tax	75	30-All	
Amount You Owe	76	Amount you owe. Subtract line 72 from line 61. For details on how to pay, see instructions		76	30-All
	77	Estimated tax penalty (see instructions)	77	OFS	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No				
	Designee's name	Phone no.	Personal identification number (PIN)		
Sign Here	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.				
Joint return? See instructions. Keep a copy for your records.	Your signature	Date	Your occupation	Daytime phone number	
	30-All				
	Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation		
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> self-employed	PTIN
	30-32-All				
	Firm's name	Firm's EIN			
	Firm's address	Phone no.			

Form 1040 (2011)



Important Tax Law Changes for 2011



Due Date of Return

The due date for the US Individual Income Tax Return for Tax Year 2011 is April 17, 2012. The due date is April 17, instead of April 15, because April 15, 2012 is a Sunday and April 16, 2012, is the Emancipation Day holiday in the District of Columbia.

Wage Threshold for Household Employees

For 2011, the social security and Medicare wage threshold for household employees remains unchanged at \$1,700. This means that taxpayers who paid a household employee cash wages of less than \$1,700 in 2011 do not have to report and pay social security and Medicare taxes on that employee's 2011 wages.

Income Limits Increased for Excluding Education Savings Bond Interest

For 2011, the amount of the interest exclusion is phased out for Married Filing Jointly taxpayers or Qualifying Widow(er) taxpayers whose modified AGI is between \$106,650 and \$136,650. If the modified AGI is \$136,650 or more, no deduction is allowed.

For Single and Head of Household filing statuses, the interest exclusion is phased out for taxpayers whose modified AGI is between \$71,100 and \$86,100. If the modified AGI is \$86,100 or more, no deduction is allowed.



Married taxpayers who file separately do not qualify for the exclusion.

Standard Deduction Increases

The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) has increased. The standard deduction amounts for 2011 are:

- \$11,600 – Married Filing Jointly or Qualifying Widow(er)
- \$8,500 – Head of Household
- \$5,800 – Single or Married Filing Separately

Taxpayers who are 65 and Older or are Blind

For 2011, the standard deduction for these taxpayers has increased:

- \$1,150 - Married Filing Jointly, Married Filing Separately, or Qualifying Widow(er)
- \$1,450 - Single or Head of Household

Temporary Decrease in Employee's Share of Payroll Tax

In 2011, social security tax is withheld from an employee's wages at the rate of 4.2% (down from 6.2%) up to the social security wage limit of \$106,800. There is no change to Medicare withholding.

The same reduction applies to net earnings from self-employment – the temporary rate is 10.4% (down from 12.4%) up to the social security wage limit of \$106,800. The method of figuring "one-half of self-employment tax" for adjusted gross income changed slightly. A worksheet was developed to compute the deduction.

Exemption Amount

The amount a taxpayer can deduct for each exemption increased to \$3,700 for 2011.

Alternative Minimum Tax (AMT) Exemption Amount Increased

For 2011, the AMT exemption amount is increased to \$48,450 (\$74,450 if Married Filing Jointly or a Qualifying Widow(er); \$37,225 if Married Filing Separately).

Retirement Savings Contribution Credit Income Limits Increased

In order to claim this credit, your MAGI must not be more than \$28,250 (\$56,500 if Married Filing Jointly; \$42,375 if Head of Household).

Earned Income Credit (EIC)

Amount of Credit Increased

For 2011, the maximum credit is:

- \$3,094 with one qualifying child
- \$5,112 with two qualifying children
- \$5,751 with three or more qualifying children
- \$464 with no qualifying child

Earned Income Amount Increased

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

- \$36,052 (\$41,132 if Married Filing Jointly) with one qualifying child
- \$40,964 (\$46,044 if Married Filing Jointly) with two qualifying children
- \$43,998 (\$49,078 if Married Filing Jointly) with three or more qualifying children
- \$13,660 (\$18,740 if Married Filing Jointly) with no qualifying child

Investment Income

Taxpayers whose investment income is more than \$3,150 cannot claim the EIC.

Advance Payment of the Credit

The Education Jobs and Medicaid Assistance Act of 2010 eliminated the advance EIC for tax years beginning after December 31, 2010.

Adoption Credit or Exclusion

The maximum adoption credit or exclusion for employer-provided adoption benefits has increased to \$13,360 for 2011. To claim either the credit or exclusion, the taxpayer's MAGI must be less than \$225,210. This credit is outside the scope of the VITA/TCE Program.



Standard Mileage Rate

Business-Related Mileage

For 2011, two rates are in effect:

- January 1 through June 30 – The standard mileage rate for the cost of operating a car, van, or pickup/panel truck for business use is 51 cents per mile
- July 1 through December 31 – The rate increases to 55.5 cents per mile

Medical and Move-Related Mileage

For 2011, two rates are in effect:

- January 1 through June 30 – The standard mileage rate for the cost of operating a vehicle for medical reasons or as part of a deductible move is 19 cents per mile
- July 1 through December 31, 2011 – The rate increases to 23.5 cents per mile

Charitable-Related Mileage

For 2011, the standard mileage rate for the cost of operating a vehicle for charitable purposes remains at 14 cents per mile.

Modified Adjusted Gross Income (AGI) Limit for Traditional IRA Contributions Increased

For 2011, if a taxpayer is covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) if the modified AGI is:

- More than \$90,000 but less than \$110,000 for a married couple filing a joint return or a qualifying widow(er),
- More than \$56,000 but less than \$66,000 for a single individual or head of household, or
- Less than \$10,000 for a married individual filing a separate return

If only one spouse is covered by a retirement plan at work, and the taxpayers live together or file a joint return, the deduction is phased out if the modified AGI is more than \$169,000 but less than \$179,000. If the modified AGI is \$179,000 or more, no deduction for contributions to a traditional IRA is allowed.

Deductible Long-Term Care Premium Limits Increased

For 2011, the maximum amount of qualified long-term care premiums includible as medical expenses has increased. Qualified long-term care premiums up to the amounts shown below can be included as medical expenses on Schedule A (Form 1040) Itemized Deductions.

- \$340: age 40 or under
- \$640: age 41 to 50
- \$1,270: age 51 to 60
- \$3,390: age 61 to 70
- \$4,240: age 71 and over



The limit on premiums is for each person.

Qualified Charitable Distribution (QCD)

Tax-free treatment of distributions from traditional and Roth IRAs for charitable purposes has been extended through December 31, 2011, with the following special rule.

- For QCDs made during January 2011, taxpayers can elect to have the distribution deemed to have been made on December 31, 2010. If this election is made, the QCD counts toward the 2010 exclusion limit of \$100,000, as well as the 2010 minimum required distribution.

Lifetime Learning Credit Income Limits Increased

To claim a lifetime learning credit, a taxpayer's MAGI must be less than \$61,000 (\$122,000 if Married Filing Jointly).

Nonbusiness Energy Property Credit

This credit has been extended for 1 year with a reduced rate of 10%. Amounts provided by subsidized federal, state, or local energy financing do not qualify for the credit. The energy-efficiency standards for qualified natural gas, propane, or oil furnaces, or hot water boilers have been increased.

For 2011, the credit is limited as follows:

- A total combined credit limit of \$500 for all tax years after 2005 (Form 5695, Part I)
- A combined credit limit of \$200 for windows for all the amount of your tax years after 2005
- A maximum credit for residential energy property costs of \$50 for any advanced main air circulating fan; \$150 for any qualified natural gas, propane, or oil furnace, or hot water boiler; and \$300 for any item of energy-efficient building property

Social Security and Medicare Taxes

The maximum amount of wages subject to the social security tax for 2011 is \$106,800. There is no limit on the amount of wages subject to the Medicare tax.

Self-Employment Tax

Self-employment tax consists of two parts: social security and Medicare. The maximum amount of net earnings subject to the social security part of the self-employment tax for tax years beginning in 2011 is \$106,800. All net earnings of at least \$400 are subject to the Medicare part of the tax.

Tax Forms and Schedules

Form 1099-K

Payment settlement entities (PSE) may have to report merchant card payments and third network payments on the new Form 1099-K, Merchant Card and Third-Party Payments. Box 1 shows the aggregate gross amount of merchant card/third party network payments made to the taxpayer through the PSE during the tax year. For more information, see Lesson 9: Income – Business.

Form 1098-MA

Form 1098-MA, Mortgage Assistance Payments, is a new information return. The form is used to report to the IRS and homeowners the total amounts of certain mortgage assistance payments made to mortgage servicers. Mortgage assistance payments are not included in income. However, taxpayers cannot deduct the interest that is paid for them.



Tax Forms and Schedules

Form 1099-B

Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, includes five new boxes:

- Box 1b to report the date of acquisition
- Box 3 to report cost or other basis
- Box 5 to report the amount of loss disallowed due to a wash sale
- Box 6 to report whether the property sold is a noncovered security, and
- Box 8 to report whether the gain or loss is short-term or long-term

Brokers must complete boxes 1b, 3, 5, and 8 when reporting sales of securities, unless box 6 is checked. In addition to these changes, other boxes on the form were either moved or renumbered.

Form 8949

A new Form 8949, Sales and Other Dispositions of Capital Assets, contains all capital gain and loss transactions. Transactions will no longer be reported directly on Form 1040, Schedule D, Capital Gains and Losses. The subtotals from Form 8949 are carried over to Schedule D, where gain or loss is calculated in aggregate.

Using a checkbox in Part I and Part II, the taxpayer identifies short and long-term transactions in these categories:

- Form 1099-B, box 3, shows basis
- Form 1099-B, box 3, does not show basis
- Form 1099-B not received

Only one box may be checked in each part; a taxpayer with more than one type of transaction must file a separate Form 8949 for each type. For more information, see Lesson 10: Income - Capital Gain or Loss.

Schedule D

Form 1040, Schedule D, Capital Gains and Losses, was revised to allow for changes made to Form 1099-B and the new Form 8949. Individual transactions will no longer be listed on Schedule D. The Short and Long-Term sections of the revised Schedule D separate the three types of transactions carried over from Form 8949 to Schedule D. Form 8949 replaces Schedule D-1.



Foreign Earned Income and Housing Exclusions

For 2011, the maximum Foreign Earned Income Exclusion increased to \$92,900. The base housing amount increased to \$40.72 per day or \$14,864 for the entire calendar year.



Expiring Provisions

The following provisions expired in 2010 and are no longer available:

- Making work pay credit
- Computer technology and equipment allowed as qualified higher education expenses for qualified tuition programs
- Advance earned income credit

Link & Learn Taxes – Optional Courses

Qualified Medical Expenses

For HSA, MSA, FSA, and HRA purposes, a medicine or drug will be a qualified medical expense only if the medicine or drug:

- Requires a prescription
- Is available without a prescription (an over-the-counter medicine or drug) and you get a prescription for it, or
- Is insulin



This applies to amounts paid after 2010. However, it does not apply to amounts paid in 2011 for medicines or drugs purchased before January 1, 2011.

Increase in Additional Tax on Certain Distributions Not Used for Qualified Medical Expenses

The tax on distributions from health savings accounts (HSAs) and Archer MSAs made after December 31, 2010, that are not used for qualified medical expenses, is increased to 20%.



Congress may enact additional legislation that will affect taxpayers after this publication goes to print. For the most current tax law information, go to www.irs.gov.



Lesson 1: Course Introduction

Welcome

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

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

Objectives

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

- The various course levels and certification process
- The responsibilities of a VITA/TCE volunteer
- The critical components involved in the return preparation process
- The resources available to assist you

What will I learn?

To successfully assist taxpayers in satisfying their tax responsibilities, you must understand tax law and the tools available to assist you in preparing and filing accurate tax returns – Forms 1040EZ, 1040A, 1040, etc. A tax return is accurate when tax law is applied correctly and it is free from error based on the taxpayer's interview and supporting documentation, and a completed Form 13614-C, Intake/Interview & Quality Review Sheet.

The VITA/TCE return preparation process consists of five critical components that will be taught in your training class as follows:

- **NEW** Volunteer Standards of Conduct Training
- Screening and interviewing taxpayers, using Form 13614-C
- Understanding and applying tax law
- Using references, resources, and tools including return preparation software
- Conducting quality reviews on all returns

You **must** complete the Volunteer Standards of Conduct training and complete and sign Form 13615, Volunteer Standards of Conduct Agreement – VITA/TCE Programs, prior to working at a site. Form 13615 must be signed and dated by the Site Coordinator, sponsoring partner, instructor, or IRS contact. They must verify your identity, that you have completed the required training, and have signed Form 13615 prior to working at a site. More information on Standards of Conduct can be found in Publication 4299, Privacy, Confidentiality, and Standards of Conduct – A Public Trust.

What do I need?

- Publication 4491
- Publication 4491-W
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Form 6744
- Intake and Interview Sheet
- Form 13614-C Job Aid
- Form 13615

Optional:

- Publication 3
- Publication 596
- Publication 972
- Publication 4299
- Publication 4403
- Publication 4575
- Form 13645
- Internet Access (optional but highly recommended)



Volunteer Standards of Conduct training and test is located in Form 6744, VITA/TCE Volunteer Assistor's Test/Retest and on Link & Learn Taxes.

Your ability to prepare an accurate return will be measured in these ways:

- The testing and certification process gauges how you apply the tax law knowledge you gained during training. A minimum score of 80% is required for each course of study. The test is open book.
- How effectively you interview the taxpayer, verifying Form 13614-C, and using the technical resources to deliver a complete and accurate return.
- A 100% quality review of all tax returns is required.
- A random selection of returns will be reviewed at selected sites by IRS SPEC Quality Statistical Sample (QSS) reviewers.

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

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

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

Let's get started!



Volunteers at all sites must complete Form 13614-C, Section C (electronic or paper) during the quality review process.



To prepare an accurate return, you must understand the importance of all the information that taxpayers provide during the intake and interview process and from their supporting documentation.

How is the course structured?



Due to the production schedule for this training guide, draft forms may be used in illustrations. The draft forms should never be used for actual tax preparation. Final forms are available on www.irs.gov, in the tax preparation software, in the instruction booklet (e.g., Form 1040 Instructions), or in other publications.

There are five courses presented in this publication, each representing a level of certification. The first seven lessons apply to all levels of certification. Beginning in Lesson 8, the course levels for the subject being covered will be indicated by the following icons:



Basic covers the completion of wage earner type returns.



Intermediate covers completion of returns for wage earners who receive pension income, and more complex Forms 1040.



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



Military covers the full scope of VITA/TCE returns presented by members of the Armed Forces, Reserve, and National Guard.



International covers the completion of returns for military and nonmilitary taxpayers living outside the United States.

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

What is the training approach?

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

- The questions from Form 13614-C to interview the taxpayer for eligibility, verify information provided, and prepare the return.
- Reference materials, such as Publication 4012, Volunteer Resource Guide; Publication 17, Your Federal Income Tax for Individuals; and tax software help features, as well as other resources available at your site, to prepare the return. These materials will provide you with standardized questions to ask taxpayers during your interview, to help you prepare a 100% accurate tax return.
- Form 13614-C, Section C, to conduct a quality review of all returns. Adhering to a quality review process helps ensure accurate returns are prepared at all VITA/TCE sites.

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

What do I need to get started?

Prior to assisting taxpayers at the VITA/TCE Site, be sure to complete the “Are You Ready to Get Started?” assessment in the front of the Volunteer Resource Guide.

In addition to this publication, your training kit includes the following items:

- Publication 4491-W, Comprehensive Problems and Practice Exercises Workbook
- Publication 4012, Volunteer Resource Guide
- Form 6744, Volunteer Assistor’s Test/Retest

Important information about the products in your kit are shown on page ii of this guide.

What other resources are available to help me learn?

Additional assistance in conducting an effective and thorough intake/interview and quality review process using Form 13614-C can be found in Appendix A, located in the back of this publication. Interview scenarios are provided for a fictional taxpayer, Vanessa Franklin, to help you learn and visualize the complete intake/interview and quality review process.

Publication 4491-W, a companion book to this course, provides many opportunities to practice tax return preparation using the information taught in this guide.

Directions at the end of many lessons suggest using Publication 4491-W to practice the lesson material. Although it might not be possible to work each exercise with the knowledge you have at that point, at the end of the course, you will have the opportunity to complete all of the comprehensive problems and exercises in Publication 4491-W.

You may use the Practice Lab integrated with the online course, Link & Learn Taxes, to complete exercises, practice returns, and test scenarios using tax software.



Keep in mind that the Practice Lab is not updated with late tax law changes.

What happens after I complete this course?

You will be tested on your understanding of tax law, the Volunteer Standards of Conduct, and the guidelines and tools needed to prepare an accurate return. After you have been certified, complete and sign Form 13615, you will be ready to volunteer at a VITA/TCE site.

How does this certification work?

To participate in the VITA/TCE program, you must pass the Volunteer Standards of Conduct Training and at least the Basic certification test. After your Basic certification, you can test for Intermediate certification. Once you have achieved both Basic and Intermediate certifications, you may test for any or all certifications. A minimum score of 80% is required to pass each certification test. You may take online tests that are available in Link & Learn Taxes on www.irs.gov. Online testing is fast and efficient; you will know immediately if you passed, and can print out the certification for your Site Coordinator. Volunteers who do not pass the test the first time may review the course material and try again. A paper test option (Form 6744) may also be available. Talk with your instructor or Site Coordinator for more information on these options.



You must pass the Volunteer Standards of Conduct training prior to accessing the Basic certification test.

Two optional specialty courses (Health Savings Accounts and Cancellation of Debt) are also available only on Link & Learn Taxes. The Health Savings Accounts course is available for volunteers with Intermediate certification. The Cancellation of Debt course is available for volunteers with Advanced, Military, or International certification. Check with your Site Coordinator to determine if you should be certified in either of these lessons.

All volunteer instructors and site quality reviewers must be certified, at a minimum, at the Intermediate level. If the site is preparing returns at the Advanced, Military, or International levels, the volunteer's certification level should be comparable. It is strongly encouraged for volunteers to certify at the Advanced level.

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

When you pass the test, your Site Coordinator or instructor may provide you with a VITA/TCE program Form 13645, Wallet Card. The wallet card was created to acknowledge the accomplishment of certified volunteers, as well as to assist internal and external stakeholders in identifying certified volunteers. This credential provides an objective measure that you have mastered enough tax law to prepare returns. You should bring your wallet card and photo ID to the tax preparation site.

What types of returns can I prepare?

It is important that you assist only with returns, supporting schedules, and forms for which you have been trained and certified. Refer taxpayers with tax situations outside your scope of training and certification to your Site Coordinator and/or a professional tax preparer. The training resources and tools discussed in this guide only support the completion of a basic Form 1040 and associated tax forms. A complete list of what is within the scope of the VITA/TCE program can be found in the front of the Volunteer Resource Guide. Do not prepare returns that fall outside the scope of the VITA/TCE program. Applicable lessons include out of scope tax law topics for the VITA/TCE programs.

How does the IRS identify volunteer-prepared returns?

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

More detailed information can be found in the Quality Review of Tax Return lesson.

Am I legally liable for returns I prepare?

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

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



Access a copy of this Act by typing "Volunteer Protection Act of 1997" into any Internet search engine.



Volunteer preparers who receive over \$500 in compensation as employees of a program sponsor should seek legal advice on liability.

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

As a VITA/TCE program volunteer, you have a responsibility to provide quality service and to uphold the ethical standards of the program. When you begin as a volunteer, you will be asked to sign Form 13615, which states that you will adhere to these standards:

- Follow the Quality Site Requirements (QSR)
- Never accept payment or solicit donations for tax return preparation
- Never solicit business from taxpayers you assist or use the knowledge gained about a taxpayer for any direct or indirect personal benefit
- Never knowingly prepare false returns
- Never engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct deemed to have a negative effect on the IRS
- Treat all taxpayers in a professional, courteous, and respectful manner

Identity Theft

Refer taxpayers to the Identity Protection Specialized Unit at 1-800-908-4490 if identity theft affects their current federal income tax return. The Protection Specialized Unit may issue these taxpayers a notice. You may prepare returns for taxpayers who have a CP01A Notice or special PIN (six-digit IPPIN). Include the IPPIN on the tax software Main Information Sheet. Refer to Form 1040 Instructions for more information.

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



Identity theft is a growing problem; treat all taxpayer information as confidential.

How do I maintain the taxpayer's trust?

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

- Do not disclose any personal tax information gained as a result of the service provided.
- Do not openly discuss taxpayers by name in the presence of other volunteers or taxpayers. You may discuss tax situations with other taxpayers and volunteers. For example, a volunteer may refer to a situation (not a taxpayer) and ask or give advice about the appropriate tax treatment for that specific situation.
- Do not retain taxpayers' documents for a follow-up visit. If you cannot fully complete the taxpayer's return at the time of service, return all documents to the taxpayer.
- Do not take taxpayers' information for preparation of the return outside the presence of the taxpayer.
- Do not prepare a tax return when you suspect an individual is not providing truthful information.
- Do not exclude any of the taxpayer's income or expenses disclosed during the interview.

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

If you or a taxpayer should have a concern or issue regarding unethical behavior at a site, call 1-877-330-1205, or e-mail WI.Voltax@irs.gov. Also, see Publication 730 or Publication 4481 for reporting Civil Rights (Title VI) and EEO concerns.



Refer to Publication 4299, Privacy, Confidentiality, and Standards of Conduct – A Public Trust, for more information.

Are there other materials available to assist me?

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

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

- Instruction booklets, schedules, and worksheets for Form 1040
- Frequently used tax publications (e.g., Publication 596, Earned Income Credit; Publication 972, Child Tax Credit; and Publication 3, Armed Forces' Tax Guide)
- Equipment and supplies along with security requirements and use restrictions

You may reinforce your knowledge of tax law by viewing online training courses such as Link & Learn Taxes and Understanding Taxes on www.irs.gov.

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



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

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

How do I get started using the tax software?

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

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

Where do I find information about the tax software?

The Volunteer Resource Guide contains step-by-step procedures for electronic return preparation and helpful hints for using the tax software under the yellow tabs. Information specific to the online version of the software can be found under the blue tabs. Information about completing the return is listed in the Volunteer Resource Guide, Finishing the Return tab.

Summary

Welcome to the VITA/TCE program. Remember:

- Make sure you have the resources and support you need to provide each taxpayer with high-quality service and an accurate return.
- A return is accurate when tax law is applied correctly and the return is free from error based on the taxpayer's interview and supporting documentation, and a completed Form 13614-C.
- Know your roles and responsibilities and adhere to the Volunteer Standards of Conduct.
- Prepare returns that are:
 - within the scope of the VITA/TCE program
 - within your certification level
- Use VITA/TCE equipment and supplies (including hardware and software) for their intended purposes.
- Complete the "Are You Ready to Get Started?" assessment in the Volunteer Resource Guide prior to assisting taxpayers to determine if you have everything you need to provide high-quality professional service.



Lesson 2: Screening and Interviewing

Introduction

Every taxpayer who uses VITA/TCE services should be confident they are receiving accurate return preparation and quality service.

This lesson will guide you through the intake and interview process and enable you to conduct a thorough and effective interview using Form 13614-C, Intake/Interview & Quality Review Sheet and Publication 4012, Volunteer Resource Guide. Also, this lesson will help you learn probing techniques, a key component of the interview process.

Objectives

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

- Explain how Form 13614-C, Intake/Interview & Quality Review Sheet should be completed
- Confirm information on Form 13614-C by conducting an interview with the taxpayer
- Make corrections to Form 13614-C as errors are identified
- Locate tools to assist you in Publication 4012, Volunteer Resource Guide
- Use various communication techniques to probe and secure necessary information

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17

What is IRS policy regarding the intake and interview process?

All certified volunteer tax preparers participating in the VITA/TCE programs **must** use an intake and interview process for every return.

NEW For 2012, all VITA/TCE sites are required to use Form 13614-C, Intake/Interview & Quality Review Sheet.



Form 13614-C, Intake/Interview & Quality Review Sheet is mandatory for all VITA/TCE sites.

What is Form 13614-C, Intake/Interview & Quality Review Sheet?

Form 13614-C, Intake/Interview & Quality Review Sheet is what you will use as a basis for an interview with the taxpayer and to determine program eligibility and level of certification required to prepare the return. It will help you ask the right questions to obtain all the information needed to prepare an accurate tax return.

Upon arriving at the site, taxpayers will be given Form 13614-C for completion. It is important for taxpayers to thoroughly complete Section A. This section asks for information about the taxpayers and other individuals they would like to claim on the return, income the taxpayer received, expenses paid, and life events.

What tool is available to help me conduct a probing interview?

Publication 4012 is a reference tool that you will use when reviewing Form 13614-C for accuracy and while conducting the interview with the taxpayer. It includes decision trees, interview tips, and other information to assist with gathering, clarifying, and verifying the taxpayer's information in Sections A and B on the intake and interview sheet.

Publication 4012 is divided into four major sections – General Information, Tax Law, the Tax Software, and the Tax Software Online.

- General information located in the front and back section and the covers of the book offer guidance as well as a line-by-line job aid using the intake and interview sheet.
- White tabs contain tax law in the form of decision trees, charts, and interview tips.
- Yellow tabs contain step-by-step procedures for electronic return preparation using the tax software.
- Blue tabs contain information specific to users of the web-based option for the tax software.

How should I use the intake and interview sheet?

When the taxpayers indicate that their portion of the intake and interview sheet is complete, you will need to:

- Review the intake and interview sheet carefully with the taxpayers to ensure that all questions in Section A have been addressed and answered correctly.
- Use probing questions to confirm the accuracy of the taxpayers' responses.
- Correct or update the intake and interview sheet if missing information or an error is identified. The suggested method of correction is to circle the error and make the correction. You may put additional notes on page 4.
- Provide clarification and assist the taxpayers with all questions that have been marked "Unsure." Questions marked "Unsure" must be changed to a "Yes" or "No" response.
- Assist the taxpayers with completing the intake and interview form if needed. A line-by-line job aid is available to assist you with completing Form 13614-C.



A line-by-line job aid can be found in the front of Publication 4012; it provides line-by-line instructions for using the intake and interview sheet.

You will need to confirm that the taxpayer has brought to the site all necessary supporting documentation needed to prepare the return. Using the intake and interview sheet, carefully review all questions that are checked "Yes" to ensure that *all* required Forms W-2, Forms 1099, expense amounts (e.g., real estate taxes, mortgage interest, educational, and child care) have been provided. You should not prepare the tax return until all required documentation has been received and all income and expenses have been provided by the taxpayer during the interview, including cash received for services rendered. Enter these amounts on page 4 of the intake and interview sheet.

Sample Interview

Here is an example of how a volunteer addressed the unsure box on the intake sheet of Savannah, a taxpayer:

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	SAVANNAH RESPONDS...
<i>Well Savannah, after reviewing your intake and interview sheet, I see that you checked the "Unsure" box for the question "Can your parents or someone else claim you on their tax return."</i>	Yes I did. I still live at home with my parents, but I'm not sure if they are claiming me. I forgot to ask them.
<i>Okay. Well I need to ask you a few questions to determine if you or your parents can claim you.</i>	Sure, no problem.
<i>Based on your date of birth, it looks like you are 23 years old. Were you a full-time student last year?</i>	No, I am planning to go back to school in a year or so.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

Good for you. I see that you checked "No" for the "Totally and Permanently Disabled" question. You also checked "Yes" that you have wages, so let's take a look at your income. It looks like you made about \$12,000, so you can claim yourself. I am going to change your "Unsure" response to a "No" because your parents will not be able to claim you.

SAVANNAH RESPONDS...

Wonderful. That should help me out a bit.

Why is it so important to review the intake and interview sheet?

An incorrect answer on the intake and interview sheet that is not identified could affect a taxpayer's eligibility for a credit or deduction. All sites must complete Form 13614-C, Section C, (electronic or paper) during the quality review process to determine if the taxpayer qualifies for a credit or deduction. Use reference material listed in the What do I need? section on page 2-1.

In addition, the intake and interview sheet, along with the income supporting documents (i.e., Forms W-2 and 1099), will assist you in determining if the taxpayer falls within the scope of the VITA/TCE program and your level of certification. If the return does not fall within the scope of the program or within your certification level, you should:

- Advise the taxpayers that their return is outside the scope of your training and seek assistance from your Site Coordinator. If there is another volunteer available who has the appropriate certification, that volunteer may resume the interview, or
- Explain courteously that volunteer services are limited to those who fall within the scope of the program. Use the Scope of Service - Form 1040 chart in Publication 4012 to show why they do not qualify.
- Encourage the taxpayers to use the information they recorded on the intake and interview sheet when working with a professional tax preparer.
- Thank the taxpayers for coming and express regret that you cannot assist them.

TIP

Information from the Volunteer Resource Guide is referred to throughout this training. You must use it at your VITA/TCE site. Refer to it often during class to prepare for your taxpayer interviews.

Sample Interview

Here is an example of how a volunteer addressed program eligibility for Ms. Clark, a taxpayer.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Ms. Clark, are you aware that the volunteer program is limited and that as volunteers we can only prepare returns within the scope of our training?

Well, I'll see what I can do. First, I'll need to review your W-2s, interest statements, and any other documents that report your income. I'll also need to review the intake and interview sheet that you completed. Do you mind if I take a look?

MS. CLARK RESPONDS...

No, I did not know that. Do you think you'll be able to prepare my return?

Sure. Here's everything.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

MS. CLARK RESPONDS...

I see here that you checked “Yes” to the question about Income from Rental Property. Are you in the business of renting property?

Yes, I am. I own some apartment buildings and collect rent from them.

I’m very sorry to tell you but business income from rental property is outside the scope of the volunteer program. I’m afraid we will not be able to help you.

Are you sure? I don’t know what I’m going to do.

Yes, I’m sure. You are more than welcome to take the intake sheet with you. It may be helpful as you work with another preparer to complete your return. I’m sorry we weren’t able to complete your return. Thanks so much for coming in.

Okay. Well, thanks anyway.



Do not recommend a specific business or a person when encouraging a taxpayer to use a professional tax preparer.

What else is involved in the intake and interview process?

Always verify identity and compare the taxpayers’ personal information to the supporting documents (e.g., social security cards, ITIN letters, driver’s license, other picture ID) to ensure that the names and addresses are all correct, especially when carrying forward taxpayer information. Verify Employer Identification Numbers (EIN). Reviewing social security cards, a form/letter from the Social Security Administration, or Individual Taxpayer Identification Number (ITIN) letters for each person to be listed on the return is an absolute must.

Pay particular attention to marital status and dependent information. Decision trees located in Publication 4012 (or the Help feature in the tax software), will assist with determining verification of filing status and qualifying dependents.

Complete Form 13614-C, Section B, only if persons are listed on page 1, Part II, “Marital Status and Household Information.” Section B will help you determine if the taxpayer qualifies to claim the Head of Household filing status and claim persons listed as dependents, as well as other tax benefits.

What type of interview techniques should I use?

Greet the taxpayer, introduce yourself, and try to put the taxpayer at ease. Take a few moments for small talk; for example, ask how the taxpayer heard about the site or discuss the weather and traffic.

Explain the intake/interview and tax preparation process and make sure the taxpayer clearly understands. Always encourage the taxpayer to ask questions throughout the process.

Sample Interview

Here is an example of how Scott, a volunteer, correctly welcomed Kerry, a taxpayer.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	KERRY RESPONDS...
<i>Hi, my name is Scott. How are you doing today?</i>	Hi, I'm Kerry. I'm doing just fine. How about you?
<i>I'm doing very well. Thanks so much for visiting our site. How did you hear about us?</i>	A friend of mine has been coming here for a few years, and she recommended it to me. I thought I'd give it a try.
<i>Well that's great. We've been preparing taxes here for about 6 or 7 years now. Did you by any chance complete the intake and interview sheet. It looks like this?</i>	Yes, I did, but I'm not sure about a couple of things. I may not have answered all of the questions correctly.
<i>That's okay. I'm going to review all of the information with you to ensure it's complete and that you understand each question and have answered everything correctly. After I've verified all of your information, I'll input it into the computer to create your tax return. Once I've completed the return, I'll review it with you and also have our site quality reviewer check it one last time for accuracy. Since we'll be filing your return electronically, you won't have to mail your return and you'll receive your refund even faster. Just let me know if you have any questions or do not understand something.</i>	Sounds good to me. What do I need to do first?

How can I build rapport?

You need to establish the taxpayer's trust and confidence and open a line of communication. As you welcome the taxpayer:

- Be friendly and respectful
- Have materials organized
- Speak clearly and simply

How do I ask effective questions?

Conducting an interview with taxpayers requires asking many questions and may make you feel like you are prying. You are not! Requesting information needed to file an accurate return is an essential part of the interview and ensures that taxpayers are receiving the benefits and credits they are due.

Use open-ended questions that require more than a simple yes or no response. For example, when reviewing the taxpayer's Forms W-2, instead of asking, "are these your W-2s from last year," you may want to ask "how many jobs did you have last year." This helps the taxpayer think about the number of jobs held to ensure that all Forms W-2 were received.

Avoid asking leading questions because they make the taxpayers feel that you have a specific answer in mind. Do not make assumptions about taxpayers—let them speak for themselves.



Asking open-ended questions lets the taxpayer decide what is important and can help you discover special situations; for example, "What changes have you had this year that might make your tax situation different from last year?"

What are active listening skills?

Active listening shows that you are paying close attention and will also reassure the taxpayers that you are interested and care about what they are saying. Here are a few ways to engage in active listening:

- Use nonverbal cues such as nodding, smiling appropriately, and making eye contact
- Give the taxpayers time to express themselves
- Restate what the taxpayers have said to ensure you fully understand
- Express empathy or other appropriate emotions

Sample Interview

Here is an example of how a volunteer used effective questioning and active listening skills with Ms. Sterling, a taxpayer.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	MS. STERLING RESPONDS...
<i>Okay, Ms. Sterling. Let's go over your intake sheet now. I see that you checked the box for "Married" but did not provide a "Yes" or "No" answer to indicate if you and your spouse lived together at any time during the last six months of the year. Is there something you do not understand or that I can help you with?</i>	I wasn't sure how to answer that question. My marital situation was kind of complicated last year.
<i>I understand. [nodding] Well, can you tell me a little bit more? To determine your filing status, I need to know more about your situation. [question with explanation of why it is needed]</i>	I guess so. This past year has been rather difficult for me. My husband moved out in October but comes back sometimes to visit the kids.
<i>Okay, thank you. I can see how a situation like that could be difficult. [expressing empathy] What I am going to do then is check the "Yes" box that you were living together within the last six months.</i>	Okay, that makes sense.

How do I overcome communication barriers?

There are times when taxpayers may become upset or defensive. When this happens, show that you understand and care about their concerns, feelings, and needs.

Here are a few ways to accomplish this:

- Do not become upset
- Reassure the taxpayer (e.g., "I hear you" or "I totally understand")
- Keep on track by asking the tax question
- Provide a motivator (e.g., "I know this is difficult, but I need this information to determine the benefits available to you.")
- Use your active listening skills
- Allow the taxpayer enough time to respond
 - If taxpayers are silent, encourage them by saying, "Tell me more about that..."
 - If taxpayers are upset, show that you understand by paraphrasing what they have told you

TIP

Refer to The Five-Step Interview Process in the Volunteer Resource Guide for more information on overcoming communication barriers.

While these communication techniques may appear to be common sense, it is important to remember that many taxpayers are experiencing financial hardship during these difficult economic times.

Sample Interview

Here is an example of how a volunteer overcame communication barriers with Mr. Bailey, a taxpayer.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	MR. BAILEY RESPONDS...
<i>I'm sorry, but according to this information, you do not qualify for this deduction.</i>	What? I can't take the deduction? That can't be right! That means I'll end up owing taxes and won't get a refund!! I can't afford to pay more taxes!
<i>[not upset, shows compassion] I do understand, Mr. Bailey. Nobody wants to pay more taxes. [paraphrasing, understanding] Keep in mind that we're still trying to identify other deductions that you may qualify to take, so your taxes will be as low as possible. Let's look at the next set of deductions, okay? [did not become upset, kept on track by asking the tax question]</i>	Okay. I know you're trying to help but I'm just afraid that . . . [silent]
<i>Take your time, Mr. Bailey. When you're ready, explain it to me. [gave taxpayer time to respond and encouraged him to talk about it]</i>	I'm just afraid that I won't be able to pay the bill on time.
<i>I can understand how you would be concerned about paying your tax bill on time. [paraphrasing, reassuring the taxpayer] Should you end up owing more in taxes, there are payment options that we can talk about. Why don't we keep looking for other possible deductions?</i>	Yes, thank you. That's a good idea.

What do I do next?

Based on what you have learned from the taxpayers' Form 13614-C and from the interview, one of the following will be your next step:

- Advise the taxpayers that their return is outside the level of your training and seek assistance from your site coordinator. If another volunteer is available who has the appropriate certification, that volunteer may resume the interview.
- Advise the taxpayers that their tax situation is outside the scope of the VITA/TCE program and refer them to your site coordinator and/or to a professional tax preparer.
- Provide guidance for obtaining missing documentation if the taxpayers qualify for VITA/TCE services but did not bring all necessary documents.
- Begin to prepare the return.

After the return is completed and the quality review is finished, the intake and interview sheet can be returned to the taxpayers along with a copy of their return(s) or it can be retained until the return has been accepted.

If tax preparation is not provided, return the intake and interview sheet to the taxpayers.

For guidance on proper procedures, consult the site coordinator at the site where you are volunteering.

To further assist you with conducting an intake and interview process, and to practice what you will learn throughout this training, refer to our taxpayer, Vanessa Franklin, located in Appendix A.

Summary

Knowledge, of both tax law and interview skills, is required to identify taxpayers who qualify for volunteer return preparation assistance and to conduct effective probing interviews. Good interview techniques, combined with Form 13614-C and resource materials, make the interview more effective and comfortable for you and the taxpayer. Remember, establishing rapport and educating taxpayers produce accurate returns.

Having the ability to communicate with all types of people, knowing where and how to get “the right answer,” understanding and applying tax law, and preparing accurate returns are the skills you will need to be a successful volunteer.

Necessary tools are:

- Probing questions
- Form 13614-C
- Publication 4012, Volunteer Resource Guide
- Publication 17

Helpful interview techniques are:

- Building rapport
- Asking effective questions
- Using active listening skills
- Overcoming communication barriers

A black square with the word "TIP" in white, bold, uppercase letters.

During the screening and interview process, strive to acquire the information needed to prepare 100% accurate returns. Make notes on the intake and interview sheet. Remember, a return is accurate when tax law is applied correctly and the return is based on information acquired during this process.

When assisting taxpayers, safeguard the confidential information they share with you.



Lesson 3: Filing Basics

Introduction

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

Objectives

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

- Determine who *must* file a tax return
- Determine who *should* file a tax return
- Verify the taxpayer's identity
- Determine how to file the return
- Tell taxpayers how long they should keep certain records and documents

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17

Optional

- Publication 559
- Form 1040 Instructions

Who must file?

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

Remember to use the interview techniques and tools discussed in the Screening and Interviewing lesson when determining who must file.

What do I need to know?

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

- Age
- Gross income
- Filing status

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

Look at the intake and interview sheet for the taxpayer's date of birth. Confirm this date during the interview. Refer to the sample intake and interview sheet at the beginning of the Volunteer Resource Guide.

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

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

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

To approximate gross income:

- Obtain the total of wages, tips, and other employment compensation reported in box 1 of the taxpayer's Form(s) W-2.
- On Part III, page 2 of the intake and interview sheet, review the income questions with the taxpayer to see if there was any additional income from investments, retirement plans, social security, unemployment, self-employment, or other income not reported on Form W-2 or Form 1099 and determine each amount.



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

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



Use the gross sale price, not the net profit, when estimating gross income for a taxpayer who sold stock or other assets.

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

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

example

Based on the intake and interview sheet shown, this taxpayer will most likely use the Married Filing Jointly filing status.

12. Total any other marital property Yes No

13. Can anyone claim you or your spouse on their tax return? Yes No Unsure

Part II. Marital Status and Household Information

1. As of December 31, 2011, were you?

Single

Married: Did you live with your spouse during any part of the last six months of 2011? Yes No

Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____

Widowed: Year of spouse's death: _____

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who lived outside of your home that you supported during 2011. If additional space is needed please check here and list on page 3.

Name (first, last) Do not enter your name or spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. daughter, son, mother, sister, none)	Number of months lived in your home in 2011	US Citizen or resident of the US, Canada or Mexico in 2011 (yes/no)	Marital Status as of 12/31/11 (S/M)	Full- time student in 2011 (yes/no)	Received less than \$3700 income in 2011 (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Joe Smith	01/01/2003	son	12	yes		no	

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

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

Use the Volunteer Resource Guide's Determination of Filing Status decision tree and the Interview Tips (Tab B) for helpful probing questions.

Who is legally required to file a federal tax return?

To determine whether a taxpayer is legally required to file a return, start with the Volunteer Resource Guide (Tab A) Chart A – For Most People Who Must File and Chart B – For Children and Other Dependents. Use these charts to review the examples.

example

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

example

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

What are the special taxpayer situations affecting filing status?

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

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

- Self-employed with net earnings of \$400 or more
- Taxpayers who owe special taxes



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



EXERCISES

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

Question 1: Bob is 27 years old. His gross income was \$9,550 during the tax year. Based only on this information, is he required to file a tax return? Yes No

Question 2: Janet and Harry are married and usually file jointly. During the tax year, she turned 66 and he turned 64. Their gross income was \$16,200. Based only on this information, are they required to file a tax return? Yes No

Question 3: Juanita has a dependent child and can file as a Qualifying Widow. She is 47 years old. Her gross income was \$15,400. Based only on this information, is she required to file a tax return? Yes No

Who should file?

Even if individuals are not required to file a tax return, they should file a return if they qualify for certain credits or a refund. These items are listed in the Volunteer Resource Guide (Tab A), Chart D—Who Should File. Use the interview techniques and tools discussed in the Screening and Interviewing lesson to make this determination.

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

- A refund of withheld taxes
- The earned income credit (EIC)
- The additional child tax credit
- The health coverage tax credit (out of scope, included for awareness only)
- The American opportunity credit

Taxpayers who should file may be entitled to a tax credit, and filing a return is the only way to get it. Individuals who are not required to file a return and who would not benefit from filing a return can reduce the cost, time, and effort of unnecessary processing by not filing a return.

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

To determine whether a person should file a return in order to claim a tax refund or refundable tax credit, check the taxpayer's:

- Form(s) W-2, boxes 2 and 17, and Form(s) 1099
- The Marital Status and Household Information and Life Events sections of the intake and interview sheet

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

- Federal or state income tax was withheld on any income form, and/or
- The taxpayer had earned income, and/or
- The taxpayer has a qualifying child
- The taxpayer paid higher education expenses
- The taxpayer made estimated tax payments

When in doubt, it may be worthwhile to begin a tax return for the taxpayer and then file the return only if the taxpayer is eligible for a refund.

Refer taxpayers who may qualify for the health coverage tax credit to a professional tax preparer.

TIP

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

How do I verify taxpayer identity?

Before you enter the taxpayer identification information on the tax return, you should first verify the identity of the taxpayer(s), the accuracy of each SSN or ITIN, and the spelling of names entered on the taxpayer's intake and interview sheet. Use the interview techniques and tools discussed in the Screening and Interviewing lesson.

What documents do I use to verify identity?

- Ask to see a social security card, an ITIN letter, or other appropriate document for each individual who will be listed on the return
- Ask to see proof of identity for the taxpayer (and the spouse if filing a joint return)
- Verify the SSN or ITIN and proof of identity are for the same person
- Verify the SSN or ITIN and the spelling of each individual's name on the social security card or other acceptable documents match the information you enter on the tax return
- Verify the address and birth date on the intake and interview sheet matches the information on the identification and discuss any discrepancies with the taxpayer
- Make sure the taxpayer understands how critical it is to have the correct information in order to receive any age-related tax benefits

TIP

Identity documents include a U.S. driver's license, employer ID, school ID, birth certificate, U.S. state identification card, military ID, national identity card, visa, or passport. However, any other valid form of identification that would normally be used to prove identity is acceptable.

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

What about taxpayers filing for decedents?

If you are providing assistance to someone who is filing a return for a decedent:

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

For additional information about filing a return for a decedent, refer to Form 1040 Instructions, Publication 17, or Publication 559.

What are Taxpayer Identification Numbers?

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

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

Who has a social security number?

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

TIP

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

Who has an Individual Taxpayer Identification Number?

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

The ITIN contains nine digits and is formatted like a SSN (XXX-XX-XXXX), but begins with the number 9 and has a range of 70 to 88 in the fourth and fifth digits. You should enter the ITIN on the return wherever the SSN is requested.

Who has an Adoption Taxpayer Identification Number?

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

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

Like an ITIN, the nine-digit ATIN begins with the number 9. You should enter the ATIN on the return whenever the child's social security number is requested.



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



Taxpayer, spouse, and dependent name and social security number mismatch is rated as one of the top five errors in processing a tax return.

What are acceptable documents if the taxpayer does not have a social security card?

For individuals who do not bring their social security card, you may accept either of the following:

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



Driver's licenses and passports are *not* acceptable substitutes for social security or TIN cards.

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

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

For a taxpayer who cannot obtain a SSN and has not yet applied for an ITIN, you can use a temporary identification number to prepare the return in the tax software. Turn to the Volunteer Resource Guide (Tab 1), Apply for an ITIN.

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

Attach the tax return behind Form W-7, Application for Individual Taxpayer Identification Number along with documentation that will establish foreign status and true identity and have the taxpayer submit according to Form W-7 instructions.

- If it is not available at the volunteer site, the taxpayer can obtain Form W-7 by calling the IRS at 1-800-829-3676 (1-800-TAX FORM) or at www.irs.gov
- If taxpayers need assistance in completing Form W-7, refer them to an IRS Taxpayer Assistance Center or for professional assistance unless a volunteer at that site has been trained in completion of Form W-7 or an authorized acceptance agent is available



When preparing a return to include with a Form W-7 application, refer to the instructions in the Volunteer Resource Guide (Tab 1), Apply for an ITIN.

What if the TIN on Form W-2 does not match the TIN on the tax return?

The SSN or ITIN on the taxpayer's Form W-2 is expected to match what you enter on the tax return. A mismatch will delay return processing and can create serious errors.

Taxpayers with a Valid SSN

If the taxpayer's Form W-2 does not have the correct SSN, you can prepare the return with the materials provided. However, the taxpayer needs to request a corrected Form W-2 from the employer before submitting the tax return.

Taxpayers with a Valid ITIN

Taxpayers who file tax returns using their ITINs (and other taxpayers without valid SSNs) often attach Forms W-2 showing erroneous SSNs. If such an ITIN/SSN mismatch occurs:

- Do *not* change any information on Form W-2
- It is acceptable to e-file a return with an ITIN/SSN mismatch
- The return should reflect the ITIN for the taxpayer, *not* the SSN on Form W-2
- When entering Form W-2 information, the mismatched SSN should be entered exactly as shown on the Form(s) W-2 issued
- The taxpayer is not eligible for the Earned Income Credit (EIC)



EXERCISES (continued)

Question 4: It is your responsibility as a volunteer tax preparer to check the accuracy of every social security number you enter into the tax return.

True False

How do I enter the identification data?

For paper returns, fill in the name, address, and social security information in the label section of the return. If you are using tax software, review the Volunteer Resource Guide (Tab 1), Main Information Sheet section. Be sure to read all the details and helpful hints for entering the taxpayer's identification information.



Tax Software Hint: Turn to the Volunteer Resource Guide (Tab 1) for more information about the Main Information Sheet.

How do I choose the appropriate tax return form?

All taxpayers can use Form 1040. Individuals must meet certain requirements to use Form 1040EZ or Form 1040A.



Tax Software Hint: The software defaults to Form 1040. You should prepare all returns on Form 1040. After you complete the return, the Main Information Sheet will show the simplest form you can use to print the return.

Form 1040EZ

Form 1040EZ is the simplest tax return form. The one-page form is designed for individuals who file as either Single or Married Filing Jointly and who have no dependents. Most individuals who can be claimed as a dependent on another taxpayer's return use Form 1040EZ.

example

Trudy, a single 22-year-old full-time college student, is claimed as a dependent on her mother's tax return. Last year Trudy grossed \$6,100 from her part-time job as an administrative assistant. Trudy can use Form 1040EZ.

Form 1040A

Form 1040A is a two-page form. Page 1 shows the filing status, exemptions, income, and adjusted gross income. Page 2 shows standard deduction, exemption amount, taxable income, tax, credits, payments, amount owed or refund, and signature.

Turn to the Volunteer Resource Guide (Tab A) Which Form to File chart to see which income and expenses can be reported with a Form 1040A.

example

Ramon and Julia are married and have two dependents. They will file Married Filing Jointly. Their sources of income include salaries from their jobs, Ramon's pension, and Julia's IRA. Their combined taxable income was \$65,000 for the tax year. Ramon and Julia can file Form 1040 or 1040A, however, Form 1040 is recommended if the return will be e-filed.

Form 1040

Form 1040 is a two-page form that contains all the entries on Form 1040A plus entries for more types of income, itemized deductions, and other taxes. Form 1040 provides schedules for reporting these various types of income and deductions.

Taxpayers whose taxable income exceeds \$100,000 or who have self-employment income must use form 1040.



For taxpayers who filed Form 1040EZ or Form 1040A the previous year, determine whether their situation has changed. It may be to their advantage to file Form 1040 if additional adjustments or deductions will result in a lower tax!

example

Cynthia is divorced and will file as Head of Household. She has two children she will claim as dependents. She owns a medical transcription business and earned \$35,000 in taxable income for the year. She plans to itemize her deductions. Cynthia must file Form 1040.

How do I file a return?

A return can be filed electronically using IRS e-file or by sending in a paper return.

What is electronic filing?

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



Detailed instructions for completing and filing the return are covered in the Concluding the Interview lesson.

What do I tell taxpayers about recordkeeping?

Taxpayers should keep a copy of the tax return, worksheets used, and records of all items appearing on it (such as 1099 forms) until the statute of limitations runs out for that return. Usually, this is the later of:

- Three years from the date the return was due or filed or
- Two years from the date the tax was paid

In addition, taxpayers should keep the following records with these additional needs in mind:

- Forms W-2 until the Social Security Administration has recorded the earnings reflected on the forms
- Property records (including those on a home) as long as they are needed to figure the basis of the original or replacement property
- Closing statements for a home until the home is sold
- Brokerage statements showing the purchase price of stock until the stock is sold
- Records of contributions to nondeductible IRAs until all IRA funds are withdrawn
- Calculations determining the nontaxable portion of pension income until all of the pension income is taxable



For additional recordkeeping information, see Publication 17.

How do I answer taxpayers' administrative questions?

The Volunteer Resource Guide and Publication 17 contain answers to many administrative questions asked by taxpayers during the interview process.

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

Turn to the "Frequent Taxpayer Inquiries" located at the back of the Volunteer Resource Guide and review this helpful information. For a list of phone numbers you can provide to taxpayers, refer to the bottom portion of the "Contact Information for Volunteers," located on the back of the Volunteer Resource Guide.

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



EXERCISES (continued)

Using your reference materials, answer the following question.

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

Additional information on a variety of topics can be obtained by contacting the IRS at 1-800-829-1040, accessing www.irs.gov, or by visiting an IRS Taxpayer Assistance Center in your area.

What potential pitfalls should I keep in mind?

To avoid any difficulties when preparing tax returns:

- Always treat the information used to prepare an individual's income tax return as confidential.
- Canadians have a number that is like a social security number, but it is for their old age pension. Do not use this number on a U.S. tax return. Canadians often have both a U.S. and a Canadian social security number.
- Many taxpayers erroneously report amounts from Form 1099-MISC, *Miscellaneous Income*, with wages or other income. Income from Form 1099-MISC, box 7, generally should be reported on Schedule C or C-EZ and on Schedule SE, Self-Employment Tax. If the income is reported incorrectly, the IRS may later issue a notice of proposed tax increase for unpaid self-employment tax.
- Be alert to the following possible indications of fraudulent activity:
 - A Form W-2 that is typed, handwritten, or has noticeable corrections
 - A Form W-2 that looks different from other Forms W-2 issued by the same company
 - A suspicious person accompanying the taxpayer and observed on other occasions
 - Multiple refunds directed to the same address or P.O. box
 - Employment or earnings, which are a basis for refundable credits, that are not well documented
 - Similar returns (e.g., same amount of refund, or same number of dependents, or same number of Forms W-2)

Notify your site's coordinator if you suspect any fraudulent or unusual activity.

Which forms and documents need to be filed?

Refer to the chart listing the forms, types of income, and the line item entries for both Form 1040 and the tax software in the Volunteer Resource Guide (Tab 2).



Tax Software Hint: Once the main information and income statements are entered, the software automatically makes available most forms and applicable schedules. These credit forms and schedules will be annotated with a red mark. The volunteer must still be alert to other deductions and credits, such as American opportunity, lifetime learning credits, and retirement savings contribution credit if there is only a Roth IRA contribution.

Practice – Vanessa Franklin



Let's practice what we've learned with our taxpayer, Vanessa Franklin. Go to Appendix A to determine if Vanessa has a filing requirement and verify her identity.

Summary

Who must file?

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

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

How do I verify taxpayer identity?

Before entering the taxpayer's identity information in the Main Information Sheet or the appropriate tax return form, first verify the identity of the taxpayer(s), the accuracy of each SSN or ITIN, and spelling of names with the appropriate documents.

Which tax return form should I use?

The three federal tax return forms are Form 1040EZ, Form 1040A, and Form 1040.

When using tax software, always select Form 1040 from the Main Information Sheet. After you have completed the return, the Main Information Sheet will show the simplest form you can use to print the return.

Filing the Return

E-filing is faster and more accurate than traditional paper filing, and taxpayers receive their refund in about half the usual time.

Recordkeeping Requirements

Taxpayers should keep a copy of the tax return, worksheets used, and records of all items appearing on it (such as Forms 1099) until the later of:

- Three years from the date the return was due or filed or
- Two years from the date the tax was paid

Refer to Publication 17 for more information.

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

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

- Taxpayers who may qualify for the health coverage tax credit
- Taxpayers who **cannot** substantiate their identity



Lesson 4: Filing Status

Introduction

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

Filing Status		<input type="checkbox"/> You <input type="checkbox"/> Spouse	
1	<input type="checkbox"/> Single	4	<input type="checkbox"/> 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. ▶
2	<input type="checkbox"/> Married filing jointly (even if only one had income)	5	<input type="checkbox"/> Qualifying widow(er) with dependent child
3	<input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶	6a <input type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a.	
Check only one box.		Boxes checked	

On Form 1040, check the box for taxpayer's filing status in the Filing Status section. To determine a taxpayer's filing status, use the interview techniques and tools discussed in the Screening and Interviewing lesson. See the Volunteer Resource Guide (Tab B) for the Determination of Filing Status decision tree and the interview tips for helpful probing questions.

Objective

At the end of this lesson, using your resource materials, you will be able to determine the most beneficial filing status allowed for the taxpayer.

What are the five filing statuses?

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

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



Tax Software Hint: Filing status is selected on the Main Information Sheet. Go to the Volunteer Resource Guide (Tab 1), Main Information Screen, to review the software entries.

How does marital status affect filing status?

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

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17

Optional:

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



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

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

- Unmarried
- Legally separated, under a separate maintenance decree, **or**
- Divorced under a final decree on or before December 31

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

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

What are the requirements for each filing status?

Who is considered Single?

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

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

Can Single taxpayers qualify for another status?

Some single taxpayers qualify for Head of Household or for Qualifying Widow(er) with Dependent Child status, which can mean a lower tax. These statuses will be discussed later in this lesson.

What is Married Filing Jointly?

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

- Were married and lived together as husband and wife
- Were married and living apart, but were not legally separated or divorced
- Lived together in a common law marriage that is recognized in the state where they currently live or the state where the common law marriage began, or
- Did not remarry after their spouse died during the year

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

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

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



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



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

What is Married Filing Separately?

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

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

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

Can Married Filing Separately taxpayers qualify for another status?

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

Why are taxes usually higher for Married Filing Separately?

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

- The tax rate is generally higher than on a joint return.
- Taxpayers cannot take credits for child and dependent care expenses, earned income, and certain adoption and education expenses.
- Some credits and deductions are reduced at income levels that are half those for a joint return such as the child tax credit and the retirement savings contribution credit.

If a taxpayer is Married Filing Separately and the spouse itemizes deductions on their return, the taxpayer must itemize *or* take a standard deduction of zero.

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

TIP

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

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

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

If your tax assistance program views community property tax laws for Married Filing Separately taxpayers as beyond the scope of the program, refer such taxpayers to a professional tax preparer.

For Married Filing Separately taxpayers, you must enter the other spouse’s name and social security number or ITIN on the tax return. This is explained in the Form 1040 Instructions for line 3.



Tax Software Hint: Go to the Volunteer Resource Guide (Tab 1). Find the section of the Main Information Sheet that addresses filing status. Notice the questions asked of the Married Filing Separately taxpayers. If the taxpayer is in one of the community property states mentioned on the form, additional questions must be answered. You may have to complete a worksheet titled Allocation of Income for Community Property Income.

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

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

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

Who is considered to be an injured spouse?

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

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

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

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



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

What if a spouse died during the tax year?

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

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

Determine the most advantageous filing status for the taxpayer. Surviving spouses who have a dependent child may be able to use the Qualifying Widow(er) with Dependent Child status in the two tax years following the year of the spouse's death. This is discussed later in this lesson.

Who is Head of Household?

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

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

A qualifying person who is the taxpayer’s dependent parent does not have to live with the taxpayer. However, the parent(s) must qualify as the taxpayer’s dependent(s) for the taxpayer to qualify as Head of Household. For more information, review the Volunteer Resource Guide, Who is a qualifying person for Head of Household status?

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

What are the costs of keeping up a home?

The costs of keeping up a home include expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. Payments from Temporary Assistance for Needy Families (TANF) or other public assistance programs that contribute to keeping up the home do not count as money the taxpayer paid. However, they must be included in the total cost of keeping up the home to determine if the taxpayer paid over half the cost. See Publication 17, Filing Status, Keeping Up a Home, for more information.

Who is a qualifying person for Head of Household status?

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

- A qualifying child who is single, whether or not the child can be claimed as a dependency exemption
- A married child who can be claimed as a dependent
- A dependent parent
- A qualifying relative who lived with the taxpayer more than half the year, *and* is one of the relatives listed in the Volunteer Resource Guide (Tab C), Table 2, Step 2, *and* for whom the taxpayer can claim an exemption.



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

Refer to the the Volunteer Resource Guide (Tab B), Who is a Qualifying Person Qualifying You to File as Head of Household?, when reviewing these examples.

example

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

example

Michael provided all the costs of keeping up his home for the year. Michael’s son Justin lived with him the entire year. Justin is 22 and was not a full-time student in 2011. Although Justin only worked part-time, he earned too much for Michael to claim him as a dependent. Therefore, Michael cannot file Head of Household because he does not have a qualifying person.

example

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

example

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



EXERCISES

Answers are after the lesson summary.

Question 1: Alexandra's younger brother, Sebastian, is seventeen years old. Sebastian lived with some friends from January through February 2011. From March through July 2011, he lived with Alexandra. On August 1, Sebastian moved back in with his friends, with whom he stayed for the rest of the year. Since Sebastian did not have a job, Alexandra gave him money every month. Assuming Alexandra had no other dependents, can she file as Head of Household for 2011? Yes No

Notice that the relatives who qualify a person for Head of Household may not be the same relatives who could qualify a taxpayer for a dependency exemption.

example

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

However, Joan is *not* a qualifying person for Head of Household because she is not related to Mary Ann in one of the ways listed in Publication 17, Relatives who do not have to live with you. She is Mary Ann's qualifying relative dependent *only* because she lived with Mary Ann all year as a member of her household. Joan does not fall under the other relative definition in the Volunteer Resource Guide (Tab B), Filing Status.



Tax Software Hint: Turn to the Volunteer Resource Guide (Tab 1). Find the Main Information Screen that shows the filing status section. The child's name and social security number must be entered on line 4 *only* if the child is not included in the Dependents/Nondependents section.



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

What are the advantages of filing as Head of Household?

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

Who can be “considered unmarried” for Head of Household?

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

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

A legally married taxpayer with a qualifying child whose spouse died during the year (even if they were not living together) may also qualify as Head of Household.

example

Denise is married and has lived apart from her husband for two years. Denise’s 12-year-old son lives with her. As long as Denise meets all the qualifications for Head of Household, she can choose to file as Head of Household for the year of her husband’s death.

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

Who is a Qualifying Widow(er) with Dependent Child?

In the year a taxpayer’s spouse dies, if the taxpayer does not remarry, the taxpayer can use the Married Filing Jointly filing status with the deceased spouse. The taxpayer may be able to use the Qualifying Widow(er) with Dependent Child filing status for the two years following the spouse’s year of death. To qualify, the taxpayer must:

- Be entitled to file a joint return for the year the spouse died, regardless of whether the taxpayer actually filed a joint return that year.
- Have had a spouse who died in 2009 or 2010. The taxpayer must not remarry before the end of 2011.
- Have a child, stepchild, or adopted child who qualifies as the taxpayer’s dependent for the year.
- Live with this child in the taxpayer’s home all year, except for temporary absences.
- Have paid more than half the cost of keeping up the home for the year.

TIP

A foster child does not qualify a taxpayer for the Qualifying Widow(er) with Dependent Child filing status.

The standard deduction and tax tables are the same for Qualifying Widow(er) with Dependent Child and Married Filing Jointly filing statuses. These are more favorable than those for Head of Household filing status.

example

Laura's husband, Jim, died in September of the tax year. She has not remarried, and provides all the support for their dependent children, ages 8 and 10. Laura can file as Married Filing Jointly, claiming an exemption for her deceased husband. For the next two years, she can use the Qualifying Widow(er) with Dependent Child status if she does not remarry.



Tax Software Hint: Go to the Volunteer Resource Guide (Tab 1), Main Information Sheet, which includes the filing status section, for the software entries.

How do I determine the correct filing status?

To determine the best filing status, follow the Filing Status Interview Tips or the Determination of Filing Status flow chart in the Volunteer Resource Guide (Tab B). Then enter the filing status on the intake and interview sheet.



EXERCISES (continued)

Check your understanding of each filing status. Review the lesson and use the Filing Status Interview Tips in the Volunteer Resource Guide (Tab B) if you are not sure of an answer. Answers are after the lesson summary.

Question 2: Jane's husband died in 2011. She and her husband qualified to file a joint return in 2010, but they did not. Jane's children are grown and they maintain households of their own. She has not remarried. What filing status(es) can she use?

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

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

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



EXERCISES (continued)

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

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

Question 5: Sydney's wife died in January of 2009. He filed a joint return for that year as the surviving spouse. In 2011, Sydney, who has not remarried, still maintains a home for his young children all year, and he provides their sole support. Using the Filing Status Interview Tips in the Volunteer Resource Guide, determine what filing status Sydney should use?

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

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A to determine the most appropriate filing status for her.

Summary

This lesson covered the five filing statuses:

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

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

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

A widow or widower with one or more dependent children may be able to use the Qualifying Widow(er) with Dependent Child filing status, which is available for two years following the year of the spouse's death.

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

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

- A spouse who may be relieved of joint liability
- Depending on your tax assistance program, community property tax laws for Married Filing Separately taxpayers
- Taxpayers who are not certain they are in a common law marriage (rules are complex and differ from state to state)



EXERCISE ANSWERS

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

Answer 2: Remember, if a spouse died during the year and the surviving spouse did not remarry, the surviving spouse is considered to be married on December 31 for filing status purposes. Answer "yes" to Step 1 of the Interview Tips.

Because she was widowed in 2011 and has not remarried, Jane can file as Married Filing Jointly or Married Filing Separately. However, she is likely to pay a lower tax if she chooses Married Filing Jointly. Jane is not eligible for the Qualifying Widow(er) with Dependent Child status because those rules are in effect for the two years after the year in which the spouse has died and she must have dependent children. Note: The exercise question stated that they did not file as Married Filing Jointly in 2010, and this would be an opportunity to use the interview techniques to determine why they did not. There might have been circumstances that made it more advantageous to file as Married Filing Separately, which might still exist.

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

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

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



Lesson 5: Personal Exemptions

Introduction

Identifying and entering the correct number of exemptions is a critical component of completing taxpayers' returns, because each allowable exemption reduces their taxable income.

Personal exemptions are reflected in the Exemptions section of the tax software and on Form 1040, page 1. Refer to the Volunteer Resource Guide (Tab 1) for a display of an entry screen.

The screenshot shows a software interface for entering exemptions. It includes sections for '6a Yourself', '6b Spouse', and '6c Dependents'. The '6c Dependents' section is a table with columns for (1) First name, Last name, (2) Dependents' social security number, (3) Dependents' relationship to you, and (4) If child under age 17 qualifying for child tax credit. To the right of the table are checkboxes for 'Boxes checked on 6a and 6b', 'No. of children on 6c who: * lived with you', '* did not live with you due to divorce or separation', and 'Dependents on 6c not entered above'. At the bottom right is a box for 'Add numbers on lines above'.

Objectives

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

- Distinguish between personal and dependency exemptions
- Determine if a taxpayer can claim a personal exemption
- Determine how many personal exemptions a taxpayer can claim

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Optional:** Publication 501

What are exemptions?

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

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

This lesson discusses personal exemptions.



The exemption amounts are indexed for inflation and are generally updated every year.

When can a taxpayer claim personal exemptions?

To claim a personal exemption, the taxpayer must be able to answer “no” to the intake question, “Can anyone claim you or your spouse on their tax return?”

This applies even if another person does not actually claim the taxpayer as a dependent. A taxpayer who could be claimed as a dependent must claim “0” exemptions. This means they will not be able to subtract the exemption amount from their gross income, and they may have to use a smaller standard deduction amount. See the lesson Standard Deduction and Tax Computation for more information on this topic.

If married taxpayers file a joint return, they can take a personal exemption for each spouse. If they file separate returns, they can each take a personal exemption for themselves.

When can taxpayers claim an exemption for their spouse?

A spouse is never considered the dependent of the other spouse. However, taxpayers may be able to take an exemption for their spouse simply because they are married.

To claim a personal exemption for one's spouse, the taxpayer must meet these conditions:

- Married as of December 31 of the tax year, and
- Spouse cannot be claimed as a dependent on another person's tax return, and
- Files a joint return, or files a separate return *and* the spouse had no income and is not filing a return

TIP

Taxpayers who are divorced or legally separated at the end of the tax year cannot claim their (former) spouse as an exemption.

TIP

A common-law marriage is recognized for federal tax purposes if it is recognized by the state where the taxpayers currently live or in the state where the common-law marriage began. Legal advice may be necessary to determine if a common-law marriage exists. However, filing a joint return for a common-law marriage applies to the federal return only. You must check state or local law before completing a state return.

What about a deceased spouse?

A taxpayer whose spouse died during the tax year can generally claim the personal exemption for the deceased spouse if the taxpayer meets all of these conditions:

- Did not remarry by December 31 of the tax year, and
- Was not divorced or legally separated from their spouse on the date of death, and
- Would have been able to claim the exemption under the rules for a joint or separate return

How do I use the interview techniques to determine how many personal exemptions a taxpayer can claim?

The Interview Tips for Personal Exemptions in the Volunteer Resource Guide (Tab C) can help determine whether the taxpayer can claim any personal exemptions. Use these questions as a guide when you interview the taxpayer.

How do I enter the personal exemptions?

Check the appropriate boxes and enter the number of exemptions claimed on Form 1040, line 6.



Tax Software Hint: The tax software will auto-fill the entries for line 6 once the names and applicable filing status is selected. Review the Volunteer Resource Guide (Tab 1), Main Information Screen, for the required entries if the taxpayer is not able to claim his or her own personal exemption.

Taxpayer Interview and Tax Law Application

Ray Jackson is a widower whose wife died during the 2011 tax year. Ray's intake and interview sheet shows the following responses.

Can anyone claim you or your spouse on their tax return? Yes No

Part II. Marital Status and Household Information

1. As of December 31, 2011, were you?

Single

Married: Did you live with your spouse during any part of the last six months of 2011? Yes No

Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____

Widowed: Year of spouse's death: 6/1/2011

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who

Which personal exemptions can Ray claim?

Use the Volunteer Resource Guide (Tab C), Interview Tips for Personal Exemptions, to help you complete lines 6a and 6b on his tax return. Here's how the conversation might sound:

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	RAY RESPONDS...
<i>The questions I'm about to ask you will help us figure out if you can claim any personal exemptions. First of all, you've told me that you were married until your wife died on June 1. I'm sorry for your loss, sir.</i>	Yes, I was. Thank you.
<i>And you did not remarry, right?</i>	That's right.
<i>Are you filing a joint return with your late wife this year?</i>	Yes.
<i>Can anyone else claim either of you as dependents?</i>	Well, I don't think so. We lived off our own income.
<i>Based on your answers, you can claim an exemption for both yourself and for your late wife.</i>	
[On the intake and interview sheet, volunteer should check "No" for the question, "Can anyone claim you or your spouse on their tax return?" which Ray left blank.]	



Tax Software Hint: When preparing a return for a deceased taxpayer, enter the date of death on the main information screen. You must also enter the name of the surviving spouse or personal representative on Name line 2. Refer to the Volunteer Resource Guide (Tab 1), Main Information Screen, for more information.

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A to determine the personal exemptions she can claim.

Summary

There are two types of exemptions:

- Personal
- Dependency

A personal exemption can be claimed for:

- The individual taxpayer, unless he or she can be claimed as a dependent on another person's tax return.
- The taxpayer's spouse, if a joint return is filed and the spouse cannot be claimed on another taxpayer's return.
- The taxpayer's spouse, if the taxpayer is not filing a joint return and the spouse had no income, is not filing his or her own return, and is not a dependent of another person.

Personal exemptions are claimed in the Exemptions section of the tax return.

Exemptions reduce the taxpayer's taxable income.

Claiming an incorrect number of exemptions is one of the most common errors made on a return.



Lesson 6: Dependency Exemptions

Introduction

Identifying and entering the correct number of exemptions is a critical component of completing the taxpayer's return. Taxpayers can claim one exemption for each qualified dependent on their return, thereby reducing their taxable income.

To determine the dependency exemptions, use the interview techniques and tools discussed in the Screening and Interviewing lesson. See the Volunteer Resource Guide (Tab C) for the interview tips in this lesson. The interview tips can provide helpful probing questions.

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

Objectives

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

- Determine if a taxpayer can claim an exemption for a dependent by applying the applicable dependency test
- Determine how many exemptions a taxpayer can claim for dependents

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17

Optional:

- Publication 501
- Form 2120
- Form 8332

Who are dependents?

Dependents are either a qualifying child or a qualifying relative of the taxpayer. As explained in the Personal Exemptions lesson, the taxpayer's spouse cannot be claimed as a dependent but can be claimed as a personal exemption. Some examples of dependents include a child, step-child, brother, sister, or parent.



Persons who qualify to be claimed as a dependent may file a return for taxes withheld, but they cannot claim any exemptions.

How do I apply the dependency tests?

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

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

Does it matter if I use the interview tips?

Whether you are a new or returning volunteer, the interview tips provide guidelines and definitions to help you apply the dependency tests. They incorporate all of the exceptions, such as the special rules for children of divorced or separated parents, found in the Volunteer Resource Guide (Tab C), Table 3, as well as the special multiple support rules. As you become more experienced with the qualifying child and qualifying relative rules, you may find that you prefer the Overview of the Rules for Claiming an Exemption for a Dependent chart instead.

TIP

A taxpayer's spouse *cannot* be claimed as a dependent but can be claimed as a personal exemption.

How do I use the interview tips?

When determining if a taxpayer can claim a dependent, always begin with Table 1: Dependency Exemption for Qualifying Child. If you determine that the person is not a qualifying child, then move to Table 2: Dependency Exemption for Qualifying Relative. Depending on the taxpayer's answers, you may also be prompted to use Table 3: Children of Divorced or Separated Parents or Parents Who Live Apart or the Qualifying Child of More Than One Person chart.

Who may be claimed as a dependent?

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

What tests must be met for all dependents?

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

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

TIP

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

Dependent Taxpayer Test

A taxpayer (or taxpayer's spouse, if filing a joint return) who can be claimed as a dependent by someone else cannot claim anyone as a dependent. Part I of the intake and interview sheet asks, "Can anyone claim you or your spouse on their tax return?"

Joint Return Test

A married person who files a joint return cannot be claimed as a dependent unless the joint return is filed strictly to claim a refund and there would be no tax liability for either spouse on separate returns.

example

Ruth, who had no income, was married in November of the tax year. Ruth's husband had \$16,700 income, and they claimed two personal exemptions on their return. Although Ruth's father supported her and paid for the wedding, he cannot claim her as a dependent because she is filing a joint return with her husband. While the return is being filed to claim a refund of taxes withheld, Ruth's husband would have tax liability if he filed a separate return.

Citizen or Resident Test

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

- If a U.S. citizen or U.S. national legally adopts a child who is not a U.S. citizen or resident, this test is met as long as the child lives with the taxpayer as a member of the household all year. If all other dependency tests are met, the child can be claimed as a dependent. This also applies if the child was lawfully placed with the taxpayer for legal adoption.
- Foreign exchange students generally are not U.S. residents and do not meet the citizen or resident test; they cannot be claimed as dependents.

example

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

What are the tests for qualifying children?

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

Relationship

To meet this test, the child must be:

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

An adopted child is treated the same as a natural child. This includes a child who was lawfully placed with the taxpayer for legal adoption.

Age

To meet this test, the child must be:

- Under age 19 at the end of the tax year and younger than the taxpayer (or the taxpayer's spouse, if filing jointly), or
- A full-time student under the age of 24 at the end of the year and younger than the taxpayer (or spouse, if filing jointly), or
- Any age if permanently and totally disabled at any time of the year

TIP

School does not include an on-the-job training course, correspondence school, or a school offering courses only through the Internet.

Residency

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

Exceptions to the Residency Test

The child is considered to have lived with the taxpayer during periods of time when either the child or the taxpayer is temporarily absent due to illness, education, business, vacation, or military service.

A child who was born (or died) during the year is treated as having lived with the taxpayer all year, if the taxpayer's home was the child's home for the entire time he or she was alive.

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

TIP

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

example

Hugh's daughter died on January 15 of the tax year. If she met all the dependency tests up until her death, Hugh can claim an exemption for her on his return.

A taxpayer may *not* claim dependency exemptions for a housekeeper, other household employee, or for a stillborn child.

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

Support

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

example

Bob, 22, is a full-time student and lives with his parents when he is not in the dorm. He worked part-time and made \$6,000, but that was not over half of his total support. Bob meets the relationship, age, and support tests. If he meets the rest of the tests for a qualifying child, he can be claimed as a dependent by his parents.

example

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

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

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

- Dependency exemption
- Child tax credits
- Head of Household filing status
- Credit for child and dependent care expenses
- Exclusion from income for dependent care benefits
- Earned income credit

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

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

To determine which taxpayer can treat the child as a qualifying child and claim the benefits, apply these rules:

- If only one of the taxpayers is the child's parent, the child is the qualifying child of the parent.
- If both taxpayers are the child's parents and they do not file a joint return together, either one can claim the child. If both claim the child, IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time in 2011. If the child lived with both parents the same amount of time, IRS will treat the child as the qualifying child of the parent who had the higher Adjusted Gross Income (AGI) for 2011.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for 2011.
- If a parent can claim the child as a qualifying child but no parent does, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who could claim the child. If the parents file a joint return together, this rule allows the parents to divide their combined AGI equally (between themselves).

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

example

Lynne and her mother, Margaret, share a home and both contribute to the household expenses. Lynne's twelve-year-old-daughter, Karen, lives with them. Although Karen meets all the conditions to be a qualifying child for both Lynne and her mother, Lynne is the taxpayer who can claim Karen as a qualifying child, because she is Karen's parent.

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

Publication 17 and Publication 501 provide more information about qualifying children of more than one person.

What are the tests for qualifying relatives?

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

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

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

Not a Qualifying Child Test

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

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

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

example

Todd has lived with his girlfriend, Eva, and her two children all year in his home. Eva is not required to file, and does not file, a 2011 tax return. Eva and her two children pass the "not a qualifying child test" to be Todd's qualifying relatives. Todd can claim them as dependents if he meets all the other tests. (Eva and Todd's relationship does not violate local laws.)

example

All the facts are the same as in the previous example, except that Eva is required to file a tax return since she earned \$12,000. Since Eva has a filing requirement and her children meet the tests to be Eva's qualifying children, Todd can no longer claim the children as qualifying relatives.

example

Since late in 2010, Sally has been supporting her friend, Ann, and Ann's young son, Bobby. Ann and Bobby lived with Sally all of 2011 and meet all the tests to be Sally's qualifying relatives. Ann worked part-time and made \$3,100 in wages during 2011. Ann files a return only to have her withholding refunded. She does not claim her own exemption. Sally can claim Ann and Bobby as dependents.

example

All the facts are the same as in the previous example, except, when Ann files her tax return, she also claims the earned income credit. Because Ann is filing to claim the earned income credit and to get a refund of her withholding, Bobby is considered Ann's qualifying child. Therefore, Sally cannot claim Bobby as a dependent under the rules for qualifying relative. Ann cannot claim Bobby as a dependent either, since Ann is a dependent herself. Ann *can* use Bobby as a qualifying child for the earned income credit (covered in the Earned Income Credit lesson).

Member of Household or Relationship Test

To meet this test, the person must either:

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

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

example

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

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

Note that:

- A person is still considered living with the taxpayer as a member of the household during periods when that person or the taxpayer is temporarily absent due to special circumstances such as illness, education, business, vacation, military service, and placement in a nursing home.
- Cousins can meet the relationship test for qualifying relative *only if* they live with the taxpayer for the entire year.
- Qualifying relatives can be unrelated, as long as they lived with the taxpayer all year.

Gross Income Test

To meet this test, the dependent's gross income for the tax year must be less than the personal exemption amount (\$3,700 for 2011). Gross income is all income in the form of money, property, and services that is not exempt from tax. Specific examples are found in Publication 17, Personal Exemptions and Dependents. Remember this test does not apply to qualifying children, only qualifying relatives. For purposes of this test, the gross income of an individual who is permanently and totally disabled does not include income from a sheltered workshop.

example

Joe is 65 years old and lives with his son and daughter-in-law. In 2011, Joe's taxable pension income was \$4,700. Joe's son and daughter-in-law cannot claim a dependency exemption for Joe because Joe's income exceeds the exemption amount for 2011, which is \$3,700.

Support Test

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

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

example

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

example

Steve provided \$4,000 toward his mother's support during the year. His mother had earned income of \$600, nontaxable social security benefit payments of \$4,800, and tax-exempt interest of \$200. She used all of these for her support. Steve cannot claim a dependency exemption for his mother because the \$4,000 he provided was not more than half of her total support of \$9,600.

example

In December 2010 Mary and her 6-year-old-son, Ricky, moved in with their neighbor, Ellen, who lives down the street. Mary and Ricky lived with Ellen the entire 2011 year. Ellen paid all the household bills for her home and provided all the support for Mary and Ricky. Mary did not have any income in 2011 and she did not support anyone else. Neither Mary nor Ricky are qualifying children of any other taxpayer. All are U.S. citizens and have valid SSNs.

Even though they are not related to Ellen, both Mary and Ricky meet the tests to be her dependents under the rules for Qualifying Relative.

Ellen does not qualify as Head of Household since neither Mary nor Ricky are qualifying persons for purposes of Head of Household. For Head of Household, the qualifying person must be related to the taxpayer.



State benefit payments like welfare, Temporary Assistance for Needy Families (TANF), food stamps, Medicaid, or housing assistance are considered support provided by the *state*, not by the taxpayer.

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

Refer to the Worksheet for Determining Support in the Volunteer Resource Guide or the Personal Exemptions and Dependents chapter of Publication 17.

Multiple Support Agreements (Form 2120)

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

- The taxpayer claiming the exemption for the dependent must file Form 2120, Multiple Support Declaration or similar statement, with the tax return.
- The other taxpayers providing over 10% of the person's support must sign this written statement agreeing *not* to claim the exemption for that year. The person who claims the exemption must keep a copy of this written statement as a record.



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

example

Fred's father, Charlie, lives with him and receives 27% of his support from social security, 40% from Fred, 24% from Charlie's brother Ray, and 9% from one of Charlie's friends. Either Fred or Ray can take the exemption for Charlie because they each provided more than 10% of Charlie's support, and together contributed more than 50% toward his support. If they agree that Fred should take the exemption, Ray will sign Form 2120 and Fred will attach the form to his tax return.

example

Diane and her brother each provided 20% of their grandmother's support for the year. Two persons who are not related to Diane's grandmother, and who do not live with her, provided the remaining 60% of her support equally. No one is entitled to the dependency exemption, since more than half of the grandmother's support is provided by people who cannot claim her exemption.



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

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

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

1. The parents
 - are divorced or legally separated under divorce or separate maintenance decrees or written separation agreements, or
 - lived apart at all times during the last six months of the year whether or not they are or were married
2. The child received over half of his or her support for the year from the parents. (Multiple Support Agreement rules do not apply.)
3. The child was in the custody of one or both parents for more than half the year.



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

4. The custodial parent signs a written declaration (Form 8332 or a similar statement) that he or she will not claim the child as a dependent for the year and the noncustodial parent attaches this declaration to his or her return. If the decree or agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332. For a pre-1985 decree or agreement, see Publication 17.

This special rule is the exception to:

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

Custodial and Noncustodial Parent

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

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

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

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

example

Chloe has one child, Timmy, and is divorced. In 2011, Timmy lived with Chloe 209 nights and with his father 156 nights. Timmy lived with Chloe more nights during the year, Chloe is the custodial parent.

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

example

Ted is divorced and has a daughter who lived with him and his ex-spouse for an equal number of nights. Ted's adjusted gross income is \$45,000 and his ex-spouse's adjusted gross income is \$30,000. Ted is his daughter's custodial parent because he had a higher adjusted gross income.

If a child is emancipated under state law, the child is treated as not living with either parent.

example

When Troy turned age 18 in May 2011, he became emancipated under the law of the state in which he lives. As a result, he is not considered in the custody of his parents for more than half of the year. The special rule for children of divorced or separated parents does not apply.

See more examples and additional information in Publication 17, Personal Exemptions and Dependents.

Revocation of Release of Claim to an Exemption

Custodial parents can revoke a release of claim to exemption they previously provided to the noncustodial parent on Form 8332 or a similar statement. The custodial parent must provide, or make a reasonable effort to provide, the noncustodial parent with written notice of the revocation in the calendar year prior to the tax year in which the revocation is to take effect. Therefore, if the custodial parent provided notice of revocation to the noncustodial parent in 2010, the first year the revocation would take effect is the 2011 tax year. Part III of Form 8332 can be used for this purpose. Attach a copy of the revocation to the return for each tax year the child is claimed as a dependent as a result of the revocation.



Tax Software Hint: The tax software determines the taxpayer's dependency exemptions based on the Dependents/Nondependents information entered on the Main Information Sheet.

Be sure to include and verify all the family and dependent information on the taxpayer's intake and interview sheet before entering the data into the Dependents/Nondependents section of the tax software.

For detailed instructions, refer to the Volunteer Resource Guide (Tab 1), Main Information Sheet.

Taxpayer Interview and Tax Law Application

Elaine Smith has one Form W-2 from her clerk job of 36 years, showing wages of \$37,000. She has been divorced from her husband for over 20 years. She is the main provider for her two grandchildren and two of her grown sons, who live with her. Her sons worked part time and earned \$4,000 each. They are not disabled. The grandchildren are not the children of the sons that live with her. She would like to file a tax return and claim her sons and grandchildren as dependents.

The intake and interview sheet should look like this:

Widowed. Year of spouse's death.

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who lived outside of your home that you supported during 2011. If additional space is needed please check here and list on page 3.

Name (first, last) Do not enter your name or spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. daughter, son, mother, sister, none)	Number of months lived in your home in 2011	US Citizen or resident of the US, Canada or Mexico in 2011 (yes/no)	Marital Status as of 12/31/11 (S/M)	Full-time student in 2011 (yes/no)	Received less than \$3700 income in 2011 (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Lisa Smith	12/01/05	granddaughter	12	yes	s	yes	yes
Brian Smith	12/01/05	grandson	12	yes	s	yes	yes
Michael Smith	03/17/83	son	12	yes	s	no	no
Todd Smith	09/05/81	son	12	yes	s	no	no

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

Use the interview tips in the Volunteer Resource Guide to apply the test to each of Elaine's sons.

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

Use the interview tips in the Volunteer Resource Guide to apply the test to each of Elaine's grandchildren. You will find that Lisa and Brian are qualifying children of Elaine and her adult sons, Michael and Todd. However, under the tie-breaker rules, Elaine would be entitled to the dependency exemptions for Lisa and Brian because she has the highest AGI.

Dependent/Nondependent Determinations

Elaine can claim her two grandchildren as dependency exemptions, but not her adult sons. Therefore, use the Marital Status and Household Information section of Elaine's intake and interview sheet to enter the information for her two grandchildren.

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to dependency exemptions.

Summary

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

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



Lesson 7: Unique Filing Status and Exemption Situations



Introduction

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

This lesson also covers exemption issues related to taxpayers who may have:

- A nonresident alien spouse, or
- Nonresident alien stepchildren (children of a nonresident spouse who is married to U.S. citizen or resident alien)

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

The Foreign Student Course and certification test are part of Link & Learn Taxes, which is available on www.irs.gov.

Objectives

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

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

What do I need?

- Intake and Interview Sheet
 - Publication 4012, Volunteer Resource Guide
 - Publication 17
- Optional:**
- Publication 3
 - Publication 54
 - Publication 519
 - Publication 4588
 - Form 1040NR-EZ
 - Form 1040NR

How do I apply tax law to nonresident aliens?

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

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

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

Who is a resident alien or nonresident alien?

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

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

- Green card test
- Substantial presence test

• Proof of identity (such as a valid drivers license or other government issued picture ID).

Part I. Your Personal Information					
1. Your First Name	M. I.	Last Name		Are you a U.S. Citizen? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
2. Spouse's First Name	M. I.	Last Name		Is spouse a U.S. Citizen? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
3. Mailing Address	Apt#	City	State	Zip Code	

What is the green card test?

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

More information for green card holders is available in Publication 4588, Basic Tax Guide for Green Card Holders, found at www.irs.gov.

What is the substantial presence test?

This test is based on a formula of days and years a person is physically present in the United States. If individuals do not have green cards, find out if they meet the substantial presence test, which allows them to be treated as resident aliens for tax purposes.

Use the Determining Residency Status decision tree in the Volunteer Resource Guide (Tab A) to determine an individual’s residency status for tax purposes. Information can also be found in Publication 17, “Do I have to file?” section.

example

Gloria’s husband, Dante, has neither a green card nor a visa. Dante does not have a tax home in another country. He was physically present in the U.S. for 150 days in each of the years 2009, 2010, and 2011. Is Dante a resident alien under the substantial presence test for 2011?

The decision tree indicates that Dante does meet the substantial presence test and is considered a resident alien for tax purposes.

2011: 150 days 2010: 1/3 of 150 = 50 days 2009: 1/6 of 150 days = 25 days

Total = 225 days

What counts as days of presence?

Count any day a person is physically present in the United States, at any time during the day, as a day of presence. There are exceptions to this rule. For example, do not count days a person regularly commutes to work in the United States from their home in Canada or Mexico, or days the person is an exempt individual.

Who is an exempt individual?

Generally, an exempt individual is a:

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

Do not count the days present in the U.S. for purposes of the substantial presence test for an exempt individual. In general, they will be considered *nonresident aliens for tax purposes* and should file a Form 1040NR or Form 1040NR-EZ if required.

Publication 519, U.S. Tax Guide for Aliens, has detailed information on determining who is a resident or nonresident alien.

TIP

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

What if a nonresident alien meets the substantial presence test?

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

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

All persons listed on the return must have either a valid social security number or an individual tax identification number (ITIN). ITINs are discussed in the Filing Basics lesson.

TIP

A return with an ITIN can be e-filed. A return missing an ITIN *cannot* be e-filed.

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

If an unmarried nonresident alien does not meet the green card or substantial presence test, refer the taxpayer to a professional tax preparer to file Form 1040NR or Form 1040NR-EZ.

If a U.S. citizen or resident alien is married to a spouse who does not qualify to be treated as a resident alien using the green card or substantial presence test, you can provide assistance.

example

Paul, a U.S. citizen, and his wife, Gabriella, were married at the end of 2011. Gabriella does not have a green card or a valid visa. They have no children and are not supporting anyone else.

Gabriella lived in the U.S. for 120 days in 2011 (from September to December) as a nonresident alien. She was also in the U.S. for 120 days in each of the years 2009 and 2010. Gabriella does not have a tax home in another country. Does Gabriella meet the substantial presence test?

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

2011: 120 days 2010: 1/3 of 120 days = 40 days 2009: 1/6 of 120 days = 20 days

Total = 180 days

What are the filing status options?

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

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

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

The U.S. citizen can file a Married Filing Separately return and may be able to claim a nonresident alien spouse’s personal exemption. The nonresident alien spouse, if required to file a return, would file Form 1040 NR. In this situation, the volunteer can assist in the preparation of Form 1040 for the U.S. citizen but must refer the spouse to a professional tax preparer. Claiming a nonresident alien spouse’s personal exemption is covered in more detail in this lesson.

When can nonresident aliens file a joint return?

A married couple may elect to treat a nonresident alien spouse as a resident alien for tax purposes.

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

If the nonresident alien spouse agrees to file a joint return, worldwide income of both spouses must be reported, and a declaration signed by both spouses must be attached to the joint return stating:

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



For more information, see Publication 17, Filing Status.

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

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

example

Even though Gabriella, Paul’s nonresident alien wife, does not pass the green card or substantial presence test, they both agree to choose to treat Gabriella as a resident alien by attaching a signed statement to their joint return. Paul and Gabriella must report their worldwide income for the year and for all later years unless the choice is ended or suspended. Although Paul and Gabriella must file a joint return for the year they make the choice, they may file either joint or separate returns for later years.

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

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

- The taxpayer is a U.S. citizen, or resident alien for the entire year, and meets all the “considered unmarried” rules for Head of Household except for living with a nonresident alien spouse.

- The nonresident alien spouse chooses **not** to file a joint return.
- The spouse is **not a qualifying person** for head of household purposes. The taxpayer must have a qualifying person in order to be eligible for this filing status.



EXERCISES

Answers are at the end of the lesson summary.

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

What filing status options do Gloria and Dante have?

Question 2: Raul is a U.S. citizen and serving in the U.S. Army in Japan. His wife and his children live with him and he is able to claim the children as dependents. Raul’s wife, a citizen of Japan, chooses not to be treated as a resident alien for tax purposes. She does not want to file a joint return with him.

Raul meets all of the other qualifications for Head of Household. Even though he is married and living with his spouse, can he claim Head of Household status?

Yes No

Can a taxpayer filing Head of Household who is married to and living with a nonresident alien spouse claim the earned income credit?

If the taxpayer or spouse was a nonresident alien for any part of the year, they cannot claim the earned income credit unless their filing status is Married Filing Jointly. Remember the taxpayer, spouse, and any qualifying children must have valid SSNs to claim the earned income credit; it cannot be claimed using an ITIN.

If a taxpayer who has a nonresident alien spouse is filing as Head of Household, the 2011 Form 1040 Instructions say to enter “NRA” on the head of household line of Form 1040. Additionally, the word “No” should appear on the dotted line next to the earned income credit line of Form 1040.



In the Volunteer Resource Guide (Tab B), Filing Status – Decision Tree, note that if a spouse is a nonresident alien, the *living apart* rule does not apply to the taxpayer. This information is also in Publication 17, under Head of Household, Nonresident alien spouse.

What exemptions can be claimed?

Can a taxpayer claim a personal exemption for a nonresident alien spouse?

A taxpayer can claim the personal exemption of a nonresident alien spouse who does not choose to file a joint return, if certain tests are met.

Use the Volunteer Resource Guide (Tab C), Interview Tips for Personal Exemptions, to determine if the taxpayer can claim the personal exemption of the nonresident alien spouse. It does not matter if the taxpayer is filing as Married Filing Separately or as Head of Household. For a nonresident alien spouse, income is defined as U.S. source income only. All the other rules apply as stated, including the requirement that the person cannot be claimed as a dependent on another U.S. tax return.

example

As mentioned earlier, Raul is a U.S. citizen serving in the U.S. Army in Japan. His wife and children live with him and he is able to claim the children as dependents. Raul's wife, a citizen of Japan, chooses not to file a joint return with him. Raul can claim his wife's personal exemption as long as she has no U.S. source income, she is not anyone else's dependent, and has an SSN or ITIN.

example

Tom is a U.S. citizen. He married Anna, a Korean citizen, in 2011, but came back to the U.S. without her. Anna is still in Korea getting her paperwork in order. She did not choose to file a joint return with him. Tom is filing as Married Filing Separately. Anna has no U.S. source income and cannot be claimed as a dependent on anyone else's U.S. tax return. She has an ITIN for now. Tom can claim her personal exemption on his tax return.

For Married Filing Separately status, claim the exemption by checking the spouse's exemption on Form 1040 and enter the name of the spouse in the space to the right of the box. The SSN or ITIN of the spouse is entered in the space provided at the top of Form 1040, where the spouse's SSN or ITIN would be entered if a joint return was being filed.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 1), Main Information Sheet, for more information on claiming the spouse's exemption.

Can a taxpayer claim a dependency exemption for a child born overseas?

A child born overseas to U.S. citizen parents is considered a U.S. citizen for tax purposes. A child can be claimed as a dependent as long as all the other rules for qualifying child or qualifying relative are met.

The birth of a child abroad should be reported as soon as possible to establish an official record of the child's claim to U.S. citizenship. Form FS-240, Consular Report of Birth Abroad, establishes official evidence that the child is a U.S. citizen.

example

Patricia, a U.S. citizen and member of the armed forces, is married to Gilberto, a nonresident alien from Spain. Their daughter, Eva, was born in Spain, where they live.

Eva is entitled to U.S. citizenship. Her mother should check with the military office for information on reporting the birth of the child, so Eva will be recognized as a U.S. citizen. Eva will need a social security number to be claimed as a dependent on her mother's tax return.



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

Can a foreign-born stepchild be claimed as a dependent?

Before addressing the dependency exemption question, it is necessary to determine the child's U.S. residency status for tax purposes by answering the questions in the resident or nonresident alien decision tree. If the foreign-born child is a nonresident alien for tax purposes, the child must be a resident of Canada or Mexico to be claimed as a dependent.

example

Terry, a U.S. citizen, is married to a German citizen whose three children are German citizens and do not have green cards. Terry has not adopted the children. They all live in Germany. The children were not physically present in the U.S. during the tax year.

Since the children are not U.S. citizens and are not residents of the U.S., Canada, or Mexico, Terry cannot claim the children as dependents.

Can a taxpayer claim an adopted foreign-born child as a dependent?

A U.S. citizen or national can claim a legally adopted child who is not a U.S. citizen, U.S. resident alien, or U.S. national provided the child is a member of the taxpayer's household all year. All the other rules for a qualifying child or qualifying relative must be met, and the child must have a SSN, ITIN, or ATIN to be claimed as a dependent.

An Adoption Taxpayer Identification Number (ATIN) can be obtained when a domestic adoption is pending and other rules are met. An ATIN can be obtained in a foreign adoption when the child already possesses a green card or a certificate of citizenship, which identifies a child born overseas as a U.S. citizen.

See Publication 17, Personal Exemptions and Dependents, for more information about the citizen or resident test, including who is considered a U.S. national.



An adopted nonresident alien child must live with the taxpayer all year to pass the citizen or resident test.



EXERCISES (continued)

Question 3: Terry moved his family to the U.S. in January. The stepchildren are still not U.S. citizens and they do not have green cards. They meet the other dependency tests. If he can claim them, he will apply for ITINs for them. Can he claim the stepchildren as dependents on his tax return?

Yes No

Question 4: John, a U.S. citizen, lives in Germany. His wife is a German citizen who has never lived in the U.S. Their two-year-old son was born in Germany. John's 12-year-old stepdaughter, a German citizen whom John has not adopted, also lives with them. John and his wife provide all the support for the two children. How many dependency exemptions can John claim on a joint return?

- A. One
- B. Two
- C. Three
- D. Zero

Summary

Resident aliens follow the same tax laws as U.S. citizens.

To determine the residency status of a noncitizen, use the Determining Residency Status decision tree in the Volunteer Resource Guide (Tab A).

If a citizen or resident alien is married to a person who does not meet the green card or substantial presence test, the couple can elect to treat the nonresident spouse as a resident alien for tax purposes and file a joint return.

If the nonresident alien spouse does not meet the green card or substantial presence test and does not choose to file a joint return, under certain circumstances, the U.S. citizen or resident alien can file as Head of Household even though the couple lives together.

A U.S. citizen or resident alien may claim the nonresident alien spouse's personal exemption as long as the spouse:

- Had no U.S. source income
- Cannot be claimed as a dependent on someone else's U.S. tax return, and
- Has a TIN

A U.S. citizen's child is usually a U.S. citizen by birth, even if the child is born in another country.

A nonresident alien stepchild generally will not pass the citizenship or resident test and therefore cannot be claimed as a dependent, unless the child is a resident of Canada or Mexico.

An adopted nonresident alien child can usually be claimed as a dependent if the child lives with the taxpayer the entire year.

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

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

- Taxpayers with F, J, M, or Q visas, unless there is a volunteer at your site with Foreign Student certification
- Unmarried nonresident aliens who do not meet the green card or substantial presence test



EXERCISE ANSWERS

Answer 1: *Since Dante meets the substantial presence test, he is considered a U.S. resident alien for tax purposes and must follow U.S. tax laws. Dante and Gloria can use either the Married Filing Jointly or Married Filing Separately filing status*

Answer 2: *Yes. Raul can claim Head of Household status because his children are his qualifying persons. If Raul's children did not live with him, he would have to use the Married Filing Separately filing status since his wife chose not to file a joint return.*

Answer 3: *Yes. The children meet the substantial presence test because they were in the United States more than 183 days. Terry's stepchildren are considered resident aliens for tax purposes. As long as the other requirements for qualifying child or qualifying relative are met, Terry can claim the stepchildren as dependents on his tax return. They have to obtain SSNs or ITINs.*

Answer 4: *A. John can claim one dependency exemption for his son on his joint return. The son qualifies as a U.S. citizen because his father is a U.S. citizen. The stepdaughter does not meet the U.S. citizen or resident test. A spouse is never considered a dependent, although John may be able to claim her personal exemption.*



Lesson 8: Income – Wages, Interest, Etc.; Form 1040, Lines 7–11

Introduction

This is the first of nine lessons (lessons 8–16) covering the Income section of the taxpayer’s return. A critical component of completing the taxpayer’s return is distinguishing between taxable and nontaxable income and knowing where to report the different types of income on Form 1040, lines 7–22.

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

Objectives

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

- Compute taxable and nontaxable income
- Distinguish between earned and unearned income
- Report income correctly on Form 1040, lines 7–11






The income lessons follow the order of the Income section of Form 1040. The following chart will help you select the appropriate topic for your certification course.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Form 1040 Instructions
- Schedule B
- Publication 531
- Publication 550
- Publication 926
- Publication 970

Lesson	Form 1040	Topics	Certification Course				
			 Basic	 Intermediate	 Advanced	 Military	 International
8	Line 7	Wages	■	■	■	■	■
8	Line 8	Interest Income	■	■	■	■	■
8	Line 9	Dividend Income	■	■	■	■	■
8	Line 10	Taxable Refunds	N/A	■	■	■	■
8	Line 11	Alimony Received	N/A	■	■	■	■
9	Line 12	Business Income	N/A	■	■	■	■
10	Line 13	Capital Gain/Loss	N/A	N/A	■	■	■
N/A	Line 14	Other Gains/Losses	N/A	N/A	N/A	N/A	N/A
11	Line 15	IRA Distributions	N/A	■*	■	■	■
11	Line 16	Pensions/Annuities	N/A	■*	■	■	■
12	Line 17	Rental Income	N/A	N/A	N/A	■	■
		Schedule K-1 Distributions	N/A	N/A	■	■	■
N/A	Line 18	Farm Income	N/A	N/A	N/A	N/A	N/A
13	Line 19	Unemployment Compensation	■	■	■	■	■
14	Line 20	Social Security Benefits	■	■	■	■	■
15	Line 21	Other Income	■	■	■	■	■
		Foreign Earned Income	N/A	N/A	N/A	N/A	■
16	Line 21	Military Income	N/A	N/A	N/A	■	N/A
*Pensions/Annuities are Intermediate if the taxable amount is already determined.							

How do I determine taxable and nontaxable income?

The income chart in the Volunteer Resource Guide (Tab D) includes examples of taxable and nontaxable income.

Gross income is all income received in the form of money, goods, property, and services that is not exempt from tax. It includes income from sources outside the U.S., even if part or all of that income can be excluded. Gross income may include part of social security benefits received and certain scholarship and fellowship grants.

- Income that is taxable must be reported on a taxpayer's return and is subject to tax.
- Income that is nontaxable may have to be shown on a taxpayer's return but is exempt from tax.

What are types of taxable income?

The Income section of Form 1040 is used to report earned and unearned taxable income. The sum of all earned and unearned income is reported on Form 1040, line 22, as total income.

- Earned income – any income received for work, such as wages or business income
- Unearned income – any income produced by investments, such as interest on savings, dividends on stocks, or rental income

What are types of nontaxable or exempt income?

Some nontaxable income such as gifts and inheritances are excludible and not shown on the return.

Exempt income includes such things as interest income produced from certain types of investments. There are some instances when exempt income is shown on the return but not included in the income tax computation, for example, tax-exempt interest income.

How do I get started?

To determine a taxpayer's income, discuss and review the Income section of the intake and interview sheet with the taxpayer. Use the interview techniques and tools discussed in the Screening and Interview lesson to probe for this information.

Income is reported on a variety of forms depending on its source. Ask the taxpayer to show you all Forms W-2, Forms 1099, and other statements reporting income. (Do not confuse Form 1099 with Form 1098. Generally, Form 1098 reports expenses the taxpayers have paid, not income they have received.) You may also find it useful to use page 1 of Form 1040 as a guide to address income items.



Tax Software Hint: After you have collected all the income statements, review Income and How/Where to Enter Income in the Volunteer Resource Guide (Tab 2). These pages will show you where to correctly report income items.



How do I report wages, salaries, tips, etc.?

What is Form W-2?

Most employers issue a standardized version of Form W-2, Wage and Tax Statement. Review Form W-2 in the Volunteer Resource Guide (Tab 2).

Employers must report wages and other employee compensation on Form W-2 and have it available to the employee by January 31. Employers are not required to mail Forms W-2, but they must make them available to the employees. Employees may need to pick up Form W-2 from their employers, or obtain it electronically.

TIP

According to current law, oil spill payments for lost wages or business income are taxable. The law treats compensation for lost wages or income differently for tax purposes than compensation for physical injuries or property loss, which generally is nontaxable. Some issues, such as casualty losses, should be referred to a professional tax preparer.

For guidance in providing assistance to Gulf Oil Spill Victims, refer to Publication 4906, Gulf Oil Spill Overview & Guidance for VITA/TCE, and Publication 4899, Decision Tree - Gulf Oil Spill Affected Taxpayers. These publications are available on www.irs.gov. Additional guidance, including frequently asked questions, can be found on www.irs.gov; keywords – Gulf Oil Spill Information Center.

What if the taxpayer does not receive Form W-2 by January 31?

Taxpayers who do not receive Form W-2 by January 31 should first contact the employer and find out if, or when, the form was mailed, or if it can be picked up or accessed online.

If Form W-2 is still not received after allowing a reasonable amount of time for the employer to issue or reissue it, then the taxpayer should contact the IRS for assistance at 1-800-829-1040, but not before February 15.

If taxpayers do not receive Form W-2 before the filing deadline, they should file their tax return with Form 4852, Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Taxpayers should keep a copy of Form 4852 for their records. Usually Form 4852 can be filed with a state return as well.

If the earnings reported on Form 4852 are not reflected on the yearly Social Security Statement, the taxpayer should contact the Social Security Administration at the number shown on the statement.



If the taxpayer eventually receives the employer's Form W-2, and the numbers differ from those on Form 4852, the taxpayer will need to amend the return to report the correct amounts.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2) for instructions on entering income. It is important to enter the information from Form W-2 exactly as it appears. Once you enter all Forms W-2 into the software, it automatically reports the total on Form 1040, line 7, and automatically transfers necessary information for credits, deductions, withholding, etc., from the forms to other sections of the tax return.

example

During the tax year, Tina earned income from both a full-time and a part-time job. She received two Forms W-2, each listing different employer addresses. Her return will list her wages as the total of the amounts in box 1, but each Form W-2 must be entered into the tax software separately.

Tip Income

If taxpayers have jobs in which tips are normally received (e.g., waiter/waitress, bellhop, or motel/hotel housekeeper), be sure to ask about any tips they may have received. All tip income is taxable, whether or not it is reported to the employer.

- If individuals receive more than \$20 per month in tips at one job and report their tip income to their employer, the tips will be included in the amount on Form W-2, boxes 1, 5, and 7.
- The individual is not required to report tip income of \$20 or less per month while working for one employer. Since these tips are taxable, ask taxpayers if they have any tip income that was not reported to their employer.
- Noncash tips (e.g., tickets or passes) do not have to be reported to the employer, but must be included as taxable income at their fair market value.
- Any tip income not reported to the employer is added to other amounts on Form 1040, line 7.
- If tips of more than \$20 a month were not reported to the employer, the taxpayer must also pay social security and Medicare taxes. Complete Form 4137 for the taxpayer.
- Tips of less than \$20 per month or noncash tips are not subject to social security and Medicare taxes.



Self-employed taxpayers who receive tips, such as hair stylists and manicurists, should include their tips in gross receipts on Schedule C.

Allocated Tips

To ensure that everyone reports their fair share of income from tips, some employers have tip allocation programs. These programs are approved by the IRS. If an employee reports tips to the employer that were less than the designated share based on the employer's formula, the employer reports the difference as "allocated tips" and includes it on the employee's Form W-2.

Allocated tips are shown separately in Form W-2, box 8. Social security and Medicare taxes are not withheld on allocated tips. Allocated tips are not included in the amount in Form W-2, box 1. Explain to the taxpayers that unless they kept a written and reliable record of tips actually received at that job and can prove the allocated amount is inaccurate, the allocated tips must be included in Form 1040, line 7. If the taxpayers did keep a reliable written record of tips, then their figures are used in place of the amount in box 8 when including tip income on Form 1040, line 7.



Tax Software Hint: When allocated tips are reported in Form W-2, box 8, the software automatically adds them to Form 1040, line 7, and also completes Form 4137. If, based on the taxpayer's records, this amount is not correct, or if the taxpayer has unreported tips, enter this information on Form 4137. This form will calculate the required social security and Medicare taxes. Go to the Volunteer Resource Guide (Tab 2) for instructions on how to enter unreported or allocated tips.



For more information about tip income, see Publication 531, Reporting Tip Income.

Other W-2 Income

What about income received by household employees?

The term "household employee" refers to one who works in someone's home performing household duties such as caring for children, cleaning, or cooking. Generally, an employer is not required to provide Form W-2 to a household employee who earns less than \$1,700 a year. In this situation, neither the employer nor the employee will owe social security or Medicare tax on those wages. However, employers who withhold federal income taxes from their employee's wages must issue Form W-2. Regardless of whether Form W-2 is issued, the income must be included on Form 1040, line 7.



For further information and a definition of who is a household employee, see Publication 926, Household Employers Tax Guide.



Tax Software Hint: See the Volunteer Resource Guide (Tab 2) for guidance on determining and entering taxable income.

Are scholarships and fellowships taxable income?

Form W-2 and Form 1098-T

Scholarships and fellowships may be fully or partially taxable, or nontaxable. Taxable amounts include:

- Payment for services
- Money used for personal living expenses, such as room and board

If the taxpayer received Form W-2 for the scholarship or fellowship, include the amount on Form 1040, line 7, just as you would for any other Form W-2.

Form 1098-T lists qualified tuition and related expenses billed by the school. Verify that these amounts have been paid. It also lists scholarship and grant money the student received. If scholarships or grants exceed the qualified educational costs, some of the grant or scholarship money may be taxable.

To determine if any scholarship or grant is taxable or to determine if the taxpayer can claim an education credit, see the Volunteer Resource Guide (Tab D), Tax Treatment of Scholarship and Fellowship Payments and Publication 970, Tax Benefits for Education. Education credits will be discussed in a later lesson.

What about loan repayment assistance programs (LRAPs) for health care professionals?

Education loan repayments are not taxable if they are made to taxpayers by:

- The National Health Service Corps Loan Repayment Program
- A state education loan repayment program eligible for funds under the Public Health Service Act, or
- Any other state loan repayment or loan forgiveness program that promotes increased availability of health professionals/services in underserved areas

What about ministers or other members of the clergy?

The ministry profession presents unique issues, such as the parsonage/housing allowance, whether earnings are covered under FICA or SECA (self employment tax), and the rules for being exempt. Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers, covers this topic. This information is provided for awareness only and is out of scope for the VITA/TCE program. Taxpayers who have these issues should be referred to a professional tax preparer.



What interest is taxable?

Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, U.S. government bonds, interest on insurance proceeds, and loans that the taxpayer makes to others. Some savings and loans, credit unions, and banks call their distributions “dividends.” These distributions are really interest and are reported correctly as interest on Form 1099-INT.

Where do I get interest income information?

There are many sources of information about interest income. Ask the taxpayer to supply all Form(s) 1099-INT from institutions that pay interest. (If a taxpayer received less than \$10 in interest, the financial institution might not issue Form 1099-INT.) Some institutions issue a year-end statement with the title “In lieu of Form 1099-INT or Form 1099-DIV” rather than preparing multiple documents.

Original Issue Discount (OID) is a form of interest. A debt instrument generally has OID when issued for an amount that is less than its stated redemption price at maturity. The issuer of the debt instrument will report the amount of OID on Form 1099-OID, Original Issue Discount, or a similar statement.

If the taxpayers cashed in Series EE or Series I bonds, they should have a Form 1099-INT from the bank. Most taxpayers report the total interest when they cash the bonds. Some taxpayers may report savings bond interest as it accrues each year. This method is out of scope for the volunteer program and taxpayers should be referred to a professional tax preparer.

If a U.S. savings bond is issued in the names of co-owners, such as the taxpayer and child, or the taxpayer and spouse, interest on the bond is generally taxable to the co-owner who purchased the bond. To determine who is responsible for paying the tax on the interest from the redemption of a bond, see Publication 17, Interest Income.

TIP

Interest on qualified U.S. Series EE and Series I savings bonds that are used to pay for higher education expenses may be eligible for exclusion from income using Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989.

- Taxpayers with Series HH bonds receive interest twice a year.
- Ask the taxpayer for the bank statements reporting the interest received.
- Ask if the taxpayer holds any loans or seller-financed mortgages.

example

Bob holds a promissory note for a cash loan that he made to his brother-in-law, Stan. Stan pays Bob principal and interest each month. Even though Bob does not receive a Form 1099-INT, he reports that interest on Schedule B of his tax return.

example

Hazel has four savings accounts in four different banks. The total amount of interest earned from the accounts is \$1,700. Hazel will receive four Forms 1099-INT. She will list each payer and amount on Schedule B and file it with her tax return.

What interest income is tax-exempt?

Certain types of interest are exempt from federal income tax. However, they may be taxable by the state, and sometimes the reverse is true; the interest may be taxable on the federal return and exempt from state income tax.

Interest from bonds issued by the following are exempt from federal income tax:

- State and political subdivisions (county or city)
- District of Columbia
- U.S. possessions and political subdivisions
- Port authorities
- Toll-road commissions
- Utility service authorities
- Community redevelopment agencies
- Qualified volunteer fire departments
- Amounts indicated on broker statements as tax-exempt interest or tax-exempt dividends

Read the taxpayer's Form(s) 1099-INT carefully; both taxable and tax-exempt interest may be listed.

Sometimes interest from Private Activity Bonds (PAB) is shown on the statement with tax-exempt interest and must be included.

Although tax-exempt interest is not taxable, it must be reported on Form 1040, line 8b. Tax-exempt interest is used in calculating the taxability of some income items, such as social security benefits.

What if a bond is sold between interest payment dates?

If a bond is sold between interest payment dates, part of the sales price represents interest accrued to the date of the sale. This amount is taxable to the seller and must be reported as interest income for that tax year, even if the seller does not receive a Form 1099-INT. The buyer of the bond may receive a 1099-INT reflecting the accrued interest, and will treat this amount as a return of capital investment, reducing their basis in the bond. This topic is complex and is out-of-scope for the VITA/TCE program. Taxpayers who buy or sell bonds between interest payment dates should be referred to a professional tax preparer. If taxpayers would like additional information, refer them to Publication 550, Investment Income and Expenses.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), Additional Interest, NAEOB, and State Adjustments.

What about the interest on an IRA?

Generally interest on a Roth IRA is not taxable. However, if the criteria for distribution are not followed, the interest is taxable.

Interest on a traditional IRA is tax-deferred. Do not include that interest in taxable income until the taxpayer receives distributions from the IRA, which will be reported on Form 1099-R. See the Retirement Income lesson, Publication 17, and Publication 590 for more information on IRAs.

example

Mike makes contributions to a traditional IRA each year. Throughout the year, he gets statements listing the interest earned. Because it is tax-deferred, he does not report any of the interest income from his traditional IRA on his tax return.

How do I report interest income?

Interest income is entered on Form 1040, line 8a or line 8b. Amounts in Form 1099-INT, boxes 1 and 3, are reported as taxable interest, and the amount in box 8 is reported as tax-exempt interest. Ensure that other amounts on Form 1099-INT are entered in their proper places on Form 1040; e.g., amounts in box 2 are entered in the Adjustments section and amounts in box 4 are entered in the Payments section. Box 5 will be discussed in the Itemized Deductions lesson, and amounts in box 6 and 7 will be discussed in the Foreign Tax Credit lesson. If box 9 contains an amount, refer the taxpayer to a professional tax preparer.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2), How/Where to Enter Income, for instructions on entering interest income in the Interest Statement. The software will file Schedule B if required.

If the taxpayer receives Form 1099-OID, report as interest the amounts in boxes 1, 2, and 6. Box 3, early withdrawal penalty, is reported in the Adjustments section of Form 1040. Box 4 is reported in the Payments section of the return. Box 7, investment expenses, can be taken as an itemized deduction on Schedule A subject to the 2% limit. If taxpayers indicate there are adjustments needed for any of the amounts listed on Form 1099-OID, or if they have income from original issue discount but did not receive a Form 1099-OID, refer them to a professional tax preparer to ensure the correct amount is reported.



Tax Software Hint: Regardless of the amount, when entering interest income, use the Interest Statement as shown in the Volunteer Resource Guide (Tab 2).

Taxpayer Interview and Tax Law Application

Barbara Smith is a window clerk with the United States Postal Service. She has one Form W-2.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

BARBARA RESPONDS...

Now we will complete the income section of your return. I believe you told me that you work at the post office?

Yes. Here is my W-2.

Are you employed by anyone else?

No way, they keep me busy enough at the post office!

Let me enter your Form W-2 information...

No, I'm not disabled.

Did you have any disability income?

Now, let's go on to interest income. Did you earn any interest on checking accounts, savings accounts, or a certificate of deposit?

Yes, I have a savings account that earns interest. Here is the 1099-INT.

What about U.S. savings bonds? I know that a lot of postal employees buy them at work.

Yes, I do, every pay period.

Are they for educational purposes, or just an investment?

No, they aren't educational. I don't have any information about my bonds with me. Why would I need that?

Some people report the interest as it accrues every year. You have to make this decision in the first year after you buy the bonds. Have you ever declared accrued interest from your savings bonds on your federal tax return?

Oh, no, never.

Well, did you redeem any bonds in 2011, or did any of them mature that year?

No to both questions. I've been buying them for 15 years and they don't become fully mature for 30 years.

Okay, then it sounds like your only interest income is from the savings account. Let's enter that now.

[On page 2 of the intake and interview sheet, indicate Barbara's responses to these questions.]



How do I handle dividends?

The corporate distributions that volunteer tax preparers may handle are:

- Ordinary dividends
- Qualified dividends and distributions
- Capital gain distributions

These are all found on Form 1099-DIV.

What are ordinary dividends?

Ordinary dividends are corporate distributions paid out of the earnings and profits of the corporation. Any dividend received on common or preferred stock is an ordinary dividend unless the paying corporation states otherwise. Total ordinary dividends are reported in Form 1099-DIV, box 1a.

example

Olivia held both common stock and preferred stock in several U.S. corporations. Several of them paid dividends during the tax year. The following January, she received Forms 1099-DIV listing these as ordinary dividends.

What are qualified dividends?

Qualified dividends are ordinary dividends that are eligible for a lower tax rate than other ordinary income. They are shown in Form 1099-DIV, box 1b. See Publication 17, Dividends and Other Distributions, for a detailed definition of qualified dividends.

Taxpayers who have questions about why a dividend is qualified or not qualified should contact the company that issued the dividend.

What are capital gain distributions?

Capital gain distributions are also called capital gain dividends. They come from mutual funds and real estate investment trusts (REITs). They are taxed at the lower long-term capital gains rate, regardless of how long the taxpayer holds the shares. Capital gain distributions are reported to the taxpayer on Form 1099-DIV, box 2a. The taxpayer reports these distributions as long-term capital gains on Form 1040, line 13, and on Schedule D if required.



Capital gains are not the same as capital gain distributions. A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than its cost. A capital gain *distribution* is the owner's portion of the capital gains that were realized when the mutual fund or REIT sold assets. If you are not certified in this area, refer taxpayers who actually sold mutual fund shares, or other shares of stock, to a VITA/TCE tax preparer who has been trained to handle capital gains and losses.

What are nondividend distributions?

Form 1099-DIV, box 3 shows the nondividend distribution, the part of the distribution that is nontaxable because it is a return of the taxpayer's cost or other basis. Taxpayers should keep this information with their tax records in order to calculate the adjusted basis of the stock when it is sold.

Where do I get dividend information?

Most corporations use Form 1099-DIV to report dividend distributions to each shareholder. Ask the taxpayer for any Form(s) 1099-DIV. If the taxpayers did not receive a Form 1099-DIV for a dividend, ask if they received the information on their shareholder's annual brokerage statement.

example

During the tax year, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. The following January, she received Forms 1099-DIV listing these capital gain distributions.

How do I report dividend information?

Generally, all dividend income is reported on Form 1040, lines 9a and 9b. Schedule B is needed if the taxpayer's ordinary dividends are greater than \$1,500, or if the taxpayer was the nominee for dividends that actually belong to someone else. On Form 1099-DIV, only boxes 1a, 1b, 2a, 3, 4, 5, 6, and 7 are in scope for the VITA/TCE program. Refer taxpayers with amounts in other boxes to a professional tax preparer.

Amounts in Form 1099-DIV, box 4 are reported in the Payments section of the return. Box 5 will be covered later in the Itemized Deductions lesson. Boxes 6 and 7 will be covered in the Foreign Tax Credit lesson.



Tax Software Hint: In the Volunteer Resource Guide (Tab 2), find How/Where to Enter Income for guidance for entering interest and/or dividend income on Schedule B. If the taxpayer has multiple accounts, the software adds all the dividends for you, preventing math errors. Accurate use of the worksheet ensures the income will be taxed correctly and that other entries from Form 1099-DIV will be distributed to the proper locations on the return.

Taxpayer Interview and Tax Law Application

Leonard and Gloria are filing a joint return. Leonard and the volunteer are discussing dividend income.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

LEONARD RESPONDS...

Do you and your wife own shares of stock, mutual funds, or bond funds?

Yes, I have an IRA and I own shares in several mutual funds and a bond fund. My wife has an IRA. Here are the statements.

The earnings on the IRAs are tax deferred until you take a distribution. These 1099-DIVs are what we want right now. Are these the only Forms 1099-DIV that you received?

Yes.

We will enter the information from each of these on the Dividend Statement. It will add everything up and display it properly on your tax return.

[On page 2 of the intake and interview sheet, indicate Leonard's responses to these questions.]



What should be reported on Form 1040, line 10?

Taxpayers who receive a refund of state or local income taxes may receive Form 1099-G listing their refund amount in box 2. Not everyone must include the refund in their taxable income.

- Taxpayers who claimed the standard deduction on the tax return for the year they received a refund of state or local income taxes do not have to include the refund in their taxable income.
- Taxpayers who itemized deductions and received a state or local refund may have to include all, part, or none of the refund in their federal taxable income.



Refer taxpayers who received a state or local income tax refund in 2011 that is for a tax year other than 2010 to a professional tax preparer.

Only taxpayers who itemized and received a federal income tax benefit for deducting their state or local income taxes have to include their state/local tax refunds in income. If they itemized and deducted the state sales tax instead of the state income tax withheld, none of the refund is taxable.

example

Nancy itemized her deductions on her 2010 federal return. She included the income taxes she had paid to her state during 2010. However, she received a refund in 2011 on the overpaid portion of those taxes. When filing her 2011 tax return, she must use the state tax refund worksheet to see how much of the refund to include in her federal taxable income.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2) for guidance on entering the state tax refund received in a prior year. The software calculates the taxable part of the refund (if any) and enters the amount on Form 1040, line 10.



What is alimony?

Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument. It may include payments on behalf of the spouse or former spouse, such as medical bills, housing costs, and other expenses. It does not include child support or voluntary payments outside the instrument. The person receiving alimony must include it as income. The person paying alimony can subtract it as an adjustment to income. This will be discussed in a later lesson.

Where do I get alimony information?

Ask if the taxpayer received alimony under a divorce or separation instrument. If so, explain that you need the exact amount, since it may also be reported as a deduction by the taxpayer, and the two amounts must agree.

How do I report alimony income?



Tax Software Hint: On Form 1040, line 11, enter the alimony amount. There is no worksheet for reporting alimony income, and the social security number of the person paying the alimony is not needed.

TIP

If the taxpayer is unsure whether a payment is alimony or child support, ask if the payments will stop once the child is grown.

TIP

This training covers alimony paid under a divorce or separation instrument executed after 1984. Other rules apply to agreements executed before 1985. If the agreement was executed before 1985, refer the taxpayer to a professional tax preparer.

Practice – Vanessa Franklin



Our volunteer is working with our taxpayer, Vanessa Franklin. Go to Appendix A of this lesson and review the sample interview to identify Vanessa's wage and interest income.

Summary

This lesson covered income reported on Form 1040, lines 7–11, including how to differentiate taxable and nontaxable income, and earned or unearned income.

- Earned income is any income accumulated by personal effort, such as wages or business income.
- Unearned income is any income produced by investments, such as interest on savings or dividends on stock.
- Form 1040, line 7 income includes wages, salaries, tips, and scholarships; income generally reported to the taxpayer on Form W-2.
- Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, or U.S. government bonds. This interest is reported by the payer on Form 1099-INT and included in the taxpayer's income on Form 1040, line 8.
- Interest on certain bonds, such as from state political subdivisions, District of Columbia, or port authorities, are exempt from federal income tax but must be reported on Form 1040, line 8b.
- Lines 9a and 9b on Form 1040 are for reporting ordinary and qualified dividends. Dividends are reported to the taxpayer on Form 1099-DIV. Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Qualified dividends are ordinary dividends that are eligible for a lower tax rate than other ordinary income.
- Form 1040, line 10 is for taxpayers who received a state or local income tax refund. Taxpayers who itemized deductions in the previous year and received a tax benefit from deducting state or local income taxes may have to report part or all of their refund as income. Taxpayers generally receive Form 1099-G reporting their state or local tax refund.
- Alimony is income received from a spouse or former spouse under a separation or divorce instrument. It is reported on Form 1040, line 11.
- Capital gain distributions are reported on Form 1040, line 13, and Schedule D, if required.

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

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

- Taxpayers with income from the following sources reported on Form 1040:
 - Other gains/losses (line 14)
 - Farm income (line 18)
- Dependent child under the age of 18 (age 24 if a full-time student), who has investment income of more than \$1,900
- Casualty losses
- Accrual method for reporting income
- Taxpayers who buy or sell bonds between interest payment dates
- Form 1099-INT, box 9
- Adjustments needed for any of the amounts listed on Form 1099-OID, or if the taxpayer should have received Form 1099-OID but did not receive one

- Form 1099-DIV, boxes 2b, 2c, 2d, 8, 9
- State or local income tax refunds received in 2011 for a tax year other than 2010
- Alimony/divorce agreements executed before 1985
- Minister tax returns with parsonage/housing allowance



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



Lesson 9: Income – Business; Form 1040, Line 12



Introduction

This lesson will help you assist taxpayers who have business income, including self-employment income. Form 1040, line 12, is used to report income from a business or profession operated as a sole proprietor or independent contractor.

Preparation of tax returns with Schedule C are in scope for VITA/TCE under certain limited conditions and with expenses of \$10,000 or less.

NEW Form 1099-K, Merchant and Third Party Payments, is new for 2011 and will be covered in this lesson.

This lesson also covers recordkeeping requirements for taxpayers with business income and expenses. Refer to Publication 583, *Starting a Business and Keeping Records*, for more information.

Objectives

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

- Determine how to report business income
- Determine when to complete Schedule C-EZ or C
- Determine what business expenses are within the scope for the VITA/TCE program
- Determine how to complete Schedule C-EZ or C
- Determine what records to maintain

Where do I get business income information?

Business income information may come from the following:

- Forms 1099-MISC, Miscellaneous Income, box 7, Nonemployee Compensation
- Forms W-2, Wage and Tax Statement with Statutory Employee checked in box 13
- Taxpayer's books and records
- Forms 1099-K, Merchant Card and Third Party Payments

Based on your interview and the completion of the taxpayer's intake and interview sheet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. These taxpayers may not have income statements for their business income and expenses. The information to prepare their tax return comes from their records.

Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as "self-employed" if they have a small home business or work part-time as an independent contractor.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 463
- Publication 4491-W
- Form 1099-MISC
- Schedule C
- Schedule C Instructions
- Schedule C-EZ
- Schedule SE

Optional

- Publication 334
- Publication 535
- Publication 583
- Form 1099-K
- Form 1099-K Instructions

Taxpayers who are independent contractors should receive Form 1099-MISC showing the income they earned from payers. The amount from Form(s) 1099-MISC, along with any other business income payments, are reported on their tax return.

A taxpayer does not have to conduct regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may be self-employment. Ask for any Form(s) 1099-MISC that document this income. Also ask for documentation of any business income that was not reported on Form W-2 or Form 1099-MISC (e.g., check stubs generated by the taxpayer's client).

example

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-MISC that shows he received \$15,000 for the work he did for them. He also received cash payments of \$4,000 from several different individuals for the work he completed. He did not receive Forms 1099-MISC for the \$4,000. Tim must include the \$4,000 cash payments as self-employment income along with the \$15,000 from Form 1099-MISC.

NEW Form 1099-K, Merchant Card and Third Party Payments

Form 1099-K is used to report the proceeds of payment card and third party network transactions made to taxpayers under Internal Revenue Code section 6050W. Merchant card and third party network payers, as payment settlement entities (PSE), must report the proceeds of payment card and third party network transactions made to taxpayers on Form 1099-K.

Taxpayers may receive Form 1099-K if they accepted merchant cards for payments or because they received payments through a third party network that exceeded \$20,000 in gross total reportable payment transactions, and the total number of those transactions exceeded 200 for the calendar year. See Instructions to Form 1099-K for more information.

How is business income reported?

Form 1040, line 12, is used to report income from a business operated or a profession practiced as a sole proprietor. Schedule C-EZ or Schedule C shows the income and expenses and the net amount is carried to Form 1040, line 12. An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. A hobby is an activity typically undertaken for pleasure during leisure time.



Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC. Taxpayers who believe they have been misclassified should contact the IRS and ask for help.

TIP

Oil spill payments for lost wages or business income are taxable. Compensation for lost wages or income is treated differently than compensation for physical injuries or property loss (generally nontaxable). Refer issues such as casualty losses to a professional tax preparer.

Refer to Publication 4906, Gulf Oil Spill Overview & Guidance for VITA/TCE, and Publication 4899, Decision Tree - Gulf Oil Spill Affected Taxpayers, available on www.irs.gov, or search for keywords – Gulf Oil Spill Information Center – for more information.

To report income from an activity not for profit, see the instructions for Form 1040, line 21, and Publication 17, Chapter 12, Other Income.

Form 1040, line 12, is also used to report wages and expenses the taxpayer had as a statutory employee or certain income shown on Form 1099-MISC, Miscellaneous Income.

Schedule C-EZ and Schedule C

Business income is reported on either:

- Schedule C-EZ, Net Profit From Business, or
- Schedule C, Profit or Loss From Business

If preparing Schedule C, Part I, the following are out of scope for VITA/TCE programs: return and allowances, cost of goods sold (involves inventory), and other income. Taxpayers with these items should be referred to a professional tax preparer.

Figure the net profit or loss by subtracting the business expenses from business income. The total profit or loss is then transferred to Form 1040, line 12.

The net profit or loss will be reported on Form 1040, line 12. The net profit will also need to be shown on Schedule SE in order to calculate the self-employment tax. Schedule SE will be covered in a later lesson.



Tax Software Hint: The tax software calculates net profit after income and expense entries are made. Next, the software transfers the net profit to the applicable line on Schedule SE to compute the self-employment tax. Amounts are then transferred to the applicable lines of Form 1040.

The following terms are used in the preparation of business returns:

Definition of Terms	
Business expenses	Business expenses are amounts that are ordinary and necessary to carry on the business.
Cash method of accounting	The cash method of accounting reports all income when received and deducts all expenses when paid.
Inventory	Inventory is the items the taxpayer buys or makes for resale to others.
Depreciation	The cost of items that are expected to last more than a year should be spread over a period of years rather than deducted in the year of purchase. If the taxpayers have such a cost, they should be referred to a professional tax preparer.

Who can use Schedule C-EZ?

There are a number of conditions taxpayers must meet in order to use Schedule C-EZ. Taxpayers can use Schedule C-EZ only if they:

- Have less than \$5,000 in business expenses
- Use the cash method of accounting
- Have no inventory at any time during the year
- Did not have a net loss from the business
- Operate only one business as a sole proprietor during the tax year (each spouse on a joint return may use a separate Schedule C-EZ to report business income from separately owned sole-proprietor businesses if other conditions for filing Schedule C-EZ are met)
- Have no employees during the year
- Are not required to file Form 4562, Depreciation and Amortization, for this business (depreciation is out of scope for the VITA/TCE program)
- Do not deduct expenses for business use of a home



Volunteer tax preparers who are certified through Intermediate level or higher can assist with preparation of Schedule C-EZ and the limited Schedule C.

- Do not have prior year unallowed passive activity losses from this business
- **NEW** Did not receive any credit card or similar payments that included amounts that are not includible in income (see Schedule C-EZ Instructions, line 1a)

In the interview, if you discover taxpayers have issues that fall outside the scope of the VITA/TCE program, refer them to a professional tax preparer.

Who can use Schedule C for purposes of the VITA/TCE program?

Volunteers can assist taxpayers who have returns that require Schedule C with certain limits. Use the same criteria as Schedule C-EZ, except taxpayers can have expenses up to \$10,000, and more than one Schedule C can be prepared if the taxpayers have more than one business. If taxpayers have a Schedule C that falls outside these parameters, refer them to a professional tax preparer.

NEW If taxpayers receive any credit card or similar payments that included amounts that are not includible in income, refer them to a professional tax preparer. For more information, refer to Schedule C Instructions.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	JASON RESPONDS...
<i>What kind of business do you have and were you the sole owner?</i>	I install air conditioners and yes, I own the business myself. No partners or employees.
<i>Do you have a record of your business income and expenses for last year?</i>	Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.
<i>Do you use the cash method of accounting?</i>	Yes. I have a printout of my year-end summary here.
<i>And what were your expenses?</i>	Well, I do the installations myself; I spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year were \$2,212.
<i>Do you keep any parts in inventory?</i>	No, I purchase the parts wholesale when an order is placed with me.
<i>And you say you had a good year? In other words, did you make a profit?</i>	That's correct.
<i>Do you plan on deducting expenses for the business use of your home?</i>	No, I don't.
<i>Okay, and how much business income did you have?</i>	My receipts totaled \$30,762.

[On page 2 of the intake and interview sheet, indicate Jason's responses to these questions.]



EXERCISE

Question 1: Based on the information in the sample interview, does Jason qualify to fill out a Schedule C-EZ? Yes No

What business expenses are within scope for the VITA/TCE program?

Taxpayers can deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. See the Instructions for Schedule C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Advertising

Advertising expenses are the costs associated with promoting the business through various means including yellow pages, newspapers, magazines, billboards, racing sponsors, and television spots.

Car and Truck Expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation. The calculation of depreciation is outside the scope of the VITA/TCE program. If the taxpayers have used actual expenses in the past, or wish to use actual expenses in the current year, they must be referred to a professional tax preparer.

For the standard mileage deduction, the current standard mileage rate is multiplied by the number of business miles. Only parking and tolls can be added to this deduction. Commuting and other personal automobile expenses should not be included in this amount.

example

Dana is a self-employed masseuse. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Dana drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.

Commissions and Fees

Commissions are paid to both individuals and businesses.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property, automobile (business vehicles only), and malpractice.

Health insurance for the sole proprietor and his or her family is not deductible as a business expense. These medical premiums may be deducted on Form 1040, subject to qualifications. However, the deduction on Form 1040 is out of scope for the VITA/TCE program.

Other Interest

This category can include interest paid on operating loans, but not mortgage interest.

Legal and Professional Services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., tax returns, wills, or estates) and are not deductible as business expenses.

Office Expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or Lease – Vehicle, Machinery, and Equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Leases of more than 30 days are out of scope.

Repairs and Maintenance

Repairs on equipment, automobiles, office space, and buildings are some possible expenditures reflected in this category. Expenses that should *not* be reflected are:

- Capital equipment that is improperly expensed (see Cost Recovery in Publication 535).
- Repairs that substantially improve a facility or equipment that should be capitalized.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Taxes and Licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

Travel/Meals and Entertainment

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel, meal, and entertainment expenses are in the Volunteer Resource Guide (Tab F).

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses for the business. The base rate of the first telephone line to a residence cannot be deducted, but additional costs incurred for business purposes can be included as an expense. There should be no deduction for personal expenses in this category.

example

Kiana runs a small business from her home. She has only one phone line and frequently makes long-distance calls for business. The cost of the phone line cannot be deducted, but Kiana can deduct the long-distance charges for her business calls.

Other Expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Schedule C. See Form Schedule C Instructions (Part V - Other Expenses) and Publication 535 for more information.

How do I complete Schedule C-EZ?

Part I: General Information

Enter the type of business on line A. Enter the Principal Business Code on line B. A list of Principal Business Codes can be found in Schedule C Instructions and in Form 1040 Instructions.



Tax Software Hint: To find Principal Business Codes, bring up the Help screen while in Schedule C-EZ. A list is available under Business Codes.

Enter the business name, if there is one, on line C. If the business has an Employer Identification Number (EIN), enter it on line D (most Schedule C-EZ businesses do not need an EIN, since they do not have employees). If the business has an address that is different from the one shown on Form 1040, enter it on line E.

NEW Line F – Did the business make any payments in 2011 that would require filing of Form(s) 1099? Check “Yes” or “No” box.

NEW Line G – If line F is Yes, did or will the business file all required Forms 1099? Check “Yes” or “No” box.

Part II: Figure Net Profit

NEW Line 1 is now 1a through 1d: Enter the amount as stated for each line.

- 1a - Payments from Form 1099-K
- 1b- Gross receipts or sales not reported on Form 1099-K. This includes amounts paid to the business, whether or not it was reported on a Form 1099-MISC.
- 1c - Income reported to the taxpayer on Form W-2 if the “Statutory Employee” box on that form is checked. (See Schedule C-EZ Instructions before completing this line.)
- 1d – Total



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2) for guidance on entering income reported on Form 1099-MISC and other payments received that are not reported on Form 1099-MISC.

Enter on line 2 the total amount of all deductible business expenses that the taxpayer actually paid during the year. Only the portion of these costs that are attributable to the business can be deducted as a business expense.



Examples of deductible business expenses include advertising, car and truck expenses, commissions and fees, insurance, interest, legal and professional services, office expenses, rent or lease expenses, repairs and maintenance, tools that last less than a year, supplies, taxes, travel, the allowable percentage of business meals and entertainment, and utilities. The base rate of the first telephone line to a residence cannot be deducted, but additional costs incurred for business purposes can be included as an expense.

For earned income credit and self-employment tax purposes, the taxpayer must include all allowable deductions in computing net earnings.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2) for guidance on entering expenses on the Schedule C-EZ. The tax software will total all the expenses and transfer the amount to line 2.

Part III: Information on Vehicles

If the taxpayer had business expenses for a car or truck, complete the questions in Part III. Business miles do not include commuting miles between home and the business location or between business and lunch locations. Business miles do include travel between home and a temporary workplace when the taxpayer has one or more regular places of work. If the taxpayer has no regular place of employment, only the travel from one temporary place to another is counted. See the Volunteer Resource Guide, (Tab F) and Publication 463, Travel, Entertainment, Gift, and Car Expenses (Chapter 4) for more details.

Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation, which is outside the scope of the VITA/TCE program. If the taxpayer has used actual expenses in the past, or wishes to use actual expenses in the current year, refer the taxpayer to a professional tax preparer.

The standard mileage rate is multiplied by the number of business miles to calculate the vehicle expense. For 2011, the standard mileage rate is:

- 51 cents per mile from January 1, 2011 through June 30, 2011, and
- 55.5 cents per mile from July 1, 2011 through December 31, 2011

Add the total vehicle expenses to all nonvehicle expenses in line 2. The standard mileage rate represents all vehicle expenses; taxpayers may add only such fees as parking or tolls.

Complete the information in Schedule C-EZ, Part III.

How do I complete Schedule C?

Generally the same business expenses are deductible on both Schedule C and C-EZ. The expenses are totaled and included on one line on Schedule C-EZ, whereas on Schedule C, the business expenses are broken down by category.

General Information Section

Complete lines A–H.

- Line A: Enter the type of business.
- Line B: Enter the Principal Business Code. A list of Principal Business Codes can be found in Schedule C Instructions and in Form 1040 Instructions.
- Line C: Enter the business name, if no separate name, leave blank.
- Line D: Employer ID Number (EIN), if any.
- Line E: Enter the business address.
- Line F: Check accounting method. (Only cash method is in scope for the VITA/TCE program; if taxpayers use another method, refer them to a professional tax preparer.)


- Line G: Check “Yes” or “No” box for: Did the taxpayer “materially participate” in the operation of the business?
 - In general, the taxpayer materially participates if based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year. See Schedule C Instructions for specific tests to determine if the taxpayer meets the requirements for material participation.
 - If the taxpayer meets one of the tests for material participation, check the “Yes” box, otherwise the answer is “No.” If there is uncertainty about the taxpayer materially participating in the business, refer them to a professional tax preparer.
- Line H: Check the box if business was started or acquired in 2011.
- **NEW** Line I: Check “Yes” or “No” box for: Did the business make any payments in 2011 that would require filing of Form(s) 1099?
- **NEW** Line J: If line I is Yes, did or will the business file all required Forms 1099? Check “Yes” or “No” box.

Part I: Income

NEW Starting in tax year 2011, there are new lines in the Income section of Schedule C for merchant card and third party payments received.

Line 1 now is 1a through 1d. Enter the amount as stated for each line:

- 1a – Payments from Form 1099-K
- 1b – Gross receipts or sales not reported on 1a. This includes amounts paid to the business, whether or not it was reported on a Form 1099-MISC.
- 1c – Income reported on Form W-2 if the “Statutory Employee” box on that form is checked. (See Instructions before completing this line.)
- 1d – Total



Determine if the taxpayer received business income that was not reported on Form 1099-MISC. For example, tips received by self-employed hair stylists or manicurists are to be included in gross receipts on Schedule C-EZ/C.

If the total amounts that were reported in Forms 1099-MISC, box 7, are more than the total that the taxpayer is reporting on line 1b, attach a statement explaining the difference.

Statutory Employees

If the taxpayer received Form W-2 and “Statutory employee” was checked in box 13, report the income and expenses related to that income on Schedule C or C-EZ. Enter the statutory employee income from Form W-2, box 1, on line 1c of Schedule C or C-EZ. Social security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self-employment tax on these earnings. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Self-employment income and statutory employee income cannot be reported on the same Schedule C. The taxpayer must file two separate Schedules C.



Tax Software Hint: If the taxpayer has a Form W-2 with the “Statutory employee” box checked, be sure to follow the guidance for the applicable line of Schedule C or C-EZ. This income is not subject to self-employment tax since social security and Medicare taxes have already been withheld.

NEW Returns and Allowances Plus any Other Adjustments

In addition to returns and allowances, Schedule C, line 2 is used to enter any non-income amounts that were included on Form 1099-K, box 1 entered on line 1a as gross receipts from merchant cards and third party network payments. Non-income amounts include transaction fees, certain taxes, tips, and “cash back” on a debit card purchase.

example

A taxpayer received Form 1099-K showing \$1,200 in box 1. However, included in this amount is \$200 that the taxpayer paid as “cash back” to the buyer who used a debit card. The taxpayer enters \$1,200 on Schedule C, line 1a and enters \$200 on line 2 so it will be subtracted from gross receipts.

Part II: Expenses

On Schedule C there is a separate line for the most common expenses that are incurred in a business. Review the taxpayer’s information to determine if the expenses are **ordinary and necessary**.

Part III: Cost of Goods Sold

This relates to inventory and is out of scope for the VITA/TCE program.

Part IV – Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Schedule C.



Tax Software Hint: Since net losses are out of scope for the VITA/TCE program, the “Worksheet for Some Investment is Not at Risk” is not applicable.



EXERCISES (continued)

Question 2: Daniel has his own business. He received Form 1099-MISC for \$13,000 for work he completed as an independent contractor. He also received cash payments that total \$2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of \$2,500 on his return?

Yes No

Question 3: Ellen has a small business. The gross income from her business is \$40,000 and her business expenses total \$9,500. What schedule must be completed to report her business income and expenses?

- A. Schedule C-EZ
- B. Schedule C
- C. Either Schedule C-EZ or Schedule C
- D. Schedule A

Recordkeeping

Why keep records?

Everyone in business must keep records. See the Volunteer Resource Guide (Tab F) for a table on record-keeping. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify source of receipts
- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books (for example, accounting journals and ledgers). The books must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books. In addition, supporting documents must be kept.

Supporting documents

Purchases, sales, payroll, and other transactions in the business generate supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents contain information that must be recorded in the books.

It is important to keep these documents in an orderly fashion and in a safe place because they support the entries in the books and on the tax return. For instance, organize them by year and type of income or expense.

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the period of limitations for that return runs out.

The period of limitations is the time in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Publication 583.

What about self-employment tax?

A taxpayer must file Schedule SE if he or she has net earnings from self-employment of \$400 or more. The tax is computed on Schedule SE and transferred to Form 1040, line 56, to be added to other taxes owed. The Schedule SE is attached to Form 1040, and discussed in the Other Taxes lesson.

Self-employed taxpayers may claim an adjustment to income for part of their social security and Medicare taxes.



Tax Software Hint: Self employment tax and the deductible part of self-employment tax are automatically calculated. The software then enters these amounts on applicable lines of Form 1040.

Practice – Vanessa Franklin



Recall that our taxpayer, Vanessa Franklin, is an employee but she also has her own cosmetics business. Go to Appendix A to gather more information about her self-employment income.

Summary

This lesson explained:

- Where to get business income and expense information
- How business income or loss is reported
- What business expenses are within scope for the VITA/TCE program
- Who can use Schedule C-EZ
- How to complete Schedule C-EZ
- How to complete Schedule C
- How to determine what records to maintain

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

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

Schedule C with:

- Expenses over \$10,000
- Return and allowances
- Cost of goods sold
- Other income
- Expenses for employees
- Business use of home
- Casualty losses
- Vehicle expenses reported as actual expenses
- Depreciation
- Rental or lease expenses – vehicle, machinery, and equipment leases of more than 30 days
- Accounting methods other than the cash method
- Net losses
- “No” on line G, or the taxpayer does not meet any of the tests of material participation, or is uncertain about materially participating in a business
- Taxpayers who receive any credit card or similar payments that included amounts that are not includible in income



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWER

Answer 1: *Yes. Jason meets all requirements to qualify for completing Schedule C-EZ.*

Answer 2: *Yes. The cash payments must be included in Daniel's gross receipts the same as the \$13,000 on Form 1099-MISC. Cash payments are compensation for his services and must be reported on his Schedule C-EZ or Schedule C.*

Answer 3: *B. Ellen must complete Schedule C because her expenses exceed \$5,000. Schedule C-EZ cannot be used since the cap for expenses is \$5,000.*



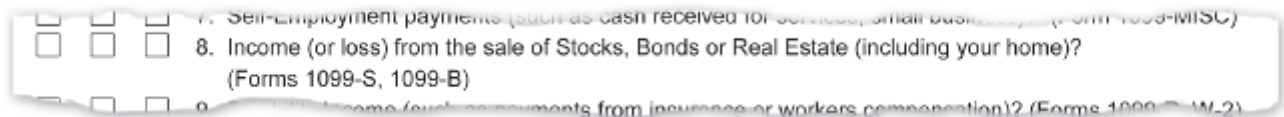
Lesson 10: Income – Capital Gain or Loss; Form 1040, Line 13



Introduction

This lesson will help you assist taxpayers who must use Form 1040, Schedule D, Capital Gains and Losses, to report capital gains and/or losses on the sale of assets. This lesson includes topics on the sale of stock, mutual funds, and the sale of a personal residence. If the taxpayers have sold any other assets, refer them to a professional tax preparer. This lesson will help you identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, the tax liability, and the amount of any capital loss carryover.

To determine if the taxpayer must report the sale of investments or the sale of a home, use the interview techniques and tools discussed in the Screening and Interviewing lesson. The intake and interview sheet lists income from the sale of property such as stock, bonds, or real estate. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year. It is important to ensure that all income is accurately reported on the return.



For additional information on the topics discussed in this lesson, see Publication 544, Sales and Other Dispositions of Assets, Publication 551, Basis of Assets, Publication 550, Investment Income and Expenses, and Publication 523, Selling Your Home.

Special rules apply to foreclosures and cancellation of debt income on a principal residence. Under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers may exclude certain debt forgiven on their principal residence. These rules are covered in a specialty course on Link & Learn Taxes for volunteers with an Advanced, Military, or International Certification. To access this online course and earn a certification for this specialty lesson, go to www.irs.gov and use the keyword/search "Link & Learn." This specialty course on cancellation of debt is optional. Check with your Site Coordinator to determine if you should be certified in this lesson.

Objectives

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

- Determine the adjusted basis of stock
- Determine if the asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss from the sale of stock
- Determine whether a home is the taxpayer's main home
- Determine if a taxpayer meets the ownership and use tests
- Determine when the 5-year ownership/use test period is suspended

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Optional:**
- Publication 523
- Publication 544
- Publication 550
- Publication 551
- Form 1040 Instructions
- Form 1040, Schedule D and Instructions
- Form 1099-B
- Form 1099-DIV
- Form 1099-S
- Form 8949

What information must I have to report a capital gain or loss?

To report capital gain or loss, you will need to identify:

- Basis and/or Adjusted Basis:
 - Basis is the original cost of the asset
 - Adjusted basis includes original cost plus any increases or decreases to that cost (such as commissions, fees, depreciation, deductible casualty losses, insurance reimbursements or major improvements)
 - **NEW** Beginning in 2011, brokers must report cost or other basis on Form 1099-B, unless the securities sold were noncovered securities
- Holding period:
 - Short-term property is held one year or less
 - Long-term property is held more than one year
 - Long-term capital gains are taxed at a lower rate than short-term gains
 - **NEW** Beginning in 2011, brokers must report whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities
- Proceeds from the sale:
 - Form 1099-B reflects gross or net proceeds for a stock or mutual fund
 - Form 1099-S usually reflects gross proceeds of real estate transactions
 - Other evidence in the absence of the above



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), How/Where to Enter Income and Capital Gain or Loss Transactions Worksheet.

What is the basis of stock?

Basis

In order to compute gain or loss on a sale, taxpayers must provide their basis in the sold property. The basis of property is usually its cost.

- If taxpayers need help determining their basis and do not have the original purchase documents, refer them to their stockbroker.
- If taxpayers cannot provide their basis in the property, the IRS will deem it to be zero.

Special rules apply to inherited property; these rules are covered in this lesson, in the topic, “Basis Other Than Cost.” If the taxpayer acquired the stock by means other than a purchase or inheritance, such as a gift or an employee stock option plan (ESOP), and does not know the basis of the stock, refer them to a professional tax preparer. The determination of basis in these situations is beyond the scope of VITA/TCE.

Adjusted Basis

An adjustment to basis may include additional commissions or fees paid to the broker at the time of purchase or sale.

Events after the purchase of stock can require adjustments (increases or decreases) to the per share basis of stock.

Stock is bought and sold in various quantities. It is important for the taxpayer to keep track of the basis per share of all stock bought and sold. Events that occur after the purchase of the stock can require adjustments (increases or decreases) to the “per share” basis of stock. The original basis per share can be changed by events such as stock dividends, stock splits, and DRIP (dividend reinvestment plan) accounts.

- Stock dividends are issued in lieu of cash dividends. These additional shares increase the taxpayer's ownership so the original basis is spread over more shares, which decreases the basis per share.
- A stock split is a method used by corporations to lower the market price of stock. A two for one stock split will decrease the basis per share by half. The original basis of \$200 for 100 shares becomes \$200 for 200 shares.
- DRIP accounts leave cash dividends with the company for the purchase of additional shares. Even though these shares are from the same company, they retain their own individual basis separate from the original purchase. Each new purchased share could have a different basis.



Although stock splits and stock dividends do not occur often, always ask taxpayers if they received any additional shares from these transactions.

Taxpayers should keep track of their basis in mutual fund shares.

- The original basis of mutual fund shares bought is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.
- The original cost basis of mutual fund shares acquired by reinvesting distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution was an exempt-interest dividend that was not reported as income.
- The basis in mutual fund shares may need to be increased or reduced. For more information, refer to Publication 550.

example

Alice paid \$1,100 for 100 shares of ABC, Inc. stock (which included the broker's commission of \$25). The original basis per share was \$11 ($\$1,100 \div 100$). She received 10 additional shares as a tax-free stock dividend. Her \$1,100 basis must be allocated to the 110 shares (100 original shares plus the 10-share stock dividend). This results in an adjusted basis of \$10 per share ($\$1,100 \div 110$).

Basis Other than Cost

There are times when cost alone cannot be used as basis. In some cases, the fair market value (FMV) or adjusted basis is used.

- Property Received as a Gift – To determine the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. Taxpayers also need to know the FMV at the time of the donation and the amount of any gift tax paid on the donation. Determination of the adjusted basis of property received as a gift can be very complex. It is beyond the scope of VITA/TCE.
- Inherited Property
 - Before 2010 and after 2010: the basis of property inherited during this time is generally the FMV of the property on the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date or other acceptable method. If the basis of the inherited property is determined by a method other than the FMV of the property on the date of the decedent's death, it is beyond the scope of VITA/TCE. Refer the taxpayer to a professional tax preparer.

- During 2010 (after December 31, 2009, and before January 1, 2011): special rules may apply to property inherited from a decedent who died in 2010. Determining the basis of such property can be complex. Refer taxpayers to a professional tax preparer for determination of basis issues. For more information on the special rules, see Publication 4895, Tax Treatment of a Property Acquired from a Decedent Dying in 2010.

For additional information on how to figure the basis, refer to the Basis of Property chapter in Publication 17, Your Federal Income Tax for Individuals.



If the taxpayer knows the basis of property that was inherited or received as a gift, you can provide assistance. If they do not know the basis of the property, refer the taxpayer to a professional tax preparer.

How do I determine the holding period?

Long-Term or Short-Term

NEW For purchases prior to 2011, taxpayers must provide the date the stock was acquired. Beginning in 2011, brokers must report the date of acquisition and whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities. Generally, a noncovered security is:

- A security other than stock
- Stock purchased before 2011
- Stock in most mutual funds and other regulated investment companies
- Stock held in a dividend reinvestment plan in 2011

Taxpayers will have to continue to provide the information for noncovered securities not reported on Form 1099-B.

Form 1099-B will also indicate the date the stock was sold. These two dates will determine the holding period. Capital gains and losses are either long-term or short-term, depending on how long the taxpayer owned the stock. Stock held for:

- One year or less has a short-term holding period
- More than one year has a long-term holding period

The holding period begins the day after the shares were purchased and includes the day the shares were sold. If investment property is inherited, the capital gain or loss is treated as long-term. This is true regardless of how long the property is held (except for property inherited in 2010).

You may provide assistance to taxpayers who sold property inherited from someone who died in 2010 as long as the taxpayer knows the basis and the correct holding period. Refer taxpayers who do not know this information to a professional tax preparer. Determining basis and the correct holding period for property inherited in 2010 is complex and outside the scope of VITA/TCE. See Publication 4895 for more information.

Determining the correct holding period is important because short-term gains are taxed at regular income tax rates and long-term gains are taxed at a lower rate than the other income reported on the return.

Stock acquired as a nontaxable stock dividend or stock split has the same holding period as the original stock owned. They are considered to have been acquired on the same day as the original stock. Stock acquired in a DRIP has its own purchase date. The holding period for stock received as a taxable stock dividend begins on the date of distribution.



If a taxpayer acquired property from a decedent who died in 2010, special rules may apply in determining tax items including basis, gain, loss, holding period, and character for the property. Determining these tax items is complex and outside the scope of the VITA/TCE program.

example

Erma bought stock on January 11, 2010 (trade date). Her holding period began the next day, January 12, 2010. If she sold that stock on January 11, 2011, she would own the stock exactly one year, and the holding period would be short-term. However, if she sold the stock on January 12, 2011 or later, the holding period would be one year and one day, which constitutes long-term.

example

Lenny bought 500 shares of XYZ Corporation stock for \$1,500, including his broker's commission. Five years later, XYZ distributed a 2% nontaxable stock dividend (10 shares). Three days after the stock dividend was distributed, Lenny sold all his XYZ stock for \$2,030.

Although Lenny owned the 10 shares for only three days, all the stock has a long-term holding period. Stock acquired as a nontaxable stock dividend has the same holding period as the original stock owned. Because he bought the stock for \$1,500 and then sold it for \$2,030 more than a year later, Lenny has a long-term capital gain of \$530 on the sale of his 510 shares.

If taxpayers do not have the purchase documents or other records showing date of purchase and cost, refer them to their stockbroker or financial planner.

For additional information on the holding period and other tax consequences of selling or trading investment property, refer to the Sale of Property Chapter in Publication 17. Some of these issues and transactions, such as like-kind exchanges, wash sales, and worthless securities can be complex. Refer taxpayers with these issues to a professional tax preparer.



In general, a wash sale occurs when a taxpayer sells or otherwise disposes of stock or securities (including a contract or option to acquire or sell stock or securities) at a loss and, within 30 days before or after the sale or disposition, the taxpayer buys, acquires, or enters into a contract or option to acquire substantially identical stock or securities.

Mutual Funds

A mutual fund is a regulated investment company generally created by “pooling” funds of investors providing the advantage of a diversity of investments and professional management.

Owners of mutual funds may receive both Form 1099-DIV and Form 1099-B. Form 1099-DIV reports capital gain distributions from sales of stock held by the mutual fund. Profits of these sales are reported to the shareholders of the fund as capital gain distributions. If taxpayers (owners) decide to sell any of their shares in the mutual fund itself, Form 1099-B will be issued. The taxable gain or loss from the sale or exchange of the taxpayer's shares in a mutual fund is reported on Schedule D.

If mutual fund dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if both the new shares and the original shares are sold, there may be both short-term and long-term gains and losses.

To figure the gain or loss on the disposition of mutual fund shares, which shares were sold and the basis of those shares need to be determined. If the shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices, making it more difficult to figure the basis. Taxpayers can choose to use either a cost basis or an average basis to figure the gain or loss. For more information on how to report the sale or exchange of mutual fund shares, refer to Publication 550.

Stock

Some taxpayers may own shares of stock they bought on different dates or for different prices. This means they own more than one “block” of stock. Each block may differ from the others in its basis (the amount paid for the stock), its holding period (long-term or short-term), or both.

In directing a broker to sell stock, the taxpayer may specify which block, or part of a block, to sell. This is called “specific identification.” To be valid, the specification must be made before or at the time of sale, **not** after the sale. If the taxpayer does not do this, the shares are sold from the earliest block purchased (FIFO method – or First In, First Out).

example

Marie bought 100 shares of Antrim Corporation stock for \$2,000. A year later, she bought another 100 shares of Antrim for \$2,300. Five years later, she sold 100 shares of Antrim for \$3,000 but she did not identify the specific block at the time of sale.

Because Marie purchased the earliest block of 100 shares at \$2,000, the adjusted basis of the shares she sold was \$2,000. The sales price of the 100 shares sold was \$3,000. Marie had a long-term capital gain of \$1,000.

However, if she had told her broker to sell the 100 shares from the second block of stock she bought, the adjusted basis would have been \$2,300, giving Marie a long-term capital gain of \$700.

What information do I need from Form 1099-B?

Sale of stock is reported to the taxpayer on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions. Form 1099-B is prepared by the broker who handled the sale of the stock. If box 5, 10, 11, 12, 13, or 14 has an entry, refer the taxpayer to a professional tax preparer. These boxes provide information about wash sales, regulated futures contracts, and bartering, which are out of scope for the VITA/TCE program.

NEW New boxes have been added to Form 1099-B for reporting the date of acquisition (box 1b), cost or other basis (box 3), amount of loss disallowed due to a wash sale (box 5), whether the property sold is a noncovered security (box 6), and whether the gain or loss is short-term or long-term (box 8). Brokers must complete boxes 1b, 3, 5, and 8 when reporting sales of securities unless box 6 is checked. Box 7 is reserved for future use. Other boxes on the form have been moved or renumbered.

If box 6 is checked, the securities sold were noncovered securities and boxes 1b, 3, 5, and 8 may be blank.

Date of Sale or Exchange

In box 1a on Form 1099-B, the stockbroker reports the date the stock was sold. If the securities sold were noncovered securities, use this date, along with the purchase date provided by the taxpayer, to determine the holding period. If the securities sold were covered securities, the stockbroker reports on Form 1099-B, box 1b, the date the stock was acquired, and in box 8, whether the gain was short-term or long-term.

Sales Price

In box 2 on Form 1099-B, the stockbroker reports the sales price of the stock and checks a box to indicate if the amount in box 2 is the sales price (gross proceeds) or sales price less commissions and option premiums (net proceeds):

- If sales price (gross proceeds) is checked, ask the taxpayer for the amount of commissions/fees paid and add it to the taxpayer’s basis
- If sales price less commissions and option premiums (net proceeds) is checked, the broker already subtracted the commissions and fees from the proceeds

example

Richard sold stock for \$2,300. He paid his broker a commission of \$35 on the sale and received net proceeds of \$2,265. Richard's broker has reported the sales price:

- Box 2 of Form 1099-B shows \$2,300
- The box next to sales price is checked

Because box 2 shows the sales price, the broker's commissions and fees (\$35) are added to Richard's basis in the stock to compute the capital gain or loss.

<input type="checkbox"/> CORRECTED (if checked)		
PAYER'S name, street address, city, state, ZIP code, and telephone no.	1a Date of sale or exchange	OMB No. 1545-0715
	1b Date of acquisition	2011
	Form 1099-B	
	2 Sales price of stocks, bonds, etc. \$ 2,300	Reported to IRS <input checked="" type="checkbox"/> Sales price <input type="checkbox"/> Sales price less commissions and option premiums
PAYER'S federal identification number	RECIPIENT'S identification number	3 Cost or other basis
		4 Federal income tax withheld



Tax Software Hint: Add the broker's commissions and fees to the basis in the stock before entering the amount on the Capital Gain or Loss Transactions Worksheet. To review information related to the software, go to the Volunteer Resource Guide (Tab 2).



EXERCISES

Answers are after the lesson summary.

Question 1: Kevin paid his broker a \$75 fee on the sale of his stock. Box 2 of his Form 1099-B shows \$925, and the box next to sales price is checked. What is the amount Kevin reports as his sales price?

- A. \$925
- B. \$1,000
- C. \$850
- D. \$75

Other Information

If the securities sold were noncovered securities, Form 1099-B would not report the date the stock was originally purchased, the original purchase price, or any adjustments to the basis. Some brokers report this information on a tax reporting supplement. If not, the taxpayer must provide this information.

TIP

Some brokers do not issue standard Forms 1099-B. Instead, they may issue their own statement sometimes entitled *1099 Consolidated Statement* or *Substitute 1099*, which shows stock sales and other types of distributions, such as dividends and interest.

Thelma Emerson 123 Any Street Your City, State Zip Account Number: 1234-5678-9012 SSN: XXX-XX-XXXX		ABC Investments 456 Main Street Your City, State Zip Phone (XXX) XXX-XXXX FEIN: XX-XXXXXXX		2011 12-31-11	
Substitute 1099-B					
Date of Sale Box 1a	Stocks, Bonds-Sales price (less commision) Box 2	Description Box 9	Noncovered Security Stocks Sold in 2011 Box 6		
2-23-11	\$ 2,100.00	20 shares Tractor Company	<input checked="" type="checkbox"/>		
6-1-11	\$ 900.00	100 shares Car Company	<input checked="" type="checkbox"/>		
6-22-11	\$14,000.00	500 shares Couch Company	<input checked="" type="checkbox"/>		
7-5-11	\$ 2,000.00	25 shares Technology Company	<input checked="" type="checkbox"/>		
Substitute 1099-DIV					
Payer	Ord. Div. Box 1a	Qual. Div. Box 1b	Cap. Gain. Dist. Box 2a	FIT Withheld Box 4	Foreign Tax Box 6
Car Company	\$ 45.00	\$ 45.00	\$ 0.00	\$0.00	\$ 0.00
Couch Company	\$910.00	\$910.00	\$ 0.00	\$0.00	\$ 0.00

How do I enter data on Form 8949 and Schedule D?

There is a change in the way capital gain and loss transactions are reported.

NEW In 2011, Form 8949, Sales and Other Dispositions of Capital Assets, replaces Schedule D-1 for reporting information from Form 1099-B. Schedule D was revised to allow for entries from the new Form 8949 and changes made to Form 1099-B.

All capital gains and losses are detailed on Form 8949; none are reported directly on Schedule D. The subtotals from Form 8949 are carried over to Schedule D, where aggregate gain or loss is calculated. Short- and long-term transactions are listed by the following categories:

- Transactions reported on Form 1099-B that show basis in box 3
- Transactions reported on Form 1099-B that do not show basis in box 3
- Transactions not reported on Form 1099-B

A check box on Form 8949 identifies the type of transaction reported; a taxpayer with more than one type of transaction must file a separate form for each type.

Form 8949, column (b) is for a code that indicates adjustments to gain or loss, such as wash sales, exclusion of gain on main home, etc. Column (g), the last column on the form, indicates the amount of the adjustment to gain or loss. Designating the last column as adjustment to gain or loss allows for adjustments and exclusions to be reported on the same line as their corresponding transaction, instead of on a subsequent line.

Here are some examples of the Form 8949 codes and how to complete columns (b) and (g):

IF...	THEN enter in column (b)	AND...
The taxpayer sold a main home and can exclude some or all of the gain from the sale	B	Enter the amount of excluded (nontaxable) gain as a negative number (in parentheses) in column (g)
The taxpayer has a nondeductible loss other than a loss indicated by code AR, W, or PA	C	Enter the amount of the nondeductible loss as a positive number in column (g)
The taxpayer received Form 1099-B (or substitute statement) and the type of gain or loss indicated in box 8 is incorrect	H	Leave column (g) blank; report the gain or loss in the correct Part of Form 8949
The taxpayer received Form 1099-B (or substitute statement), the basis shown in box 3 is incorrect, and the correct basis is higher than the basis shown in box 3 of Form 1099-B (or substitute statement)	I	Enter the difference between the two amounts as a negative number (in parentheses) in column (g)
The taxpayer received Form 1099-B (or substitute statement), the basis shown in box 3 is incorrect, and the correct basis is lower than the basis shown in box 3 of Form 1099-B (or substitute statement)	J	Enter the difference between the two amounts as a positive number in column (g)
The taxpayer has an adjustment not explained above in this column	N	Enter the appropriate adjustment in column (g)

The Schedule D instructions provide instructions for completing Form 8949, including the codes for column (b).



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), Capital Gain or Loss Transactions Worksheet. All entries are made on this worksheet. The software determines the holding period and enters the correct information on Form 8949 and Schedule D.

How do I report capital gain distributions?

Capital gain distributions are reported to the taxpayer on Form 1099-DIV. If there is no capital gain from the sale of property, enter the Form 1099-DIV amount on Form 1040, line 13.

If a taxpayer has both Form 1099-DIV *and* Form 1099-B, then capital gain distributions are added to Schedule D, Part II, line 13.



EXERCISES (continued)

Question 2: Which of the following taxpayers is required to file Form 1040 and Schedule D?

- A. Marriah, who received one Form 1099-B and no Forms 1099-DIV
- B. Lorraine, who received Forms 1099-DIV for capital gain distributions from three different mutual funds
- C. Both of the above



Tax Software Hint: If the source documents (Forms 1099-DIV and 1099-B) are recorded properly in the tax preparation program, then the numbers will be reported in the proper places. The amount from Form 1099-DIV, box 2a, will be entered on the Dividend Statement for Schedule B (along with the other information) and will automatically carry over to the capital gain distributions line (line 13) in Schedule D, Part II.

example

Eldridge received a Form 1099-DIV. Box 2a shows he received a total capital gain distribution of \$170. Eldridge also received a Form 1099-B that shows a net sales price of \$1,200 on the sale of 600 shares of ABC Group, Inc. He held the stock for over 6 years. His basis in ABC, including commission, is \$1,455.

Eldridge must use Schedule D to report his capital gain distribution because he sold stock that must be reported on Schedule D.

How do I complete reporting of capital gain or loss?

Form 8949 contains all capital gain and loss transactions; none are reported directly on Schedule D. The subtotals from Form 8949 are carried over to Schedule D, where gain or loss is calculated in aggregate.

Combining all the amounts in the gain or (loss) column on Schedule D, Part I, results in a net short-term capital gain or loss. Combining all the amounts in the gain or (loss) column on Schedule D, Part II, results in a net long-term capital gain or loss.

The combination of the net short-term and net long-term capital gains or losses impacts the tax liability. If there is a combined net capital loss in excess of \$3,000 (or if Married Filing Separately, in excess of \$1,500), then the excess is carried to the next tax year and forward until exhausted. Carryover losses retain their original holding period.

example

Bill bought 1,000 shares of stock for \$15,000 (including commission). One year later he sold 600 shares of the stock for \$7,800, net proceeds. Bill had a net loss of \$1,200 as shown below:

$$\text{Basis} = (\$15,000 \div 1,000) \times 600 = \$9,000$$

$$\text{Sales Price} = \$7,800$$

$$\text{Gain or Loss} = \text{Sales Price} - \text{Basis} = \$7,800 - \$9,000 = -\$1,200$$

Bill had a short-term loss of \$1,200.

example

Margo bought stock for \$1,500, plus a \$25 commission; 18 months later she sold all the stock for \$2,000 and paid a \$25 commission. Her Form 1099-B shows the gross proceeds of \$2,000 as the sales price.

$$\text{Basis} = (\$1,500 + \$25 + \$25) = \$1,550$$

$$\text{Sales Price} = \$2,000$$

$$\text{Gain or Loss} = \text{Sales Price} - \text{Basis} = \$2,000 - \$1,550 = \$450$$

Margo had a long-term gain of \$450.



EXERCISES (continued)

Question 3: Stella's cost basis for 600 shares of KLM Corporation stock she purchased was \$2,400. After holding the stock for seven years, Stella sold the 600 shares for \$4,400 and paid a \$100 commission. Her broker reported the gross proceeds of \$4,400 on Form 1099-B. What was the sales price for the shares and the amount of capital gain?

- A. \$4,400 sales price and \$2,000 gain
- B. \$4,400 sales price and \$1,900 gain
- C. \$4,500 sales price and \$2,100 gain
- D. \$4,300 sales price and \$1,900 gain

How do I calculate and report a carryover of a capital loss?

A taxpayer cannot take net losses of more than \$3,000 (\$1,500 for married taxpayers filing separately) in figuring taxable income for any single tax year. The allowable loss is referred to as the deduction limit. Unused losses can be carried over to later years until they are completely used up. The carryover losses are combined with the gains and losses that actually occur in the next year.

Capital Loss Carryover Worksheet

To figure any capital loss carryover from 2010 to 2011, use the Capital Loss Carryover Worksheet from the 2011 Schedule D instructions. To complete the worksheet, you will need information from the 2010 return.

Ask taxpayers for their 2010 Schedule D Worksheet (Capital Loss Carryovers from This Year to Next Year) from the previous year to determine the carryover amounts from 2010 to 2011.

- Enter short-term capital loss carryovers on Schedule D, Part I, line 6
- Enter long-term capital loss carryovers on Schedule D, Part II, line 14

If the taxpayer's 2011 capital loss exceeds the deduction limit and the remainder must be carried forward to 2012, remind the taxpayer to bring a copy of the 2011 return when the 2012 return is prepared. Make a note on the outside of the taxpayer's tax return record envelope to alert next year's preparer. Next year, whomever assists the taxpayer will use the Capital Loss Carryover Worksheet in the 2012 Schedule D instructions or the printed copy of the Schedule D Worksheet to figure how much capital loss the taxpayer can carry over from 2011 to 2012.

For additional information on Schedule D, capital gains and losses, and carryovers, refer to the Reporting Gains and Losses chapter in Publication 17.



Tax Software Hint: Tax software automatically calculates the taxpayer’s capital loss. If the loss is over the limit, tax software reports the maximum allowable deduction. The remainder can be carried over to future tax years.

Taxpayer Interview and Tax Law Application

Taxpayers Jeremy and Janice Smith checked the “Yes” box for interest/dividend income on the intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

JEREMY RESPONDS...

Previously we discussed your dividends from the Pembroke Fund, reported on Form 1099-DIV. Did you have any other income from the sale of stock, securities, or other investments?

Yes, I sold some stock this year.

Do you have a 1099 for that?

Yes, I have this Form 1099-B and this stockbroker’s statement.

[Later in interview] Earlier, you gave me this 1099-DIV from a mutual fund and these 1099-B forms from the stocks you sold. We already included the capital gain distribution from the mutual fund when we entered the dividends. We’ll enter the stock sale information now. I see the broker’s statement has the sale details I need, but do you know when you purchased the Purdue stock?

I bought the Purdue stock back on July 13, 2000.

I see the sale date was March 10, 2011. That means the holding period for the stock was more than one year. They call that long-term, and it determines both where the information is reported and the tax rate for any gain. Now, do you know the basis for the stock?

What is that?

That’s what it cost you, including any broker fees or commissions.

Yes, it cost \$10,053, plus I had to pay \$35 in fees.

Have you had any other costs related to the stock since then, such as additional fees?

No, that’s it. Wait, when I sold it, I had to pay \$35 more.

That means that the basis for the stock is \$10,123. The 1099-B shows that you received gross proceeds of \$8,859 when you sold the stock. We’ll put all these numbers into this worksheet in the tax software. As you can see, the software has calculated your net loss; this is the sales price minus the basis, for a net loss of \$1,264. After I enter these other transactions from the broker’s statement, we’ll get a final net gain or loss on Schedule D. This will determine the amount that will be reported on Form 1040, line 13.

[Indicate Jeremy’s responses to these questions on the intake and interview sheet.]

Who must file Form 8949 and Schedule D for the sale of a home?

To determine if the sale of the taxpayer's residence must be reported on Form 8949 and Schedule D, identify whether the home was the taxpayer's main home, if the taxpayer meets the ownership and use tests, and if the gain is more than the allowed exclusion amount. For additional guidance in making this determination, refer to the Selling Your Home Chapter in Publication 17 or Publication 523.

To determine if the taxpayer meets the criteria for reporting the sale of a home, use the interview techniques and tools discussed in the Screening and Interviewing lesson. The intake and interview sheet lists income from the sale of real estate. Ask taxpayers if they sold any real estate, such as their principal residence or "main home" during the tax year. The taxpayer may be eligible to exclude all or part of the gain from their taxable income.



Taxpayers who claimed the first-time homebuyer credit and then sold their home may have to repay the credit. For more information, refer to Lesson 27, Other Taxes, and Form 5405.

Who must report the sale of a home?

Taxpayers must report the sale of a home when one of the following is true:

- The taxpayer does not meet the ownership test.
- The taxpayer does not meet the use test.
- During the two-year period ending on the date of the sale, the taxpayer has excluded the gain from the sale of another home.
- The taxpayer has a gain and does not qualify to exclude all of it.
- The taxpayer has a gain and chooses not to exclude it.
- The taxpayer has a loss and received Form 1099-S.

Exclusion Amount

Taxpayers who sold their main home may be able to exclude gain up to a maximum of \$250,000 (\$500,000 for married taxpayers who file a joint return).

Generally, if the taxpayer can exclude all of the gain, it is not necessary to report the sale. If the taxpayer has gain that cannot be excluded, it is taxable and reported on the return.

A loss on the sale cannot be deducted, however, the taxpayer may be required to report it.

What is considered a "main" home?

Only gain from the sale of a taxpayer's main home may be excluded from the taxpayer's income; gain from a sale of a home that is *not* the taxpayer's main home will generally have to be reported as income.

A taxpayer's "main" home is where they live most of the time. It does not have to be a traditional house; for example, it may be a houseboat, mobile home, cooperative apartment, or condominium, but it must have cooking, sleeping, and bathroom facilities. The taxpayer's main home may also be a rented house or apartment. Taxpayers with more than one home cannot choose which home to designate as their main home.

example

Lucille owns a home in a Colorado ski area (the ski home). She stays at the ski home most weekends and spends the entire months of December, January, and February there. When she is not at the ski home, she lives in a four-room apartment that she rents in Denver. Even though she does not own it, Lucille's main home is her rental apartment in Denver, because she lives there most of the time.

What are the ownership and use tests?

To claim the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, taxpayers must have:

- Owned the home for at least two years (the ownership test), and
- Lived in the home as their main home for at least two years (the use test)

There are special rules for Armed Forces, intelligence personnel and Peace Corps volunteers in the application of the five-year period. See “Five-year Test Period Suspension” later in this lesson.

The required two years of ownership/use do not have to be continuous. Taxpayers meet the tests if they can show that they owned and lived in the property as their main home for either a total of 24 full months or 730 days (365 x 2) during the five-year period ending on the date of sale. Short, temporary absences are counted as periods of use even if the property is rented during those absences.

Ownership and use tests can be met during different two-year periods. However, a taxpayer must meet both tests during the five-year period ending on the date of the sale.

example

In 2003, Helen lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2008. In 2009, Helen became ill and on April 14 of that year she moved into her daughter’s home. On July 10, 2011, while still living in her daughter’s home, she sold her apartment.

Helen can exclude all the gain on the sale of her apartment because she met the ownership and use tests. Her five-year period is from July 11, 2006, to July 10, 2011, the date she sold the apartment. She owned her apartment from December 1, 2008, to July 10, 2011 (over two years). She lived in the apartment from July 11, 2006 (the beginning of the five-year period) to April 14, 2009 (over two years).



EXERCISES (continued)

Question 4: Emily, who is single, bought a home in 1998. She lived in the home until May 31, 2009, when she accepted an assignment with the Peace Corps in Venezuela and left the house vacant. Emily returned to her home on May 31, 2010 and lived there until she sold the house on January 10, 2011. Does Emily meet the ownership and use test? Yes No

Reduced Exclusion

Taxpayers who owned and used a home for less than two years (and so do not meet the ownership and use test) may be able to claim a reduced exclusion under certain conditions. These include selling the home due to a change in place of employment (beyond a certain distance), health, or unforeseen circumstances. If any apply, refer the taxpayer to a professional tax preparer. Reduced exclusion computations/determinations are beyond the scope of VITA/TCE.

example

Jennifer, who is single, bought her first home in August 2009. In December 2010, the company she worked for notified her that she would be transferred to another town by the end of 2011. She continued to live in the home until June 2011, when she sold it at a gain and moved 500 miles to the new town. Jennifer owned and lived in the home less than two years, so she does not meet the ownership and use tests. However, she may qualify to exclude all or part of the gain because she sold the home due to a change in place of employment. Jennifer should be referred to a professional tax preparer.

Prior Exclusions

In addition, during the two-year period ending on the date of the sale, the taxpayer must not have claimed an exclusion on a gain from the sale of another home.

Married Homeowners

The ownership and use tests are applied somewhat differently to married homeowners. Married homeowners can exclude up to \$500,000 if they meet *all* of these conditions:

- They file a joint return
- Either spouse meets the ownership test
- Both individuals meet the use test
- Neither one excluded gain in the two years before the sale of the current home

If either spouse does not satisfy all these requirements, they cannot claim the maximum exclusion (\$500,000). The most they can claim is the total of the maximum exclusions each would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. This calculation is outside the scope of VITA/TCE.

Sale of Main Home by Surviving Spouse

Beginning with main home sales after 2007, the maximum exclusion (\$500,000) by an unmarried surviving spouse is allowed if the sale occurs no later than two years after the date of the spouse's death, and all other requirements are met.

How do I figure the gain (or loss) from the sale of a home?

After determining that a taxpayer is eligible for the exclusion, figure the gain (or loss) on the sale based on the selling price, amount realized, basis, and adjusted basis. If the selling price of the taxpayer's home is less than the allowable exclusion of up to \$250,000 (\$500,000 if Married Filing Jointly), it is not necessary to calculate the gain; none of it will be taxable. Loss on the sale of a residence is not deductible. For more information, see the Selling Your Home section in Publication 17.

TIP

If the taxpayer used the home for business purposes or as rental property after May 6, 1997, refer them to a professional tax preparer. The taxpayer cannot exclude the part of the gain equal to the depreciation allowed or allowable as a deduction.

Selling Price

The selling price is the total amount taxpayers (the seller) received for their main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received.



A loss on the sale of a personal residence is not deductible.

If the taxpayer received Form 1099-S, Proceeds from Real Estate Transactions, use it to figure the selling price. Box 1 shows the date of sale (closing) and box 2 shows the gross proceeds received from the sale of the home. For taxpayers who did not receive a Form 1099-S, use sale documents and other records.



If the taxpayer can exclude the entire gain from the sale of a main home, the person responsible for closing the sale (i.e., a real estate broker or settlement agent) generally will not issue Form 1099-S. If Form 1099-S is issued and you determine that the gain is excludable, the sale should be recorded on Form 8949 and Schedule D to notify the IRS of the exclusion.



If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, the taxpayer *must* report the loss on Form 8949 and Schedule D even though it is not deductible.

Amount Realized

The amount realized is the selling price minus selling expenses (commissions, advertising fees, legal fees, and loan charges paid by the seller, such as points). Amount realized can be calculated using Worksheet 2, Taxable Gain on Sale of Home, in Publication 523. (A similar worksheet is available in the tax software.)

$$\begin{aligned} \text{Amount realized} &= \text{Selling price} - \text{Selling expenses} \\ \$246,000 &= \$250,000 - \$4,000 \end{aligned}$$



EXERCISES (continued)

Question 5: Jan meets the eligibility requirements for claiming the exclusion on the gain from the sale of his home. The selling price of the home was \$195,000. The selling expenses were \$15,000. What is the amount realized in this sale?

Basis

The basis in a home is determined by how the taxpayer obtained the home. If a taxpayer bought or built a home, the basis is what it cost the taxpayer to buy or build that home. If the taxpayer inherited the home, the basis is its fair market value on the date of the decedent’s death, or on the later alternate valuation date chosen by the representative for the estate.



Determining the basis of property inherited in 2010 is complex and outside the scope of the VITA/TCE program. Taxpayers who sold such property should be referred to a professional tax preparer if they do not know the basis and the correct holding period.



Alternative valuation issues and determining the adjusted basis of property received as a gift can be very complex and are outside the scope of this training. Advise the taxpayer to seek assistance from a professional tax preparer.

Adjusted Basis

The adjusted basis is the taxpayer’s basis in a home increased or decreased by certain amounts. Increases include additions or improvements to the home such as building a recreation room or adding a bathroom. In order to be considered an increase, the improvement must have a useful life of more than one year. Repairs that maintain the home in good condition are not considered improvements and should not be added to the basis of the property.

Decreases to basis include deductible casualty losses and gains a taxpayer postponed from the sale of a previous home before May 7, 1997. Decreases can also include depreciation during the time the home was used for business purposes or as rental property. If any of these decreases apply, the taxpayer should be referred to a professional tax preparer.

TIP

To figure the adjusted basis of a home, use Worksheet 1, Adjusted Basis of Home Sold, in Publication 523.

$$\text{Adjusted basis} = \text{Basis} + \text{Increases} - \text{Decreases}$$

How much of the gain from a home sale can a taxpayer exclude?

Once you've determined the gain or loss on the sale of a taxpayer's main home, next figure the exclusion and any taxable gain from the sale.

If all the requirements are met, an individual taxpayer may exclude up to \$250,000 of the gain from taxable income; taxpayers who use the Married Filing Jointly filing status may exclude up to \$500,000.

TIP

Use Worksheet 2, Taxable Gain on Sale of Home in Publication 523 to figure the gain or loss, the exclusion, and the taxable gain from a sale. Note that line 3 is the amount realized, line 4 is the adjusted basis, and line 5 is the amount of gain or loss from the sale.



Taxpayers who claimed the first-time homebuyer credit may be required to repay the credit in the year of sale. The repayment is limited to the amount of gain on the sale. For more information on how to adjust the basis of the home if the first-time homebuyer credit was received and exceptions to the repayment rule, see the Form 5405 Instructions.

Gain from the sale or exchange of a main home is not excludable from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period in 2009 or later where neither the taxpayer nor spouse (or former spouse) used the property as a main home (with certain exceptions). A list of exceptions to a period of nonqualified use can be found in Publication 523. To figure the portion of nonqualified use, multiply the gain by the following fraction:

$$\frac{\text{Total nonqualified use during period of ownership in 2009 or later}}{\text{Total period of ownership}}$$

This issue can be complex. Refer taxpayers with "nonqualified use" issues to a professional tax preparer.

Where do I report any taxable gain from the sale of a home?

Proceeds from the sale of a main home that meets the ownership and use tests must be reported only if the gain is greater than the taxpayer's allowed exclusion; only the excess must be reported. Gain from the sale of a home that is *not* the taxpayer's main home will generally have to be reported as income.

In both cases, the gain is taxable gain. The sale must be reported on Form 8949 and Schedule D. If the home was used for business purposes or as rental property, the gain would be reported on Form 4797 and the taxpayer should be referred to a professional tax preparer.

If the amount realized is less than the adjusted basis, the difference is a loss, which cannot be deducted. However, taxpayers who received Form 1099-S for a loss on the sale of a main home must report the loss on Form 8949 and Schedule D even though it is not deductible. Reporting the transaction should prevent the taxpayer from receiving a notice from the IRS.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).



Boxes A-C on Form 8949 are not the same as the codes entered in column b.

This is how to report the taxable gain and exclusion amount for the sale of a main home.

Form 8949 (2011) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side. **Your social security number**

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

Note. Please round and use whole dollars on this form.
Check the box below that describes the transactions listed on this page.
Caution. Check only one box. If you have more than one type of transaction, complete a separate Form 8949 for each type.

(A) Long-term gains and losses (Form 1099-B, box 3, shows basis) (B) Long-term gains and losses (Form 1099-B, box 3, does not show basis) (C) Long-term gains and losses (Form 1099-B not received)

3	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Code	(c) Date acquired (Mo., day, yr.)	(d) Date sold (Mo., day, yr.)	(e) Sales price (see instructions)	(f) Cost or other basis (see instructions)	(g) Adjustments to gain or loss
	Main home - Section 121 Exclusion	B	09/03/2004	07/07/2011	789,000	226,000	(500,000)
4	Totals. Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, line 8 (if box A above is checked), line 9 (if box B above is checked), or line 10 (if box C above is checked) ▶				789,000	226,000	500,000

Form **8949** (2011)

SCHEDULE D (Form 1040) Capital Gains and Losses

Department of the Treasury Internal Revenue Service (99) **▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.**

OMB No. 1545-0074 **2011** Attachment Sequence No. **12**

Name(s) shown on return **Your social security number**

7 Net short-term capital gain or (loss). Combine lines 4 through 6 in column (h)

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

Note: Please round and use whole dollars on this form.

	(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		()		
9 Long-term totals from all Forms 8949 with box B checked in Part II		()		
10 Long-term totals from all Forms 8949 with box C checked in Part II	789,000	(226,000)	(500,000)	63,000
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss)				

How do I report a nondeductible loss if taxpayer received Form 1099-S on the sale of a main home?

If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, you must report the loss on Form 8949 and Schedule D even though it is not deductible.

This is how to report a loss on the sale of a main home when a taxpayer received Form 1099-S.

Form 8949 (2011)		Attachment Sequence No. 12A		Page 2				
Name(s) shown on return. Do not enter name and social security number if shown on other side.				Your social security number				
Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year								
Note. Please round and use whole dollars on this form.								
Check the box below that describes the transactions listed on this page.								
Caution. Check only one box. If you have more than one type of transaction, complete a separate Form 8949 for each type.								
<input type="checkbox"/> (A) Long-term gains and losses (Form 1099-B, box 3, shows basis)		<input type="checkbox"/> (B) Long-term gains and losses (Form 1099-B, box 3, does not show basis)		<input checked="" type="checkbox"/> (C) Long-term gains and losses (Form 1099-B not received)				
3	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Code	(c) Date acquired (Mo., day, yr.)	(d) Date sold (Mo., day, yr.)	(e) Sales price (see instructions)	(f) Cost or other basis (see instructions)	(g) Adjustments to gain or loss	
	Main home - Form 1099-S	C	07/31/2005	10/25/2011	189,000	235,000	46,000	
4 Totals. Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, line 8 (if box A above is checked), line 9 (if box B above is checked), or line 10 (if box C above is checked)					4	189,000	235,000	46,000
Form 8949 (2011)								

SCHEDULE D (Form 1040)		Capital Gains and Losses		OMB No. 1545-0074			
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.		2011 Attachment Sequence No. 12			
Name(s) shown on return				Your social security number			
7 Net short-term capital gain or (loss). Combine lines 4 through 6 in column (g)							
Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year							
Note: Please round and use whole dollars on this form.				(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II					()		
9 Long-term totals from all Forms 8949 with box B checked in Part II					()		
10 Long-term totals from all Forms 8949 with box C checked in Part II				189,000	(235,000)	46,000	0
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss)							

Taxpayer Interview and Tax Law Application

Jeremy and Janice Smith checked the “Yes” box for selling some real estate on the intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

JEREMY RESPONDS...

Did you sell a home during 2011?

Yes, I was going to mention that to you because I should get a tax break on that.

Well, you may be able to exclude all or part of your gain from that sale, but to find out, I have to ask you a few questions. First, how long did you own the home?

Three and a half years.

And was it the main place you lived for at least two years of that time?

Well, yes, sort of. We lived and worked on a cruise ship for six months and let my brother live there while we were gone.

That's okay, the rule is that it must be the main place you lived for a total of 24 full months or 730 days during the five-year period prior to the sale. During the two years before you sold the house did you claim an exclusion on a gain from another house?

No, this is my only house.

Did you receive Form 1099-S?

No, but I do have my paperwork from the sale. My real estate broker said I wouldn't need that form because I was within the limits.

Your paperwork shows a selling price of \$360,000. Do you have anything that lists the basis in the home, that is, the value of the home at the time you bought it?

Yes, I bought it for \$280,000 and put in \$20,000 of improvements – mostly new bathrooms.

Clearly, with a basis of \$300,000, your gain from the sale is \$60,000 or less. As a married couple who meets the ownership and use tests, you can exclude up to \$500,000 from the sale, so you don't have to report the sale on your return.

[Indicate Jeremy's responses to these questions on the intake and interview sheet.]

What is the Five-Year Test Period Suspension?

Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on “qualified official extended duty” as a member of the uniformed services or Foreign Service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. This means that the taxpayer may be able to meet the two-year use test even if the taxpayer and/or spouse did not actually live in the home during the normal five-year period required of other taxpayers.

Taxpayers are on qualified official extended duty if they serve at a duty station at least 50 miles from their main home or live in government quarters under government order. Taxpayers are considered to be on extended duty when they are called to active duty for more than 90 days or an indefinite period.

Period of Suspension

The period of suspension cannot last more than ten years. Together, the ten-year suspension period and the five-year test period can be as long as fifteen years. The suspension can be used on only one property at a time.

For more information about the suspension of the five-year test period, see Members of the Uniformed Services or Foreign Service, Employees of the Intelligence Community, or Employees or Volunteers of the Peace Corps, in Publication 523.



This extension of time can apply to taxpayers who have recently left the military.

example

Peter bought a home in 2002 and lived in it for 2½ years. Beginning in 2005, he was on qualified official extended duty in the U.S. Army. He sold his home in 2011 and had a \$12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2006–2011). Because of the suspension, Peter's test period is the five years before he went on qualified official extended duty.



EXERCISES (continued)

Question 6: John purchased a home in 2000. Through your interview process, you discover that he sold his main home in 2011. John had not lived in the home for six years. Which of the following conditions would allow John to exclude his gain?

- A. John went on sabbatical for four years and backpacked through Europe.
- B. John lived with a co-worker for four years and let his brother occupy his home.
- C. John was deployed to Europe on official extended military duty for five years.
- D. John married and his bride had her own home. The couple chose to live in the wife's home and rent out John's home, until it was sold.

Summary

This lesson covered how to report the sale of stock and the sale of a principal residence. A taxpayer must use Form 8949 and Schedule D to report capital gains and losses on the sale of assets. You learned how to identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, and the amount of capital loss carryover.

Qualified taxpayers may be able to exclude a portion of the gain on the sale of their main home if they meet the ownership and use tests. Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on qualified official extended duty as a member of the uniformed services or foreign service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. A loss on the sale of a principal residence is not deductible but must be reported if the taxpayer received Form 1099-S.

Special rules apply to foreclosures and cancellation of debt income on a principal residence. Under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers may exclude certain debt forgiven on their principal residence. These rules are covered in a specialty course on Link & Learn Taxes for volunteers with an Advanced, Military, or International Certification.

The worksheets in Publication 523 help you figure the taxable gain from the sale of a home using selling price, amount realized, basis and adjusted basis, along with the maximum allowed exclusion.

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

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

- Taxpayers who have sold any assets other than stock, mutual funds, and a personal residence
- Determination of basis issues:
 - Basis of stock acquired other than by purchase or inheritance, such as a gift or employee stock option plan
 - Basis of inherited property determined by a method other than the FMV of the property on the date of the decedent's death
 - Basis of property acquired from a decedent who died in 2010
 - Basis of property received as a gift
- Like-kind exchanges, wash sales, and worthless securities
- Form 1099-B, boxes 5, 10, 11, 12, 13, 14
- Reduced exclusion computations/determinations in the sale of a home
- Married homeowners who do not meet all requirements to claim the maximum exclusion
- Decreases to basis, including:
 - Deductible casualty losses and gains a taxpayer postponed from the sale of a previous home before May 7, 1997
 - Depreciation during the time the home was used for business purposes or as rental property
- Taxpayers with “nonqualified use” issues
- Sale of a home used for business purposes or as rental property



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.



EXERCISE ANSWERS

Answer 1: A. Never adjust the sales price. If box 2 shows sales price (gross proceeds), add the broker's fee to the basis or purchase price of the stock.

Answer 2: A. Only Marriah sold stock and received Form 1099-B.

Answer 3: B. The sales price was \$4,400, which was \$1,900 more than the adjusted basis of \$2,500 (\$2,400 cost + \$100 commission) of the shares.

Answer 4: Yes. Emily meets the ownership and use test because she owned and lived in the home for at least two years of the five-year period ending on the date of the sale.

Answer 5: The amount realized on Jan's sale is \$180,000 (selling price minus selling expenses).

Answer 6: C. The only circumstance that will allow John to exclude the gain is if he can extend the five-year period due to official extended military duty.



Lesson 11: Income – Retirement Income; Form 1040, Lines 15-16



Introduction

This lesson will help you identify and report the taxable portion of retirement income received by the taxpayer. To do this, you must understand the types of retirement income and the forms used to report them. You should also be able to recognize when taxpayers should adjust their withholding and determine which form to use.

This lesson does not cover social security benefits or tier 1 railroad retirement benefits (social security equivalent benefits), which are discussed in the Social Security Benefits lesson.

For more information on the topics discussed in this lesson, see Publication 575, Pension and Annuity Income; Publication 590, Individual Retirement Arrangements (IRAs); Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits; and Publication 939, General Rule for Pensions and Annuities.

Objectives

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

- Identify how retirement income is reported to the taxpayer using Form 1099-R series
- Calculate the taxable portion of different types of retirement income
- Determine how to report retirement income on the tax return
- Determine when an adjustment to withholding should be made

What is retirement income?

Retirement income can include social security benefits as well as any benefits from annuities, retirement or profit sharing plans, insurance contracts, IRAs, etc. Retirement income may be fully or partially taxable. For information about social security benefits and tier 1 railroad retirement benefits, see the Social Security Benefits lesson.

Where can I get information about a taxpayer's retirement income?

To determine if the taxpayer must report retirement income, use the interview techniques and tools discussed in the Screening and Interviewing lesson. Review the taxpayer's completed intake and interview sheet, particularly the Income section. If the taxpayer had retirement income, you may need to ask additional questions to clarify the type of plan, whether the income was before-tax or after-tax dollars, etc. This is explained later in this lesson.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Publication 575
- Publication 590
- Publication 721
- Publication 919
- Publication 939
- Form 1040 Instructions
- Form 1099-R
- Form 5329
- Form 8606
- Form W-2
- Form W-4P
- Form W-4V
- Simplified Method Worksheet

- 9. Disability income (such as payments from insurance or pension) (Form 1099-R, W-2)
- 10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R)
- 11. Unemployment Compensation? (Form 1099-G)

Be considerate when probing for the information you need to complete the return. When taxpayers cannot provide the required information (and have not retained the packet of “retirement papers” they received when they retired), suggest that they contact their former employer or annuity administrator. You may even give the taxpayer a written list of questions that need to be resolved.

Form 1099-R Series

Retirement income can be reported on:

- Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments),
- Form CSF 1099-R, Statement of Survivor Annuity Paid, and
- Form RRB 1099-R, Annuities or Pensions by the Railroad Retirement Board

If Form 1099-R is for an IRA-type distribution, it will be indicated in box 7.

Examples of these forms can be found in Publication 4491-W. These forms indicate such information as the amount received, the taxable portion, and the taxpayer’s cost (investment) in the plan. If the taxable amount is indicated, Intermediate certified volunteers can complete the return. In general, if the taxable amount is not indicated, volunteers certified in Advanced, Military, and/or International must calculate the taxable portion using the Simplified Method Worksheet covered later in this lesson.

What if the taxable portion is already calculated?

In many instances, the payer will compute the taxable portion of the distribution and report it in box 2a of Form 1099-R. Taxpayers with Form RRB-1099-R can only be helped by volunteers certified in the Advanced, Military, or International courses, because the taxable portion is not shown on the form.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2), 1099-R Pension and Annuity Income.

Amounts from Form 1099-R are reported as follows:

- If the IRA/SEP/SIMPLE box is **not** checked on Form 1099-R, the gross amount (box 1 of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040, line 16a
- If the IRA/SEP/SIMPLE box is checked on Form 1099-R, report the gross amount on Form 1040, line 15a
- If the IRA/SEP/SIMPLE box is **not** checked on Form 1099-R, the taxable amount (box 2a of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040, line 16b
- If the IRA/SEP/SIMPLE box is checked on Form 1099-R, report the taxable amount on Form 1040, line 15b

Any amount in box 4 of Forms 1099-R, CSA- and CSF-1099-R should be entered in the Payments section of the tax return.



What if the taxable portion is not calculated?

If the payer did not include an amount in box 2a of Form 1099-R, CSA- or CSF-1099-R, or if taxpayers have Form RRB 1099-R, you will need to compute the taxable portion of the distribution. The following will help you determine the additional information needed to calculate the taxable portion of distributions from IRAs, pensions, or annuities.

What do I need to know about retirement income distributions?

Retirement plans are funded by either before-tax or after-tax contributions. “Before-tax” simply means that the employee did not pay taxes on the money at the time it was contributed, i.e., the taxpayer has no cost basis in the plan. “After-tax” means the employee paid taxes on the money when it was contributed, i.e., the taxpayer *has* a cost basis in the plan.

If the taxpayer made all contributions to a plan with before-tax dollars, the entire distribution will be fully taxable. The funds are taxed at the time of the distribution because neither the contributions nor the earnings/investment gains were previously taxed. This is common in 401(k) and Thrift Savings plans.



If the taxpayer did *not* contribute to the retirement plan, all the distributions are fully taxable.

If the taxpayer made all contributions to a plan with after-tax dollars, then the distributions will be partially taxable. The portion of the distribution that is considered a return of the after-tax dollars will not be taxed again. It is considered a return of the taxpayer’s cost basis (an amount for which taxes have already been paid). The portion of the distribution that represents the earnings/investment gains *is* taxable since it has not been previously taxed. This is common in employer retirement plans.

Employee Contributions	Contributions		Taxability of Distributions	
	Before-Tax	After-Tax	Fully	Partially
No	n/a	n/a	Yes	—
Yes	Yes	—	Yes	—
Yes	—	Yes	—	Yes

example

Mark retired after working 30 years for a construction company. Each week, he contributed to the Carpenter’s Pension Plan. Every year, Mark paid tax on the gross amount of his salary, including his pension contribution. This means his pension contributions were made with dollars that had already been taxed. Now that he is receiving payments from the pension, he will not be taxed on the portion that represents his contribution; he *will* be taxed on the portion that represents earnings.



Taxpayers may not always understand why they must pay taxes on their retirement income. When this is the case, take the time to clearly explain what retirement funds are taxed and why. It is usually a good idea to question taxpayers about the nature of their contributions to ensure that they will not be taxed twice on the same funds.

How do I find the taxable portion of IRA income?

Individual Retirement Arrangements

IRA distributions are reported on Form 1099-R with a check in box 7. Earnings and investment gains in a taxpayer's IRA generally accumulate tax free or tax deferred until they are withdrawn as fully- or partially-taxable distributions. There are four kinds of IRAs, each with different tax implications:

- Traditional IRA
- Roth IRA
- Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Simplified Employee Pension (SEP) IRA

Traditional IRA

Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made. See the Adjustments lesson for additional information. Form 8606, Nondeductible IRAs, is used to keep track of nondeductible contributions. Taxpayers who made nondeductible contributions should be referred to a professional tax preparer.

example

Richard contributed \$500 a year to a traditional IRA. Each year, he deducted these contributions from his income. This year he received his first distribution from the traditional IRA. It is fully taxable: Richard will pay income tax on the distributions he receives, which represent the contributions he made and deducted, as well as the earnings on these contributions over the years.

Roth IRA

Distributions from a Roth IRA are tax free and may be excluded from income if the following requirements are met:

- The distribution is made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for the taxpayer's benefit, *and*
- The distribution is:
 - Made on or after age 59½, or
 - Made because the taxpayer was disabled, or
 - Made to a beneficiary or to an estate, or
 - To pay certain qualified first-time homebuyer amounts (up to a \$10,000 lifetime limit)

If the above requirements are not met, the Roth IRA distributions could be partially taxable and subject to a 10% additional tax. Refer taxpayers in this situation to a professional tax preparer.

TIP

When you learn about IRA accounts in the Adjustments to Income lesson, be sure to note the difference between "contributions" and "deductions." Simply put, contributions are the amounts deposited into an IRA account, and deductions are the portion of the contribution that is deducted on the tax return; that portion may be total or partial.

TIP

Taxpayers are considered disabled if they cannot engage in any substantial gainful employment because of a physical or mental condition. A physician must determine that the condition can be expected to result in death or to be of long, continued, and indefinite duration.



The next two topics are out of scope for VITA /TCE. The definitions are included for your information only.

Savings Incentive Match Plans for Employees (SIMPLE) IRA

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SIMPLE plan. The employer is also generally required to make contributions on behalf of eligible employees. Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA, and the distributions are fully taxable when the employee receives them in later years.

Simplified Employee Pension (SEP) IRA

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SEP plan. Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Because of this, distributions are generally fully taxable when the employee receives them in later years.



EXERCISES

Answers follow the lesson summary.

Question 1: Distributions from all IRAs discussed in this topic are fully taxable with the exception of the Roth IRA. True False

Question 2: Mary opened a Roth IRA 3 years ago. This year, she took the full amount of her Roth IRA as a distribution to help her purchase her first home. The entire distribution is excluded from her taxable income. True False

Question 3: Amy contributed to a Roth IRA for 5 years. In year 6 (at age 60), she took a distribution from her IRA. The entire distribution is excluded from her taxable income.
 True False

How are IRA distributions reported?

Traditional IRA

If IRA/SEP/SIMPLE is checked in box 7 of Form 1099-R, ask the taxpayer:

- Was this a distribution from a traditional IRA?
- Were the contributions deducted from income in the year they were made?

If so, the entire distribution is taxable. Report the distributions on Form 1040, line 15b. It is not necessary to enter the amount on line 15a. If not, the distribution is partially taxable. In that case, refer the taxpayer to a professional tax preparer.

Roth IRA

Distributions from a Roth IRA are not taxable as long as they meet all the criteria discussed previously. If the distribution does not meet the criteria, then all or part of the funds will be taxable; refer the taxpayer to a professional tax preparer.

TIP

An early distribution from a traditional or Roth IRA may be subject to a 10% additional tax. Refer to the Other Taxes lesson for more information.

TIP

Distributions from a SIMPLE IRA and from a SEP IRA are generally fully taxable and are out of scope for VITA/TCE.

How are rollovers handled?

Generally, a rollover is a tax-free distribution to the taxpayer from one retirement account (traditional IRA or employer's pension plan) that rolls over into a similar retirement account within 60 days.

Form 1099-R will be issued to the taxpayer by the financial institution. If it was a direct rollover by the institution to another institution, box 7 will contain code G. If there is no code G, then the taxpayer must have redeposited the full amount into an appropriate account within 60 days. If this was not done, the distribution may be partially or fully taxable; refer the taxpayer to a professional tax preparer.

What about a rollover from a Roth IRA?

Most of the rules for rollovers to traditional IRAs apply to Roth IRAs. Generally, a withdrawal of all or part of the assets from one Roth IRA and a contribution to another Roth IRA within 60 days is tax free. A rollover from a Roth IRA to an employer retirement plan is not allowed.

If there is a direct rollover of a designated Roth account distribution to a Roth IRA, box 7 of Form 1099-R will contain code H.

If the distribution does not meet the tax free rollover requirements, all or part may be taxable; refer the taxpayer to a professional tax preparer.



Tax Software Hint: Additional information must be entered for retirement account rollovers. Refer to the Volunteer Resource Guide (Tab 2), 1099-R Exclusion Worksheet.

If you are preparing a paper return, the amount of the distribution is reported on Form 1040, line 15a. To show that this is a qualified rollover and none of the amount is taxable, enter zero on Form 1040, line 15b, and write "Rollover" next to line 15b.



EXERCISES (continued)

Question 4: Andrew changed jobs and received Form 1099-R from his previous employer. The amount in box 1 is \$11,200. Andrew deposited the entire \$11,200 into his IRA within 30 days of receiving the check (rollover).

Which of the following statements is true?

- A. The entire distribution is includible as income
- B. The entire distribution is excludible from income
- C. The distribution is eligible for the ten-year tax option
- D. The distribution is eligible to be taxed at a special rate

What if the distribution is used for charitable purposes?

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended tax-free distributions from individual retirement plans for charitable purposes for two years (2010 and 2011).

The taxpayer can have a qualified charitable distribution (QCD) made to an organization eligible to receive tax-deductible contributions. If all requirements are met, this action will exclude any part of the distribution that would normally be taxable. Form 1099-R would be issued to the taxpayer; there is no distribution code for box 7 that identifies a QCD. Distributions from an IRA (other than an ongoing SEP or SIMPLE IRA) are eligible.

Requirements for a QCD include:

- The taxpayer must be at least 70½ at the time of the distribution
- The distribution must be made by the trustee directly to the eligible organization
- The aggregate amount of QCDs excluded from the taxpayer's gross income cannot be more than \$100,000 (on a joint return, the spouse is eligible for the same amount)
- The amount cannot be included with other charitable contributions on Schedule A

To qualify as a QCD, the IRA trustee must make the distribution directly to the qualified charity. Any distributions, including any Required Minimum Distributions (RMDs), that the IRA owner actually receives cannot qualify as QCDs.

The taxpayer may have marked the box for charitable contributions on the intake and interview sheet. If taxpayers have Form 1099-R for a traditional IRA account and either taxpayer or spouse are at least 70½, ask if any of the funds were a direct transfer to a charitable organization.

Taxpayers should have a written acknowledgment from the recipient indicating there was no personal benefit to the taxpayer that states:

- The organization's name,
- The amount, and
- The date

This amount counts toward the required minimum distribution (see Minimum Distributions later in this lesson).

If any part of the distribution is a return of after-tax contributions, Form 8606 may need to be completed. Form 8606 requires basis information about IRAs from prior years and can be complex. Refer taxpayers who may need to file Form 8606 to a professional tax preparer.



Tax Software Hint: You must indicate in the software if a qualified charitable contribution was made. Refer to the Volunteer Resource Guide (Tab 2), 1099-R Exclusion Worksheet.

TIP

If a QCD is made in January 2011, the taxpayer can elect to treat it as if it was made in 2010. If this election is made, the QCD is included in the 2010 \$100,000 exclusion limit, as well as the 2010 RMD. For more information, see Publication 590, Individual Retirement Arrangements (IRAs).

How do I find the taxable portion of pensions and annuities?

Fully Taxable Pensions and Annuities

Pension and annuity income is reported on Form 1099-R (box 7 is unchecked), Form CSA 1099-R, and Form RRB 1099-R. In general, pension or annuity payments are fully taxable, if the following is true:

- Taxpayers did not pay any part of the cost of their pensions or annuities
- Employers did not withhold part of the cost from the taxpayers' pay while they worked
- Employers withheld part of the cost from the taxpayer's before-tax pay while they worked

TIP

Social security benefits and IRA distributions are not reported on the pension line of the tax return.

example

Sue worked for a software development company for 20 years. She retired and began receiving pension income the same year. Sue never contributed to the pension plan while she was working; her employer made all of the contributions. Her pension is fully taxable.

Partially Taxable Pensions and Annuities

Two methods used to figure the taxable portion of each pension or annuity payment are the General Rule and the Simplified Method. Unless an exception applies, retirees must use the Simplified Method for annuity payments from a qualified plan. A qualified plan is established by an employer to provide retirement benefits for employees and their beneficiaries. Employees typically do not pay taxes on plan assets until the assets are distributed; furthermore, earnings on qualified plans are tax deferred. If a taxpayer tells you they have been using the General Rule to figure the taxable portion for past years, refer them to a professional tax preparer.



If the taxpayer's annuity starting date is before July 2, 1986, the General Rule has to be used unless the Three-Year Rule can be used.

The Simplified Method is used to calculate the tax-free portion of each pension or annuity payment. The Simplified Method Worksheet calculates the taxpayer's cost basis for each monthly payment. The number of monthly payments is based on the taxpayer's age (and the spouse's age if a joint/survivor annuity is selected by the taxpayer) on the annuity start date.

Taxpayer's cost basis ÷ Number of monthly payments = Monthly Tax-Free Portion



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2), 1099-R Exclusion Worksheet, for more information on calculating the taxable portion using the Simplified Method.

Be sure to include any amounts in box 4 of Form 1099-R in the Payments section of the tax return.

To calculate the taxable portion of a pension or annuity using the Simplified Method, you will need certain information:

- The cost in the plan (box 9b of Form 1099-R)
- The taxpayer's age on the date the annuity began (and the spouse's age if joint/survivor annuity is selected); note if the annuity starting date is before or after the taxpayer's birthday for that year
- Total of tax-free amounts from previous years, available from the taxpayer's prior year worksheet

If the taxpayer has more than one Form 1099-R that is not fully taxable, calculate the tax-free portion for each form separately.

example

Melvin retired from a manufacturing plant. While he was working at the plant, his employer withheld money from each paycheck and sent it to the Engineer's Pension Fund. Melvin will receive a monthly pension payment for the rest of his life. Melvin will use the Simplified Method Worksheet to determine the tax-free part of monthly payments.



EXERCISES (continued)

Question 5: Dotty worked for the local tire plant for 32 years. She retired in June and receives a monthly pension of \$1,679. (She received six payments for July through December.) Dotty never contributed to the pension plan; her employer made all of the contributions. How much of her pension is taxable?

- A. \$12,074
- B. \$11,074
- C. \$10,074
- D. \$1,679

Disability Pension Income

Generally, taxpayers who retire on disability must include all of their disability payments in income. Disability payments are taxed as wages until the taxpayer reaches the minimum retirement age – *this age is set by the employer*. After the taxpayer reaches the minimum retirement age, disability payments are treated as pension income to determine taxability.

Minimum retirement age is generally the earliest age at which taxpayers may receive a pension, whether or not they are disabled.

Employers may report disability income on one of the following forms:

- Form W-2, if the taxpayer has not reached the minimum retirement age set by the employer
- Form 1099-R, if the taxpayer has reached the minimum retirement age

If both the taxpayer and the employer pay for a disability insurance plan, only the amount the taxpayer receives because of the employer's payments is taxable as income. The taxpayer's employer should be able to give specific details about the pension plan and the amount the taxpayer paid for the disability pension.

If the taxpayer has not reached the minimum retirement age, report the disability income as wages on Form 1040, line 7. If the taxpayer has reached the minimum retirement age, report the disability income as a taxable pension on Form 1040, line 16b.



When disability pay is treated as wages, it might affect Earned Income Tax Credit.



Some employers report disability income on Form 1099-R regardless of the taxpayer's age. You must confirm employers' minimum retirement age. If the taxpayer is under the retirement age, the volunteer must take steps in the software to ensure the income is properly reflected as wages on Form 1040, line 7.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2), 1099-R Pension and Annuity Income, for more information on how to report disability pay to ensure it is reported on the correct line of Form 1040.



EXERCISES (continued)

Question 6: Annie Jo is 47 years old and has retired on disability from her job. While loading cargo for a tractor-trailer company, a large box fell on her and left her paralyzed. She receives a monthly payment from her former employer's pension plan. She has not reached the minimum retirement age set by her company's pension plan. On which line of her Form 1040 should you report her disability income?

- A. Line 63
- B. Line 16a
- C. Line 16b
- D. Line 7

Retired Public Safety Officers

Eligible public safety officers can elect to exclude from income distributions of up to \$3,000 made directly from a government retirement plan to the provider of accident, health, or long-term disability insurance. See Insurance Premiums for Retired Public Safety Officers in Publication 575 for more information.



Tax Software Hint: If the taxpayer is eligible for the exclusion, refer to the Volunteer Resource Guide (Tab 2), 1099-R Exclusion Worksheet.

What other retirement income issues are there?

There are a few other issues related to reporting retirement income that you may encounter. Some of the following distributions are subject to various additional taxes that are computed on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. If certain exceptions are met, the additional tax does not apply.

Only the exceptions for early distributions not subject to the additional tax (Part I of Form 5329) are included in scope for the VITA/TCE training. Refer taxpayers who must complete other information on Form 5329 to a professional tax preparer. Form 5329 and exceptions are covered in Lesson 27, Other Taxes.

Lump-Sum Distributions

A lump-sum distribution is the distribution or payment within one tax year of an employee's entire balance from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains. The distribution does not include certain deductible voluntary employee contributions and certain amounts forfeited or subject to forfeiture. Distributions from IRAs or tax-sheltered annuities do not qualify as lump-sum distributions. To qualify as a lump-sum distribution, the payment must have been made:

- Because the plan participant died, or
- After the participant reached age 59½, or
- Because the participant (not including a self-employed individual) separated from service with the employer, or
- After the participant, if self-employed, became totally and permanently disabled

Lump-sum distributions are reported on Form 1099-R like any other pension distribution. Some lump-sum distributions qualify for special tax treatments. If Form 1099-R, box 7 indicates a distribution code of A, it is a lump-sum distribution qualifying for special tax treatments. Taxpayers with this situation should be referred to a professional tax preparer.

Premature Distributions

A premature distribution is an early withdrawal from a retirement fund, for purposes other than retirement, by a taxpayer who is under 59½. Early distributions can be subject to an additional 10% tax. The tax applies to the taxable portion of the distribution or payment.

If the distribution code in box 7 is 1, the taxpayer will be subject to the additional 10% tax, unless an exception applies.

Certain early distributions are excluded from the early distribution tax. If the distribution code in box 7 of Form 1099-R is 2, 3, or 4, the taxpayer does not have to pay the additional tax. The exceptions for excluding early distributions from the additional tax are covered in more detail in the Other Taxes lesson.

Minimum Distributions

To avoid an additional tax, participants in retirement plans must begin taking a Required Minimum Distribution (RMD) by a previously specified date. That date is April 1 of the calendar year following the year in which the taxpayers either reached age 70½, or retired, whichever is later. For IRAs, it does not matter if the taxpayer is employed. These rules do not apply to Roth IRAs. The trustee of the qualified plan will contact the taxpayer at the appropriate time to begin RMD.

After the starting year for RMDs, taxpayers must receive the minimum distribution for each year by December 31 of that year. (The starting year is the year in which the taxpayer reaches 70½ or retires.) If no distribution is received during the taxpayer's starting year, the required minimum distributions for two years must be received the following year, one of which must be taken by April 1.



If the taxpayer does not receive the minimum distribution, an additional tax may be imposed. The tax is 50% of the difference between the minimum distribution and the amount actually distributed for the tax year.

This information is provided for your information only, to help you answer any questions a taxpayer may ask about RMD. RMD distributions are reported on Form 1099-R and included on the return using the procedures previously discussed.

example

Peter turned 70½ on August 20, 2011. For 2011, he must receive the required minimum distribution from his IRA by April 1, 2012. He must receive the required minimum distribution for 2012 by December 31, 2012.

example

Ralph retired in 2005. He turned 70½ in 2011. He must begin taking minimum distributions from his qualified plans by April 1, 2012.

example

Myrna was 72 when she retired in 2011. She was required to begin taking minimum distributions from her traditional IRA after age 70½ even though she has not retired. Myrna has until December 31, 2011 to take her 2011 minimum distribution..

Withdrawal of Excess IRA Contributions

An excess IRA contribution is the amount contributed to a traditional IRA during the year that is more than the smaller of:

- \$5,000 (\$6,000 if age 50 or older), or
- The taxable compensation for the year

The taxpayer may not know that a contribution is excess until the tax return is completed after the end of the year. In this situation, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, the taxpayer will be subject to an additional 6% tax on this amount.

The withdrawn excess contribution is not included in the taxpayer's gross income if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn by the due date of the return, including extensions

However, taxpayers must include the earnings on the excess contribution as income on the return. This income is reported on the return for the year in which the excess contribution was made. The withdrawal of interest or other income may also be subject to an additional 10% tax on early distributions.

If the taxpayer is subject to an additional tax due to excess IRA contributions or early distributions, refer them to professional tax preparer.



EXERCISES (continued)

Question 7: Taxpayers who withdraw excess contributions and earnings on the excess contributions by the end of the tax year are not subject to an additional 6% tax on the excess contribution.

- True False

Question 8: Helen turned 70½ on March 17, 2011. She retired in 2001. She has never taken any distribution from her traditional IRA accounts. The bank told her that she now needs to take a minimum distribution of \$1,479 per year. Helen is required to:

- A. Take a distribution of \$1,479 by December 31, 2011
- B. Take a distribution of \$1,479 by April 1, 2011, and another \$1,479 by December 31, 2011
- C. Take a distribution of \$2,958 by December 31, 2011
- D. Take a distribution of \$1,479 by April 1, 2012, and another \$1,479 by December 31, 2012

How do I determine when an adjustment to withholding should be made?

After the completion of the return, if the taxpayer owes \$1,000 or more on the tax return, you should discuss their withholding and estimated tax options with them. This is covered in more detail in the Concluding the Interview lesson.

Sometimes taxpayers are not aware they can request that federal income tax be withheld from their retirement income by filing Form W-4P, Withholding Certificate for Pension or Annuity Payments. This form is sent to the payer. Also, Form W-4V, Voluntary Withholding Request, is used to request withholding from social security benefits. This form is sent to the Social Security Administration.

For additional help, taxpayers can refer to Publication 919, How Do I Adjust My Tax Withholding?, or visit the IRS Web site at www.irs.gov and use the “Withholding Calculator.” A taxpayer who chooses not to have tax withheld may have to pay estimated tax each quarter. Failure to pay enough federal income tax throughout the year can result in a large amount of tax being owed when the return is due. It can also result in a penalty. Form 1040-ES, Estimated Tax for Individuals, is used to calculate the estimated quarterly payment and provides vouchers with which to remit the payments.

TIP

Taxpayers who receive a very large refund may make better use of their funds if tax withholding is lowered. Explain ways they can reduce their withholding.



EXERCISES (continued)

Question 9: Faith comes to your site to get her tax return done. When you finish her return, you explain to her that she owes \$985, and that she needs to pay this amount by April 15. She says that she will pay the amount, but wants to know if there is some way to have more tax withheld from her pension so that she doesn't owe so much at the end of the year. Which form should she complete to increase the withholding from her pension?

- A. Form W-4P
- B. Form W-4V

Summary

This lesson helped you identify, calculate, and report the taxable portion of retirement income received by the taxpayer. It reviewed the types of retirement income and the forms used to report them. You learned when taxpayers of retirement age are required to take a minimum distribution from a retirement plan and when they may need to adjust their withholding.

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

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

- Retirement income from SIMPLE IRAs and SEP IRAs
- The taxpayer needs to file Form 8606
- Taxpayers who made nondeductible contributions to a traditional IRA
- Taxpayer subject to additional tax due to excess IRA contributions or early distributions
- Roth IRA distributions that are taxable or partially taxable
- IRA rollovers that do not meet the tax free requirements
- Part of a distribution is a return of after-tax contributions (may require Form 8606)
- Taxpayers who used the General Rule to figure the taxable portion of pensions and/or annuities for past years
- Form 1099-R, box 7 distribution code A (lump-sum distribution qualifying for special tax treatments)



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.



EXERCISE ANSWERS

Answer 1: *False. In addition to Roth IRAs, nondeductible contributions to traditional IRAs are also not taxed when they are distributed.*

Answer 2: *False. Mary's distribution was not made after the 5-year period beginning with the first taxable year she made a contribution to her Roth IRA. Therefore, the earnings/investment gains portion of the distribution will be taxable income. (She may also owe an additional tax on early distributions. This will be discussed in Lesson 27.)*

Answer 3: *True. Amy's distribution can be excluded from her taxable income because it was made more than five years after the beginning of the taxable year of her first contribution, and it was made on or after age 59½.*

Answer 4: *B. Andrew can exclude the entire distribution from income because it was rolled over into an IRA within the allowed 60-day period.*

Answer 5: *C. Dotty's entire pension amount of \$10,074 (6 x \$1,679) is fully taxable because she has never paid income taxes on her employer's contribution to her pension.*

Answer 6: *D. Because Annie Jo has not reached the minimum retirement age set by her employer, you should report her disability income as wages on line 7 of her Form 1040.*

Answer 7: *True. Taxpayers must withdraw excess contributions and any earnings by the due date of the return (including extensions) to avoid the additional 6% tax on the excess contribution.*

Answer 8: *D. Taxpayers are required to begin receiving distributions from their qualified plan by April 1 of the calendar year following the year in which they reach age 70½. Helen was 70½ in 2011. She should take a distribution of \$1,479 for tax year 2011 by April 1, 2012, and another distribution of \$1,479 for tax year 2012 by December 31, 2012.*

Answer 9: *A. Generally, Form W-4P, Withholding Certificate for Pension and Annuity Payments, is used to request a change in withholding on a pension.*



Lesson 12: Income – Rental and Schedules K-1



Introduction

This lesson covers the reporting of:

- Rental income and expenses for the Military and International courses, and
- Certain income from Schedules K-1 (Forms 1065, 1120S, and 1041)



Generally, the at-risk and passive activity issues in this lesson are beyond the scope of the VITA/TCE program. These issues are referenced for those assisting military members living abroad who have limited access to resources and professional preparers.

To determine if a taxpayer needs to file Schedule E, use the interview techniques and tools discussed in the Screening and Interviewing lesson. The intake and interview sheet provides a line to list income from rental property but does not provide a place to list income from Schedules K-1. It is important to ensure that all income is accurately reported on the return. Ask taxpayers if they rented out their home or other property during the tax year or if they received a Schedule K-1 (Form 1041, Form 1065, or Form 1120S) from an estate, trust, partnership, or S corporation.

Objectives

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

- Determine which types of rental income must be reported
- Identify how to report rental expenses
- Identify Schedule K-1 income items that are within the scope of the VITA/TCE program
- Determine how to report Schedule K-1 income items



Schedule K-1

What is reported on Schedule K-1?

Schedule K-1 is used to report the taxpayer's share of income, other distributions, deductions, and credits from partnerships, S corporations, and some estates and trusts. One copy of Schedule K-1 is sent to the IRS and is later matched with individual returns. Another copy of Schedule K-1 is sent to the taxpayer. Ask taxpayers if they received a Schedule K-1 from such an entity that reflects their share of income, reportable on their Form 1040. It is important to correctly report this income to avoid notices or correspondence from the IRS.



This lesson does not apply to taxpayers who are in the business of renting properties.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Schedule A
- Schedule E

Optional:

- Publication 527
- Publication 541
- Publication 551
- Publication 559
- Publication 925
- Publication 946
- Form 8582
- Schedule K-1 (Form 1041 and Instructions)
- Schedule K-1 (Form 1065 and Instructions)
- Schedule K-1 (Form 1120S and Instructions)

How and where can income be reported?

Income reported on Schedule K-1 will be included on the taxpayer's return in various places depending upon the type of income. Income reported on Schedule K-1 that is within the scope of the VITA/TCE program includes:

- Interest income (1040, line 8a, unless Schedule B is required)
- Dividend income (1040, line 9a, unless Schedule B is required)
- Net short-term capital gains and losses (Schedule D, line 5)
- Net long-term capital gains and losses (Schedule D, line 12)
- Tax-exempt interest income (Form 1040, line 8b)
- Royalty income (Schedule E)



Any other income, deductions, credits, etc., reported on Schedule K-1 is out of scope for VITA/TCE, and the taxpayer should be referred to a professional tax preparer.

NEW The way to report income on Schedule E is different for 2011. In Part I, enter a code 6 for royalties. Refer to the Schedule E Instructions for more information.



Royalty income is in scope for the VITA/TCE Program only when the source document of the royalty income is a Schedule K-1. For these investors, the depletion allowance would already have been figured for them by the partnership or S corporation. Royalty income reported on Form 1099-MISC continues to be out of scope.

Schedule K-1 (Form 1041)

The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041 to report income, gains, losses, etc., of the estate or trust.

Taxpayers receive Form 1041, Schedule K-1, to report their share of income from interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term). The taxpayer's income from these sources should be reported on the appropriate forms and schedules as listed on Form 1041, Schedule K-1, page 2.



Tax Software Hint: The name and identification number of the estate or trust are reported in Part III of Schedule E. For software entries, see the Volunteer Resource Guide (Tab 2), Income. Be sure to review Note 3 on the Income page.

Schedule K-1 (Forms 1065 and 1120S)

Partnerships use Form 1065, Schedule K-1, to report the taxpayers' share of the partnership's income, deductions, credits, etc. In general, a partnership is not subject to income tax and is a flow-through entity. This means the income flows through to the partners, who pay tax on their applicable share.

S corporations use Form 1120S, Schedule K-1, to report the taxpayers' share of the corporation's income (reduced by any tax the corporation paid on the income), as well as any deductions, credits, etc. The S corporation is also a flow-through entity with the income flowing to each shareholder. Shareholders pay tax on their allocated share of the income.

Taxpayers receive a Schedule K-1 (Form 1065 or Form 1120S) reporting their share of income from interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term) from partnerships and corporations. Schedule K-1, page 2, lists the appropriate forms and schedules where taxpayers' income from these sources should be reported.



Schedules K-1 are not filed with the tax return. Advise taxpayers to keep Schedules K-1 with their records.



Tax Software Hint: The name and identification number of the partnership or S corporation are reported in Part II of Schedule E. For software entries, see the Volunteer Resource Guide (Tab 2), Income.



What is rental income?

Generally, payment received for renting a room or a home to a tenant is rental income reportable on Form 1040, Schedule E. U.S. citizens and resident aliens must report rental income, regardless of whether the rental property is located in the U.S. or in a foreign country. Gross rental income may include other payments in addition to the normal and ordinary rents received, such as:

- Advanced rent
- Security deposits
- Payments for breaking a lease
- Expenses paid by the tenant
- Fair market value of property or services received in exchange for rental payments

The taxpayer's method of accounting affects when the rental income is reported. The cash method reports income when received and expenses when paid; most individuals use this method. The accrual method reports income when earned and expenses when incurred, and is out of scope for the volunteer program. Refer taxpayers using the accrual method of accounting to a professional tax preparer.

NEW Schedule E features some changes for 2011, including these new lines:

- Question A – Check the box “Yes” or “No” to the question: Did the taxpayer make any payments in 2011 that would require the filing of Form 1099?
- Question B – If Yes, did or will the taxpayer file all required Forms 1099? Check the box “Yes” or “No.”
- In Part I, line 2 – The number of fair rental value days and number of personal use days is now reported on Schedule E. Previously this was a yes or no question related to personal use.

NEW Schedule E filers will also see a line for merchant card and third party payments reported on Form 1099-K. See Form 1099-K Instructions for more information. Volunteers are unlikely to encounter this situation at volunteer sites.

See the Schedule E Instructions for more information.



Tax Software Hint: Use Schedule E to report rental income only when the taxpayer is not in the business of renting property. For software entries, see the Volunteer Resource Guide (Tab 2), Schedule E – Rental Income and Loss.

See the Schedule E Instructions for more information.



The security deposit is not included in income when the taxpayer plans on returning the deposit at the end of the lease. However, if the security deposit is intended to serve as the last month's rent, then it should be included in income when received.



It is important that property be rented at fair rental value. If a property is rented at less than fair rental value, the income and expenses are reported in a different manner than discussed in this lesson. Refer taxpayers who rent their property at less than fair rental value to a professional tax preparer.

What qualifies as a rental expense?

Taxpayers who reside in homes they own generally itemize and deduct mortgage interest and property taxes on Schedule A. However, when a taxpayer rents out a home, those become rental expenses along with the cost of certain other operating expenses. Taxpayers who do not use the rental home as their residence should:

- Include the rent as income and
- Deduct all of the rental expenses, even if they exceed income

Mortgage interest and property taxes

Mortgage interest and property taxes are deductible as rental expenses. If the residence (or a portion of the residence) was used as rental property for any part of the year, the taxpayer must allocate the property tax and mortgage interest deductions between Schedule A and Schedule E.

In general, taxpayers use Schedule A, Itemized Deductions, to report the portion of the mortgage interest and property taxes that apply to their use of the home. That portion can be based on a percentage of time (4 months as a residence and 8 months used as rental) or based on an area (1,500 sq. ft. as a residence and 500 sq. ft. as the rental portion). For the part of the year and/or the portion of the home that is rented out, taxpayers report rental income and expenses (including a portion of the mortgage interest, property taxes, and other expenses that relate to the rental time/portion of the home) on Schedule E, Supplemental Income and Loss.

If any part of the property tax is designated for local benefits that increase the value of the property, such as maintaining streets and sidewalks, that portion of the tax is added to the basis of the property rather than as an ordinary rental expense or an itemized deduction.

Mortgage interest is reported to the taxpayer on Form 1098, Mortgage Interest Statement. This statement may also include property taxes. If it does not, the taxpayer will have a document from the local taxing authority.

TIP

Generally, mortgage interest expense is fully deductible. However, refer taxpayers with rental-related interest expenses other than mortgage interest to a professional tax preparer.

example

Paul Kingman lived in his home through September, when he was notified he was being transferred overseas. He rented his home beginning in October. The total amount of Kingman's mortgage interest for the tax year was \$2,400 and his property taxes were \$600. Report nine months (January–September) of mortgage interest and property taxes as itemized deductions on Schedule A, that is, \$1,800 and \$450, and the other three months (October–December) as expenses on Schedule E, that is, \$600 and \$150.

What are other deductible rental expenses?

In addition to mortgage interest and property taxes, deductible rental property expenses include these items listed on Schedule E:

- Advertising
- Auto and travel expenses to check on the property
- Cleaning and maintenance
- Commissions paid for collecting rental income
- Insurance premiums
- Mortgage points

TIP

When a tenant does not pay the rent, a cash-basis landlord cannot take a deduction for the unpaid rent. Taxpayers cannot take a deduction for a payment they did not include in income.

- Legal and professional fees
- Property management fees
- Repairs
- Utilities paid for the tenant
- Other rental-related expenses, such as rental of equipment, long distance phone calls, and condominium/cooperative maintenance fees



EXERCISES

Question 1: John Princeton was transferred overseas and began renting out his residence on September 1 of the tax year. How much of his mortgage interest and property taxes should be reported on his Schedule E?

- A. All of it
- B. Eight-twelfths (2/3 or 67%)
- C. Four-twelfths (1/3 or 33%)
- D. None of it

What about property insurance?

The property insurance that taxpayers pay on their residence is deductible as a rental expense for the time it is considered rental property. If the residence is rented for part of the year, only the amount that covers the rental time is deductible. If a portion of the residence is rented, the deductible portion must be allocated and deducted on Schedule E.

Insurance premiums paid more than one year in advance cannot be deducted in one year. All taxpayers must prorate advanced premium payments over the period covered by the policy. The only portion deductible in the current year is that amount that covers the current year.

Can auto and travel expenses be deducted as rental expenses?

Taxpayers can deduct ordinary and necessary travel and transportation expenses attributable to the production of rental income. If the travel was in or outside of the U.S., taxpayers should substantiate the pleasure vs. business portions of the trip and allocate the expenses accordingly.

Taxpayers who use their personal automobile for rental-related trips may use either the standard mileage rate or the actual expense method for business mileage.

The standard mileage method multiplies the miles driven for business by a standard cost. Taxpayers may use the standard mileage rate only if they meet one of these requirements:

- The vehicle was owned and used the standard method the first year the vehicle was put into service or
- The vehicle was leased and used the standard method for the life of the lease

The standard mileage rate for miles driven for business purposes (including rental-related purposes) is:

- 51 cents per mile from January 1, 2011 through June 30, 2011, and
- 55.5 cents per mile from July 1, 2011 through December 31, 2011

The actual expense method figures the deduction based on a variety of factors, including gasoline, oil, repairs, insurance, and rentals and may even involve depreciation or the value of a vehicle provided by the taxpayer's employer.

TIP

This lesson discusses only the standard mileage rate. If taxpayers wish to use the actual method, refer them to a professional tax preparer.

Are repairs and improvements deductible?

Taxpayers often misunderstand when an expense qualifies as a repair or an improvement. A repair keeps the property in good operating condition; the cost is a current year deduction. An improvement adds to the life or material value of the property, prolongs its useful life, or adapts it to new uses; the cost must be depreciated over the recovery period for the improvement. The total cost of an improvement includes material, labor, and installation.



Tax Software Hint: For software entries, go to Schedule E - Rental Income and Loss in the Volunteer Resource Guide (Tab 2).

Repairs (Deduction)	Improvements (Depreciation)
Painting	Adding a room
Fixing gutters	Installing a new fence
Repairing driveways	Putting in plumbing or wiring
Replacing window glass	Replacing a hot water tank
Repairing the roof	Putting on a new roof
Repairing appliances	Replacing/adding major appliances

TIP

Additional information on rental income can be found in Publication 527, Residential Rental Property and Publication 946, How to Depreciate Property



EXERCISES (continued)

Question 2: All of the following are examples of deductible rental expenses *except* _____.

- A. Carpet cleaning fees
- B. Charges for phone calls made to the property manager
- C. Gas and electric bills paid for the tenant
- D. Repairs made to the homeowner's personal residence

Question 3: Which of the following rental expenses must be recovered by taking depreciation?

- A. Home insurance premiums
- B. Painting
- C. Installing a backyard fence
- D. Repairing a broken furnace

How do I handle depreciation of rental property?

The cost of property with a useful life of one year or more, and used in a trade or business or held for the production of income (such as rent), is recovered by deducting an expense called depreciation.

"Depreciable property" includes buildings, machinery, furniture, equipment, vehicles, and any cost for additions or improvements to rental property. The value of land, however, is not depreciable; therefore, the cost of clearing, grading, planting, or other land improvements are also not depreciable.

Depreciation allows the taxpayers to deduct some of the cost of the property each year on their tax return. The annual amount of depreciation on property reduces the taxpayers' basis in that property. Taxpayers should claim the correct amount of depreciation every year. Even if they did not deduct the depreciation during any tax year, they must still reduce their basis in the property by the amount of depreciation that they should have deducted.

What factors determine the amount of depreciation to deduct?

The factors that determine the depreciation amount are:

- Depreciation method used
- Basis of the property
- Recovery period for the property

Depreciation Method

The most common methods for determining depreciation are:

- Straight line or declining balance: Property placed in service before 1981
- ACRS (Accelerated Cost Recovery System): Property placed in service after 1980, but before 1987
- MACRS (Modified Accelerated Cost Recovery System): Property placed in service after 1986

This training focuses on the MACRS method. Under MACRS, conventions are used to determine the portion of the year to depreciate property both in the year the property is placed in service and in the year of disposition. MACRS uses mid-month convention, mid-quarter convention, and half-year convention. The mid-month convention is used to calculate depreciation on residential real property. This means that you treat the property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month.

example

Captain Barbara Ventura purchased a condo in August 2008 for \$225,000, which was her principal residence. The purchase price did not include the cost of any land. She was transferred overseas on December 20, 2010. Repairs were made to the condo in January and February 2011. On March 1, 2011, the property was rented. Assuming her depreciable basis is \$225,000, she is allowed to take 9½ months of depreciation. Using the depreciation table for residential Rental Property, Barbara is allowed a depreciation amount of \$6,478.00. (Multiply the depreciable basis of \$225,000 by .02879 the percentage from Table A-6 of Pub 946.)

example

Captain Ventura bought a new stove that she placed in service on August 27, 2011, for \$1,500. Under MACRS, using the half-year convention, she can take 6 months of depreciation, though the stove was in service for approximately 4 months. The amount of depreciation is calculated by multiplying the depreciable basis of \$1,500 by applicable percentage from Table A-1 of Pub 946.



EXERCISES (continued)

Question 4: Taxpayers have the option of not claiming a depreciation deduction they are entitled to and avoid reducing the basis in their depreciable property.

True False

Question 5: All of the following property may be depreciable *except* _____.

- A. Furniture
- B. Buildings
- C. Land
- D. Vehicles

Question 6: Which method of depreciation is used for property placed in service after 1986?

- A. Straight line
- B. MACRS
- C. ACRS
- D. Declining balance

What is considered the basis and adjusted basis for depreciation purposes?

Generally, the basis for depreciation is the purchase price of the property, including the cost of improvements, but not including the value of the land. When property is converted from personal use to rental use, the basis is the lesser of the adjusted basis or fair market value (FMV) at the time of conversion. The total of the yearly deductions for depreciation can never total more than the basis of the property.



For taxpayers who acquired their home as an inheritance or gift, the basis may not be the original cost. For more information, see Publication 551, Basis of Assets.

example

Carlos and Vanetta purchased a house in 1986 for \$100,000. The value of the building was \$85,000. They made no improvements. In 2011, they were transferred overseas and decided to rent out the home, which was their personal residence. The value of the house and land in 2011 was \$125,000. The basis for depreciation is \$85,000.

The basis of property must be increased or decreased to reflect certain adjustments before the depreciation deduction is computed. To find the adjusted basis, add the purchase price of a home to the cost of any improvements minus:

- Any casualty losses or depreciation previously deducted and
- Land value



Taxpayers cannot include the value of their own labor, or any other labor they did not pay for, in the basis of any property they constructed.

The basis of depreciable property should also be adjusted when it is acquired in a purchase with a trade-in. Again, the value of any associated land must be assessed and excluded from the basis of the property.

What are considered recovery periods?

The recovery period of property is the number of years over which the taxpayer recovers its cost or other basis. The MACRS method uses the class life of property to determine the length of time the property will be depreciated.

example

A set of major appliances that Mark Newcomb used in his rental property had an adjusted basis of \$500. He acquired a set of new appliances with a fair market value of \$2,000 by trading in the old appliances and paying \$1,000 in cash. Although the fair market value of the new appliances was \$2,000, Mark's basis for depreciation purposes is \$1,500 (the \$500 adjusted basis plus his \$1,000 cash payment).



EXERCISES (continued)

Question 7: The purchase price of Wayne's rental property, including land, was \$255,000, when the value of the land was assessed at \$155,000. He spent \$50,000 on improvements to the building and another \$10,000 on landscaping. What is Wayne's basis for depreciation in the property?

- A. \$305,000
- B. \$255,000
- C. \$160,000
- D. \$150,000

How do I figure the MACRS deduction?

To figure the MACRS deduction, you need to know the property's:

- Placed in service date
- Recovery period
- Depreciable basis

What is the placed in service date?

For depreciation purposes, property is considered placed in service when it is in a condition or state of readiness and availability for use. A property's depreciation deduction is prorated in the year it is placed in service. Even if the property is not being used, it is considered in service if it is available for use.

example

Joan Smith moved from her home in July. During August and September, she made several repairs to her house. On October 1, she listed the property for rent with a real estate company, which rented on December 1. The property is considered placed in service on October 1, the date when it was available for rent.

What are considered recovery periods under MACRS?

The recovery period of the property depends on its property class. Each item of depreciable property is assigned to a property class. Property classes are based on the property's class life and determine its recovery period. Under General Depreciation System (GDS), the recovery period of an asset is generally the same as its property class. A table is available in Publication 527, Residential Rental Property, to help determine the correct recovery period for an item.

TIP

See Publication 946, How to Depreciate Property, Appendix A, for Tables of Depreciation, which show the recovery periods for different property classes.

Under MACRS:

- A home converted in 1986, or later, to a rental property would be depreciated over a recovery period of 27.5 years.
- A stove used in this same rental would be assigned a 5-year recovery period.

Property located outside the U.S. has a longer recovery period than property in the U.S., and the taxpayer must use the Alternative Depreciation System (ADS) under MACRS. ADS generally increases the number of years over which the property is depreciated and therefore decreases the annual deduction. Residential rental property located in a foreign country is depreciated over a 40-year recovery period.



EXERCISES (continued)

Question 8: Which of the following properties would generally have the shortest recovery period for depreciation? (Use the table in Publication 527.)

- A. A rental home located in the U.S.
- B. A washing machine in a rental unit located in the U.S.
- C. Improvements to a rental unit located outside the U.S.
- D. A rental home located outside the U.S.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any rental income and expenses. Use the Interview Tips to help obtain additional information, as shown in this sample interview.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

TONY RESPONDS...

I see you were stationed overseas last year from March through December. Did you rent out your home during that time?

Yes. From February 1 through the end of the year. Actually, the tenant was there for thirteen months – he just moved out.

We only need to deal with last year. Now, during January of last year you were the only one living in the house?

Yes, that's right. How does all that affect my taxes?

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

TONY RESPONDS...

For January, we'll report a twelfth of your mortgage interest and property taxes as itemized deductions on Schedule A. For February through December, we'll report your mortgage interest, property taxes, the cost of maintenance and repairs, and other expenses on Schedule E.

O.K.

Now, how much did you receive in rent and other payments from February through December?

There was rent of \$1,200 each month and the last month's cleaning deposit.

I have Form 1098 for your mortgage interest and the invoice for your property taxes. I'll need the amount of your homeowners insurance for the year. Did you have any other expenses related to renting, such as repairs or improvements?

Yes, just before I left the country, I spent \$1,000 having the place painted and I installed a new refrigerator.

We'll report the paint job on Schedule E as an expense. We'll also work out the depreciation on both the house and the refrigerator.

How do I handle rental property that the taxpayer also uses?

When the rental property is a portion of the taxpayer's residence, the rental income and expenses must be allocated separately from the taxpayer's personal expenses.

How do I differentiate between rental expenses and personal use expenses?

Expenses that apply to only the rental part of a property are direct business expenses and should be reported in full on Schedule E. The cost of installing a second phone line strictly for a tenant's use, for example, is deductible as a rental expense. However, the taxpayer cannot deduct any part of the cost of the *first* phone in a partially-rented property, even if tenants use it.

Expenses that benefit the entire property (indirect expenses) must be divided between rental use and personal use; the rental portion is reported on Schedule E. If deductions are itemized, the personal portion of home mortgage interest and property tax may be reported on Schedule A. The taxpayer can choose any reasonable method to allocate the expenses. The most common methods are based on the number of rooms in the dwelling or on the total area of the dwelling.

On Schedule E, report expenses that apply exclusively to the rental room and the allowed percentage of expenses that benefit the entire house. For example, if the rented portion is 10% of the property, the taxpayer could deduct:

- 100% of the cost to wallpaper the tenant's room
- 10% of property taxes, utilities, mortgage interest, and depreciation

example

Gloria rents one room in her 1,200 square foot house to a tenant. The rental room measures 10 feet by 12 feet (120 square feet, or 10% of the total house). She may deduct:

- 100% of any expenses that relate only to the rental portion of the house, such as repairs or upgrades to the rented room
- 10% of any qualified expense that benefits the entire house

When taxpayers can itemize personal deductions on Schedule A, they can report the deductible expenses that benefit the entire house minus the percentage that applies to the tenant's room. In Gloria's case, if she is treating the rental portion as 10% of the residence, she can deduct the following on Schedule A:

- 90% of the mortgage interest
- 90% of the property taxes



Expenses related to days of personal use do not qualify as rental expenses. The taxpayer must allocate the expenses based on the number of days of personal use to total use of the property.

example

Charles used his rental property for personal use 7 days and rented it for 63 days. In most cases, 10% of Charles' expenses are not rental expenses and cannot be deducted on Schedule E (7 = 10% of 70 total days: 7 personal days + 63 rented days).



EXERCISES (continued)

Question 9: For taxpayers who rent part of a property in which they live, which expenses are reported only on Schedule E and not on Schedule A?

- A. Home insurance and mortgage interest
- B. Property taxes and repairs
- C. Utilities and home insurance
- D. Depreciation and property taxes

How should taxpayers report rental expenses that exceed their rental income when they live in the home for part of the year?

Questions in Part I, line 2 of Schedule E ask for information on the number of rental days at fair rental value and the number of days for personal use. If taxpayers rented out a dwelling unit that they also used for **personal purposes** during the year, they may not be able to deduct all the expenses for the rental part.

Dwelling unit (the unit) means a house, apartment, condominium, or similar property. A day of **personal use** is any day, or part of a day, that the unit was used by:

- The taxpayer for personal purposes
- Any other person for personal purposes, if that person owns part of the unit (unless rented to that person under a "shared equity" financing agreement)
- Anyone in the taxpayer's family (or in the family of someone else who owns part of the unit), unless the unit is rented at a fair rental price to that person as his or her main home
- Anyone who pays less than a fair rental price for the unit
- Anyone under an agreement that lets the taxpayer use some other unit

Are there any exceptions?

Taxpayers who used a dwelling unit as their main home may not have to count all that time as “days of personal use.” Do not count as personal use any day the taxpayer:

- Spends working substantially full time repairing and maintaining the unit, even if a family member used it for recreational purposes on that day, or
- Used the unit as the taxpayer’s main home before or after renting it or offering it for rent, if the taxpayer rented or tried to rent it for at least 12 consecutive months (or for a period of less than 12 consecutive months at the end of which the taxpayer sold or exchanged the home)

example

On February 28, 2010, Trent moved out of the house he had lived in for six years because he accepted a job in another town. He rented his house at a fair rental price from March 15, 2010, to May 14, 2011. On June 1, 2011, he moved back to town and moved back into his house. Because he rented his property for 12 or more consecutive months, his use of the house is not counted as personal use. Since these days are not counted as days of personal use, the limitations on deductions do not apply.

Are there any limitations?

There are limitations based on whether the taxpayer used the dwelling unit as a home and it meets the personal use test. The personal use test is met if the taxpayer used the unit for personal purposes in 2011 **more than the greater of:**

- 14 days or
- 10% of the total days it was rented to others at a fair rental price

Fair rental days and personal use days are reported in Part I, line 2, of Schedule E.

If the taxpayer did not use the dwelling unit as a home, the taxpayer can deduct all the expenses for the rental part, subject to the At-Risk Rules and the Passive Activity Loss Rules. For more details on these rules, refer to Publication 527, Residential Rental Property.

If the taxpayer used the dwelling as a home and rented the unit for **fewer than 15 days** in 2011, do not report the rental income and do not deduct any rental expenses. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the volunteer program.)

If the taxpayer used the dwelling as a home and rented out the unit **at least 15 days** in 2011, the taxpayer may not be able to deduct all of the rental expenses. The taxpayer can deduct all of the following expenses for the rental part on Schedule E:

- Mortgage interest
- Real estate taxes
- Casualty losses (out of scope)
- Other rental expenses not related to the taxpayer’s use of the unit as a home, such as advertising expenses and rental agents’ fees

If there is rental income left after deducting these expenses, the taxpayer can deduct other expenses, including depreciation, up to the amount of remaining income. The taxpayer can carry over to 2012 the unused expense amounts.

example

Roger owns a condominium apartment in a resort area. He rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the apartment and allowed Roger to use it even though he did not refund any of the rent. Roger's family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 days (170 – 10). Roger figures 10% of the total days rented to others at a fair rental price is 16 days. Roger's family also used the apartment for 7 other days during the year.

Roger used the apartment as a home because he used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

Roger must allocate expenses related to personal use. In addition he is limited in the expenses that he can report on Schedule E.

example

Latricia converted the basement of her home into a one-bedroom apartment. She rented the apartment out at a fair rental price to college students during the nine-month school year. During June, Latricia's brother stayed in the apartment rent-free. This is considered personal use. Limitations apply to Latricia's rental expense deductions because the apartment was used for personal purposes for 30 days, which was more than the greater of:

- 14 days or
- 10% of the 270 days it was rented (27 days)



EXERCISES (continued)

Question 10: Which of the following taxpayers cannot deduct any of their rental expenses?

- A. Julio, who rented out his house eight months last year. After the tenants moved out, he let his sister and brother-in-law stay in the house two months rent-free.
- B. Marcel, who rented a room of his condo all year and lived there himself 11 months.
- C. Cherice, who offered a room for rent in her home all year but had only one renter who stayed just one month.
- D. Lois, who rented her home 12 days and then allowed her father to live there rent-free the rest of the year while she worked overseas.



Tax Software Hint: If the property was used as a rental for the entire year, the income and expenses can be reported on Schedule E. If the property was used partially as a rental and partially as a residence, some expenses may need to be allocated. For software entries, go to the Volunteer Resource Guide (Tab 2), Schedule E – Rental Income and Loss.

How do I handle rental losses?

Deducting all rental expenses and depreciation from the rent received may result in a net loss. Rental losses are not always fully deductible. There are two restrictions on how much a loss can offset other sources of income:

- At-risk rule
- Passive activity rules

What is the at-risk rule?

The at-risk rule places a limitation on the amount the taxpayer can deduct as losses from activities often described as tax shelters. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at risk in the activity at the end of the tax year.

What are the passive activity rules?

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Passive income does not include salary, dividends, or investments but is generally attributed to such things as rental income. Therefore, losses that exceed rental income (the passive activity) are not deductible.

Passive income and active participation

The limits on deducting rental losses are affected by the degree to which renting out the property is a passive activity or involves active participation:

- Passive rental activity means receiving income mainly from the use of property rather than for services.
- Active participation means making significant management decisions, such as approving rental terms, repairs, expenditures, and new tenants. Taxpayers who use a leasing agent or property manager could be considered active participants if they retain final management rights.

Exception

Rental activities are generally considered passive activities. For this reason, rental losses are not fully deductible. However, an exception to the passive activity rule provides that taxpayers who actively participate in the rental activity can use up to \$25,000 of their rental losses to offset any other nonpassive income (\$12,500 for married taxpayers filing separately and living apart for the entire year). Examples of nonpassive income are salaries, wages, commissions, tips, self-employment income, interest, dividends, annuities, and some royalties. (This deduction is subject to phaseout if the taxpayer's adjusted gross income (AGI) exceeds certain limits.)

What is active participation?

It is considered active participation when taxpayers own at least 10% of the rental property and make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditure, and similar decisions.



For more information, see Publication 925, Passive Activity and At-Risk Rules.

example

Sally Jenkins, a U.S. citizen, lives in Europe and is paid \$25,000 in wages by the U.S. government and had \$100 of interest income. She rented out her U.S. home and incurred \$1,000 in rental loss for the tax year. Although her sister collects the rent, Sally makes all of the decisions as to whom, and for what amount, the property will be rented. While Sally is in Europe, she pays her sister to manage the property. Sally's rental loss of \$1,000 may be offset against her gross income of \$25,100 because she is considered to be an active participant in the rental activity.



Tax Software Hint: Be sure to answer the question related to active participation in the worksheet shown below the Schedule E in the tax software.

Phase-Out of Offset

The amount allowed to offset nonpassive income is:

- Reduced once the taxpayer's Adjusted Gross Income (AGI) exceeds \$100,000 (\$50,000 for Married Filing Separately)
- Completely phased out when AGI exceeds \$150,000 (\$75,000 for Married Filing Separately)



EXERCISES (continued)

Question 11: Which restriction limits the deductibility of rental loss to the amount of rental income?

- A. Phase-out of offset
- B. Passive activity rules
- C. Active participation rule

How are passive rental losses reported?

Taxpayers use Form 8582 to figure the amount of any passive activity loss allowed for the current tax year. Form 8582 summarizes losses and income from all passive activities.

Generally, taxpayers are not required to file Form 8582 if they have:

- Only one passive loss generated from a rental activity and
- An AGI of less than \$100,000



Tax Software Hint: The tax software will automatically generate and complete Form 8582 if required. If any questions arise regarding whether to file or how to complete Form 8582, refer the taxpayer to the IRS or a professional tax preparer.

Summary

Taxpayers receive Schedule K-1 (Form 1065, Form 1041, or Form 1120S) reporting their share of income from interest, dividends (ordinary and qualified), capital gains (net short-term and net long-term). Schedule K-1, page 2, lists the appropriate forms and schedules where the taxpayers' income from these sources should be reported. Royalties are only on Schedule K-1, Forms 1065 and 1120S.

Rental income and deductible rental expenses are reported on Part I of Schedule E, Supplemental Income and Loss. U.S. citizens and resident aliens must report rental income for the months their home is rented, regardless of whether the rental property is located in the U.S. or in a foreign country.

When renting out part of the property, certain expenses must be divided between rental use and personal use; some are reported on Schedule A and some on Schedule E.

Taxpayers who do not use a dwelling unit as a home (for personal purposes) should include all the rent in their income and deduct all the rental expenses. There are special rules and limitations if the taxpayer used the dwelling unit as a home and it meets the personal use test.

Rental income and expenses are not reported if the taxpayer used the dwelling as a home and rented the unit for fewer than 15 days in 2011. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the volunteer program.)

Because rental activities are generally considered passive activities, rental losses are not fully deductible. However, taxpayers who actively participated in the renting of the property may deduct up to \$25,000 of their rental losses, up to \$12,500 for married taxpayers filing separately and living apart. This deduction is subject to phaseout if the taxpayer's AGI exceeds certain limits.

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Taxpayers with rental losses may be required to file Form 8582, Passive Activity Loss Limitations.

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

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

- Income reported on Schedules K-1 (other than those listed on page 12-2)
- Deductions, credits, and other items reported on Schedules K-1
- Royalty income reported on Form 1099-MISC
- Taxpayers who rent their property at less than fair rental value
- Rental-related interest expenses other than mortgage interest
- The actual expense method (auto and travel expense deductions)
- Casualty loss
- Completing Form 8582



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: C. You would deduct four-twelfths (33%) of his mortgage interest and taxes on Schedule E, and report the other 67% on Schedule A.

Answer 2: D. Repairs made to the homeowner's personal residence are not deductible as rental expenses. However, the other expenses are deductible, along with repairs made to rental property, legal and professional fees, and property management fees.

Answer 3: C. Fencing adds to the value of the property, so the cost cannot be deducted as a rental expense. Instead, it must be depreciated over the useful life of the improvement.

Answer 4: False. Taxpayers should claim the correct amount of depreciation every year. If they do not, they still must reduce their basis in the property by the amount of depreciation that they could have deducted.

Answer 5: C. The value of land is not depreciable; furniture and vehicles are depreciable property.

Answer 6: B. MACRS (modified ACRS) is the method used for property placed in service after 1986.

Answer 7: D. Wayne's basis for depreciation is \$150,000 ($\$255,000 - \$155,000 + \$50,000$). The basis does not include landscaping expenses.

Answer 8: B. The recovery period of an appliance, based on its class life, is shorter than that of a home, and property located inside the U.S. has a shorter recovery period than property outside the U.S.

Answer 9: C. The rental portions of utilities, home insurance, repairs, and depreciation are rental deductions on Schedule E, but the personal portions are not a deductible expense reported on Schedule A. Taxpayers who rent out part of a property allocate mortgage interest and property taxes separately on both schedules.

Answer 10: D. Lois rented her home out fewer than 15 days during the year and used it for personal purposes by allowing her father to live there rent-free.

Answer 11: B. Passive activity losses can be deducted only from passive activity income. Taxpayers who are not active participants may not deduct rental losses that exceed rental income.



Lesson 13: Income—Unemployment Compensation; Form 1040, Line 19



Introduction

This lesson will help you assist taxpayers who have unemployment compensation payments.

Objectives

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

- Identify unemployment compensation income
- Determine how to report unemployment compensation on the tax return

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Optional:** Form 1099-G

What is unemployment compensation?

Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state in the U.S. In most cases, unemployment compensation is taxable.

Where can I get unemployment compensation information?

Begin with the unemployment question on intake and interview sheet, Part III, Income. Ask the taxpayer for any Form(s) 1099-G, Certain Government Payments that document unemployment compensation payments from each government entity.

In most states, taxpayers can elect to have federal income taxes withheld from their unemployment compensation benefits. Be sure to review Form 1099-G, box 4, for any federal income tax withheld.

Section A. Please complete – check Yes, No or Unsure to all questions below. Please ask if you need help.

Part III. Income – In 2011, did you (or your spouse) receive:

Yes No Unsure

- | | | | |
|-------------------------------------|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 1. Wages or Salary? (Form W-2) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 2. Tip Income? |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 3. Scholarships? (Forms W-2, 1098-T) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 4. Interest/Dividends from: checking/savings accounts, bonds, CDs, brokerage? (Forms 1099-INT, 1099-DIV) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 5. Refund of state/local income taxes? (Form 1099-G) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 6. Alimony Income? |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 7. Self-Employment payments (such as cash received for services, small business)? (Form 1099-MISC) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 8. Income (or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Forms 1099-S, 1099-B) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 9. Disability Income (such as payments from insurance or workers compensation)? (Forms 1099-R, W-2) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R) |
| <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 11. Unemployment Compensation? (Form 1099-G) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 12. Social Security or Railroad Retirement Benefits? (Forms SSA-1099, RRB-1099) |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 13. Income (or loss) from Rental Property? |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____
(Forms W-2 G, 1099-MISC) |

How do I report unemployment compensation?

The total for all amounts of unemployment received in Form(s) 1099-G, box 1, should be entered on Form 1040, line 19.

The amount of withholding from Form 1099-G, box 4 should be entered on Form 1040, line 62.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).

Summary

This lesson explained:

- How to identify unemployment compensation
- How to report unemployment compensation



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



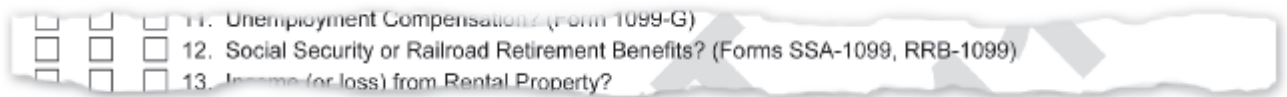
Lesson 14: Income – Social Security Benefits; Form 1040, Line 20a



Introduction

This lesson will help you assist taxpayers who have social security and equivalent railroad retirement benefits. These benefits may or may not be taxable.

To properly report income, use the interview techniques and tools discussed in the Screening and Interviewing lesson. The intake and interview sheet lists Social Security and Railroad Retirement Benefits in the Income section.



Ask the taxpayer about the receipt of either of these benefits. The Social Security Administration issues Form SSA-1099, *Social Security Benefit Statement*, to social security benefit recipients. The Railroad Retirement Board issues Form RRB-1099, *Payments by the Railroad Retirement Board*, and Form RRB-1099-R, *Annuities or Pensions by the Railroad Retirement Board*.

See Publication 575, Pension and Annuity Income, and Publication 915, Social Security and Equivalent Railroad Retirement Benefits, for additional information on the topics discussed in this lesson.

Objectives

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

- Determine the taxable portion of social security and railroad retirement benefits
- **NEW** Determine the most advantageous method of reporting lump sum social security benefits
- Report social security and railroad retirement benefits on the tax return

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Publication 575
- Publication 915
- Form RRB-1099
- Form RRB-1099-R
- Form SSA-1099
- Social Security Benefits Worksheet

What are social security and railroad retirement benefits?

Social Security Benefits

Social security benefits are payments made under Title II of the Social Security Act. They include Old-Age, Survivor, and Disability Insurance (OASDI) benefits and some workers' compensation benefits.

Social security benefits include monthly retirement, survivor, and disability benefits. They do not include Supplemental Security Income (SSI). Certain government retirees who receive a pension from work are not covered by social security.

Some portion of the social security benefits received may be taxable. Generally, if social security benefits are the only source of income, then the benefits are not taxable. In this instance, taxpayers may not be required to file a return. However, if the taxpayers are Married Filing Separately and lived with their spouse at any time during the tax year, 85% of the benefits will be taxable.

Railroad Retirement Benefits (RRBs)

Railroad Retirement Benefits (RRBs) are benefits paid to railroad employees working in jobs that are covered by the Railroad Retirement Act (RRA). The RRA benefits have two components: tier 1 (social security equivalent benefits) and tier 2 (treated as a qualified employee plan). The tier 2 benefits are reported on Form RRB 1099-R. These funds are discussed in the previous lesson on Retirement Income.

How are these benefits reported to the taxpayer?

Form SSA-1099

Social security benefits are reported on Form SSA-1099. Box 5 shows the amount of net benefits. Taxpayers who did not receive Form SSA-1099, or have misplaced it, can get a printout of benefits from their local social security office or request a replacement by accessing the Social Security Administration's web site at SSA.gov.

Form RRB-1099

Tier 1 railroad retirement benefits are equal to the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system. These benefits are called "social security equivalent benefits" and, for tax purposes, are treated like social security benefits. They are shown on the BLUE Form RRB-1099. Box 5 shows the net social security equivalent benefits for tier 1.

example

Jacob is a retired railroad switchyard operator. Using the intake and interview sheet, the volunteer determined Jacob received Railroad Retirement Benefits. He received Form RRB-1099 and Form RRB-1099-R. The amount from Form RRB-1099 will be added to any amount of social security benefits.

When are social security benefits and tier 1 RRBs taxable?

Part of the following benefits received by the taxpayer may be taxable:

- Social security benefits
- Railroad retirement benefits, tier 1 (social security equivalent portion)

To correctly calculate the taxable portion, you need to know the amount in box 5 of Form SSA-1099 or Form RRB-1099. The taxable amount, if any, of a taxpayer's social security benefits depends upon filing status and other reportable income. Generally, if social security (or social security equivalent) benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer does not need to file a federal income tax return. If the taxpayer received social security benefits and other income, complete the Social Security Benefits Worksheet to calculate the taxable portion.

A portion of the benefits is taxable if total income (including tax-exempt interest), plus one-half of the benefits received, is more than certain base income amounts, which vary based upon the taxpayer's filing status. A portion of the benefits is also taxable if the taxpayers are Married Filing Separately and lived with their spouse at any time during the year.



The taxable portion of social security benefits is never more than 85% of the net benefits the taxpayer received. In many cases, the taxable portion is less than 50%.

If the taxpayer files a joint return, combine the income and benefits of both spouses when completing the worksheet. Even if one spouse received no social security benefits, include that spouse's other income when completing the worksheet. If both spouses received benefits, combine both their benefits and income when completing the worksheet for the return.



Complete the Social Security Benefits Worksheet in the Form 1040 Instructions to determine if any portion of the benefits is taxable.

example

Wanda and Dan are both retired and will file a joint return. Wanda received Form SSA-1099 with an amount of \$4,300 appearing in box 5. Dan retired from the railroad, and box 5 of his Form RRB-1099 shows an amount of \$6,800. Wanda and Dan will use the combined benefits of \$11,100 and only one worksheet to calculate if any of their benefits are taxable.

How do I report social security or railroad tier 1 benefits?



Tax Software Hint: The tax software will perform all the calculations to determine the taxable amount based on other information on the return. Be sure to enter all income, including tax-exempt interest, in order for the software to correctly calculate taxability of benefits. If the taxpayer is itemizing deductions, include Medicare premiums (Part B and D) from Forms SSA-1099 and RRB-1099 so that it flows to Schedule A. Additionally, be sure to enter any federal income tax withholding. Go to the Volunteer Resource Guide (Tab 2), Railroad Retirement, Civil Service, and Social Security Benefits, for software entries.



EXERCISES

Answers follow the lesson summary.

Question 1: Hank comes to your site to get some help with his tax return. He is upset because his neighbor told him that he would have to pay tax on all of his social security benefits this year. After talking to Hank, you learn that his wife died several years ago. In 2011, he sold all of his stock and moved into senior housing. The sale of the stock created \$31,896 of taxable income for Hank. His neighbor told him, with that much income, the entire \$11,724 of his social security benefits would be taxable. What is the maximum taxable amount of Hank's benefits?

- A. \$31,896
- B. \$20,172
- C. \$11,724
- D. \$9,965

What are lump-sum benefit payments?

Some taxpayers may have received a lump-sum benefit payment. This payment could be for the current tax year and for prior tax years. Box 3 of the taxpayer's Form SSA-1099 or Form RRB-1099 will include the lump-sum payment. The form will also show the year, or years, of the payment. The additional information will be shown in Description of Amount in box 3 on Form SSA-1099 or in boxes 7–9 on Form RRB-1099.

When figuring the taxable portion of social security benefits, two options are available for lump-sum benefit payments:

- The **first option** allows the taxpayer to report the whole payment the year it was received. When the taxpayer chooses this option, complete the Social Security Benefits Worksheet as usual by including the entire lump-sum payment on line 1.
- The **second option** is to treat the payment as received in the earlier year or years. This is done by figuring whether any part of these benefits is taxable, based on the earlier year's income. Any part that is taxable is then added to any taxable benefits for the current year and included on Form 1040, line 20b. The taxpayer can elect this method if it lowers the taxable benefits.



Do not confuse this type of lump-sum benefit payment with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

NEW Will the lump-sum election method lower taxable benefits?

Figuring the taxable benefits under the lump-sum election method is in scope for the VITA/TCE program this year.

If the taxpayer chooses the second option, only the current year income will be adjusted. You do not file amended returns for the earlier years.

Under the lump-sum election method, refigure the taxable part of all the benefits for the earlier year (including the lump-sum payment) using that year's income; then subtract any taxable benefits for that year that were previously reported. The remainder is the taxable part of the lump-sum payment. Add it to the taxable part of the benefits for the current year (figured without the lump-sum for the earlier year).

In order to compute the taxable benefits, you will need copies of the taxpayer's prior year returns.

For additional information on the lump-sum election, see Publication 915.

example

In 2010, Jane applied for social security disability benefits but was told she was ineligible. She appealed the decision and won. In 2011, she received a lump-sum payment of \$6,000, of which \$2,000 was for 2010 and \$4,000 was for 2011. Jane also received \$5,000 in social security benefits in 2011, so her 2011 Form SSA-1099 shows benefits paid of \$11,000.

Jane had other taxable income in both 2010 and 2011. She should figure her taxable benefits under the lump-sum election method to see if it is lower.



Tax Software Hint: The tax software will figure all the calculations after you enter the prior year tax return information. Go to the Volunteer Resource Guide (Tab 2) for software entries.



Because the earlier year's taxable benefits are included in the current year's income, no adjustment is made to the earlier year's return. Do not file an amended return for the earlier year.



Once a taxpayer elects this method of figuring the taxable part of a lump-sum payment, the election can only be revoked with the consent of the IRS.

Summary

This lesson explained how to determine whether income from taxpayers' social security benefits and railroad retirement benefits is taxable.

Generally, if social security benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer does not need to file a federal income tax return. If the taxpayer received social security benefits and other income, the Social Security Benefits Worksheet must be completed to calculate the taxable portion.

When figuring the taxable portion of social security benefits, two options are available for lump-sum benefit payments. The taxpayer may report the whole payment in the year it was received or treat the payment as received in the earlier year or years.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.

If you are unable to complete the entire exercise, complete as much of it as you can. Come back later to finish the exercise after you covered all the technical topics in later lessons.



EXERCISE ANSWERS

Answer 1: *D. \$9,965 or 85% of the net benefits, is the maximum amount that could ever be taxable.*



Lesson 15: Income—Other Income; Form 1040, Line 21



Introduction

This lesson will help you determine other forms of income and how to report other sources of income. Part of the lesson is for all course levels and part is only for the International level.

The International part of this lesson will help you report income earned from worldwide sources. To do this, you need to be able to identify the type of income and, if reportable, convert it to the equivalent U.S. dollar value of the foreign currency.

This lesson will cover the foreign earned income exclusion reported on Form 2555 or Form 2555-EZ.

Objectives

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

- Other types of income and how to report other sources of income
- How to properly report income earned from worldwide sources
- Who is eligible for the foreign income exclusion and how to calculate the excludible amount using Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 54
- Publication 4491-W
- Form 1040 Instructions
- Form 2555
- Form 2555-EZ
- Optional:** Publication 525

How do I handle other income?

“Other income” is income that does not have its own line on Form 1040. Generally, these amounts are reported on line 21. Here are examples:

- Prizes and awards
- Gambling winnings, including lotteries and raffles
- Jury duty pay
- Alaska Permanent Fund dividends
- Certain Gulf oil spill payment not treated as wages or self-employment income

Even if the taxpayer does not receive an income document from the payer, the taxpayer is required to report the income.

If you are unsure about sources of other income, consult the Volunteer Resource Guide (Tab D) and Publication 17, Other Income, or discuss the income item with your Site Coordinator.

Use the interview techniques and tools discussed in the Screening and Interviewing lesson to ensure that all taxable income has been included.

COD and HSA Topics

Often when a credit card debt is canceled, it must be reported as other income. The cancellation of debt for credit cards is in scope, but is not covered in this lesson. This topic is limited to nonbusiness credit card debt involving solvent taxpayers. Information on this topic is covered in a specialty course on Link & Learn Taxes for volunteers with an Advanced, Military, or International Certification.

Certain Health Savings Account (HSA) distributions not used to pay or reimburse the taxpayer for qualified medical expenses are generally reported as other income on Form 1040, line 21. This topic is not covered in this lesson. It is covered in a specialty course on Link & Learn taxes for volunteers with an Intermediate or higher certification.

These online courses, Cancellation of Debt (COD) and Health Savings Accounts (HSAs), are optional. Check with your Site Coordinator to determine if you should be certified in one or both of these topics. To access these courses and earn a certification for these specialty lessons, go to www.irs.gov and use the keyword/search “Link & Learn.”

Gulf Oil Spill Payments

Many taxpayers in the Gulf Coast region received payments in 2011 related to the oil spill. However, claims have also been paid to taxpayers residing outside of this region. According to current law, oil spill payments for lost wages or business income are taxable. The law treats compensation for lost wages or income differently for tax purposes than compensation for physical injuries or property loss, which generally is nontaxable. Some issues, such as casualty losses, should be referred to a professional tax preparer.

For guidance in providing assistance to Gulf oil spill victims, refer to Publication 4906, Gulf Oil Spill Overview & Guidance for VITA/TCE, and Publication 4899, Decision Tree – Gulf Oil Spill Affected Taxpayers. These publications are available on www.irs.gov. Additional guidance, including frequently asked questions, can be found on www.irs.gov; keywords – Gulf Oil Spill Information Center.



Visit the Gulf Oil Spill Information Center on www.irs.gov for the most up-to-date information. Additional information can also be found in:

- Publication 4873, The Gulf Oil Spill and Your Taxes
- Publication 4873-A, Gulf Oil Spill: Questions and Answers

How do I report other income?

In most cases, if taxpayers have “other income,” they must file Form 1040 and report the income on line 21.

Gambling Winnings

The taxpayer may receive one or more Forms W-2G reporting gambling winnings. Total gambling winnings must be reported on Form 1040, line 21. If the taxpayer also had gambling losses, the losses can only be deducted on Schedule A. See the Itemized Deductions lesson for more details.



Tax Software Hint: To review information related to reporting gambling income, go to the Volunteer Resource Guide (Tab 2).

Cash for Keys Program

Cash for Keys Program income, which is taxable, is income from a financial institution, offered to taxpayers to expedite the foreclosure process. Report this income on Form 1040, line 21 as “other income.” The taxpayers should receive Form 1099-MISC with the income in box 3.

State Agency Payments for Child Care

Payments from state agencies to grandparents who care for grandchildren are taxable and may be found on Form 1099-MISC in either box 7 or box 3.

- If grandparents are not conducting a business of caring for children, this income is reported on Form 1040, line 21
- If the grandparents are conducting a business of caring for children, this income is reported on Schedule C-EZ or Schedule C

State agencies may not know if the grandparent(s) are operating a day-care center and may prefer to report the payments on Form 1099-MISC, box 7.



If the grandparent is running a day-care center business, these payments are subject to self-employment taxes. For additional information, see Form 1099-MISC Instructions for reporting boxes 3 and 7.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), How/Where to Enter Income.

Are distributions from Educational Savings Accounts, such as a Coverdell ESA and a 529 plan, taxable?

Coverdell ESAs (section 530 plans) and Qualified Tuition Programs (QTPs), also called “section 529 plans,” are educational savings accounts that include the following provisions:

- Money is contributed to a special account
- The contribution is never deductible
- Earnings on the after-tax contributions become tax-deferred

Ask the taxpayer if all the funds were used for qualified educational expenses. (Qualified educational expenses have different requirements for each plan.) If yes, none of the distribution is taxable, and it should not be reported on the return.

Refer the taxpayer/beneficiary to a professional tax preparer if:

- The funds were not used for qualified education expenses, or
- The distribution was more than the amount of the qualified expenses

Qualified education expenses include tuition and fees, books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.

Distributions from Coverdell ESAs and QTPs are reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530). Coverdell ESA distributions can be used to pay for qualified elementary, secondary, and postsecondary expenses. QTP distributions can only be used to pay qualified postsecondary expenses.

For additional information about educational savings accounts, distributions, and qualified education expenses, refer taxpayers to Publication 970, Tax Benefits for Education.



An American opportunity credit or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP or Coverdell ESAs, as long as the same expenses are not used for both benefits. See Publication 17 and Publication 970, Tax Benefits for Education, for more details.



What is worldwide income?

U.S. citizens and U.S. resident aliens are required to report worldwide income on a U.S. tax return regardless of where they live and even if the income is taxed by the country in which it was earned. Filing requirements are the same as for U.S. citizens and U.S. resident aliens living in the United States and apply whether income is from within or outside the U.S.

U.S. citizens and U.S. resident aliens living abroad may be able to claim tax benefits such as the foreign earned income exclusion and the foreign tax credit. This part of the lesson covers the foreign earned income exclusion. The foreign tax credit will be covered in another lesson.

example

In 2011, Alfredo Kendall earned \$40,000 while working in Dallas, Texas, for Dade Corporation. In September 2011, he transferred to their office in Stuttgart, Germany. While in Germany, he earned \$30,000 (U.S. dollars). All of Alfredo's wages, including the income he earned in Germany, is included in his gross income. His Form 1040, line 7, will show \$70,000.

Income is treated the same on the return regardless of the country from which it is derived. Similar income earned inside or outside the U.S. is generally taxed in the same way on the return. Likewise, income earned in the U.S. and not taxed will be treated in the same way if earned outside the U.S. The lines on which income is reported on Form 1040 are the same whether the U.S. citizen or U.S. resident alien is living within or outside U.S. boundaries.



Foreign income might be reported to taxpayers on forms or in ways that are not used in the United States. Question taxpayers closely to ensure that they are reporting all worldwide income. Review the income records to ensure that includible amounts are accurate and complete.



Tax Software Hint: To review information related to income from a foreign employer, go to the Volunteer Resource Guide (Tab 2), How/Where to Enter Income.



EXERCISES

Answers are listed following the lesson summary.

Question 1: Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her income included \$22,000 in wages earned in Germany. She earned \$300 in interest from her U.S. bank. What is Marta's total income?

- A. \$0
- B. \$22,300
- C. \$300
- D. \$22,000



EXERCISES (continued)

Question 2: Mary Carleton, a U.S. citizen, lives in Belgium. Her income included \$10,000 in wages from her Belgian employer, \$200 in interest from her U.S. bank, \$8,000 in alimony payments, and \$7,000 in child support payments from her ex-spouse. What is Mary's gross income?

- A. \$8,000
- B. \$10,200
- C. \$18,200
- D. \$25,200

How do I convert foreign income to U.S. dollars?

Exchange rates

All amounts on the U.S. tax return must be stated in U.S. dollars. Convert income that taxpayers received in foreign currency into U.S. dollars using the appropriate exchange rate. U.S. exchange rates are stated in two ways:

- Units of foreign currency to one U.S. dollar: 0.74855 Euro = 1 U.S. dollar
- U.S. dollars to one unit of the foreign currency: 1.33592 U.S. dollar = 1 Euro

To convert a sum of money into U.S. dollars, **divide** the amount of foreign currency by the exchange rate for the foreign currency to one U.S. dollar.



Exchange rates shown here are for example only. Use the exchange rates in effect when the income was received.

example

Ryan received 3,000 Euros (€3000) on a day that the exchange rate was 0.74855 Euros to one U.S. dollar. Based on this exchange rate, the value of Ryan's €3000 is: $€3000 \div 0.74855 = \$4,007.75$

In other words:

Amount of foreign currency _____ = Amount in U.S. dollars
Exchange rate of foreign currency to one U.S. dollar

$\frac{3,000 \text{ Euros}}{0.74855} = \$4,007.75$



EXERCISES (continued)

Question 3: Caryn received 200 Euros on a day that the exchange rate was .75514 Euros to one U.S. dollar. In U.S. dollars, she would have ____.

- A. \$264.85
- B. \$377.57
- C. \$115.03
- D. \$11.50



EXERCISES (continued)

Question 4: Given an exchange rate of .7000, how much is 36,000 Euros worth in U.S. dollars?

- A. \$252.00
- B. \$25,200.00
- C. \$51,428.57
- D. \$61,614.00

Which exchange rate should I use?

The exchange rate for a particular currency is likely to change every day. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. The exchange rate is determined by the date of transaction, which is either the date on the check or the date the money is credited to the taxpayer's account. If there is more than one exchange rate, use the one that most properly reflects the income.

However, the taxpayer can use the average annual exchange rate if:

- Foreign income was received evenly throughout the year, and
- The foreign exchange rate was relatively stable during the year

Taxpayers may use the monthly average exchange rates if they earned foreign income evenly for one or more months, but less than twelve months.

example

Edward Hall worked in Dallas for Lubbock Incorporated from January until September. On September 29, he was transferred to Lubbock's Mexico City office, where he will be working for three more years. In Mexico, he is paid in Mexican pesos. Because he received the majority of his annual salary in U.S. currency, he should not use the annual average exchange rate for the Mexico source income. If he does not know the exchange rate at the time he received the funds, he can use the monthly average exchange rate for October, November, and December.

Where to obtain exchange rates

In mid-January, the IRS distributes exchange rates for various currencies to its worldwide offices, including the prior year's average annual exchange rate information.

To obtain exchange rates, call the IRS International office at 267-941-1000 (not toll-free) or the overseas IRS offices. The phone numbers of these offices are listed in Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad. Exchange rates can also be found at www.irs.gov by typing "foreign currency rates" in the search box. You may also contact banks that provide international currency exchange services.

Because taxpayers should use the rate that most nearly reflects the value of the foreign currency at the time they receive the income, taxpayers may use an exchange rate that is different from the rates posted in IRS worldwide offices if they find it to be a true representation.

What is the foreign earned income exclusion?

Use Form 2555-EZ or Form 2555 to claim the foreign earned income exclusion. Certain taxpayers can exclude income earned in, and while living in, foreign countries. For 2011, the maximum exclusion amount is \$92,900. The foreign earned income exclusion **does not** apply to wages and salaries of U.S. military members and civilian employees of the U.S. government.

If the taxpayer qualifies to exclude foreign earned income, the excludable amount will be reported as a negative amount on Form 1040, line 21. Since the foreign earned income would have been reported on Form 1040, line 7 as taxable wages or on line 12 as self-employment income, the exclusion (negative amount) will reduce the total income calculated on line 22. The method of calculating the tax when the taxpayer elects the foreign earned income exclusion is based on the Foreign Earned Income Tax Worksheet. The tax software will do this calculation automatically.



Tax Software Hint: To review information related to the software for the foreign earned income exclusion, go to the Volunteer Resource Guide (Tab 2), How/Where to Enter Income.

When do I choose the exclusion?

The foreign earned income exclusion is voluntary. It is not always an advantage to claim the exclusion. If taxpayers wish to claim the exclusion, they must file either Form 2555-EZ or Form 2555 with a timely return (including extensions). If the taxpayer is not eligible for the foreign earned income exclusion, any taxes paid on this income to a foreign government may be eligible for the foreign tax credit. See the lesson Foreign Tax Credit for more information.

Once the taxpayer chooses to exclude foreign earned income, that choice remains in effect for that year and all later years until revoked. The taxpayer may revoke the exclusion for any tax year by attaching a statement. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

What are the eligibility requirements?

To claim the foreign earned income exclusion, taxpayers must:

- Demonstrate that their tax home is in a foreign country
- Meet either the bona fide residence test or the physical presence test
- Have income that qualifies as foreign earned income

The requirements are applied separately to each individual. If a husband and wife are working overseas, each must meet all requirements to qualify for the exclusion. If they do qualify, each is entitled to an exclusion of up to \$92,900 (on qualified income) for 2011.

TIP

The terms “foreign,” “abroad,” and “overseas” do not include Puerto Rico, U.S. Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Marianas, Wake Island, the Midway Islands, and Johnston Island.



EXERCISES (continued)

Question 5: Miranda has lived in Puerto Rico since 2003. Is she eligible for the foreign earned income exclusion?

Yes No

How do I determine the tax home?

To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country. The tax home is defined as the country in which the taxpayer is permanently or indefinitely engaged to work as an employee or a self-employed individual, regardless of where the family home is maintained.

For taxpayers who work abroad but do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live. The tax home for members of the U.S. Armed Forces is the permanent duty station, either land-based or on a ship.

example

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2006. Their tax home for 2011 is Germany.



EXERCISES (continued)

Question 6: Alan has lived and worked in China since August 16, 2004. For 2011, China is his tax home.

True False

What is a regular place of abode?

For purposes of the foreign earned income exclusion, if taxpayers work overseas for an indefinite period of time, and their regular place of abode is the U.S., the taxpayers cannot designate the foreign country as the tax home.

“Regular place of abode” is defined as one’s home, habitation, domicile, or place of dwelling. It does not necessarily include one’s principal place of business.

If the taxpayer maintains a place of business, or is assigned to overseas employment in a foreign country for an indefinite period, *and does not maintain a regular place of abode in the U.S.*, the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

How do I determine whether the U.S. is the taxpayer’s regular place of abode?

Ask three questions to determine whether a U.S. home is the taxpayer’s regular place of abode:

1. Did you use your home in the U.S. as a residence while you worked at your job in the U.S. just before going abroad to your new job, and did you continue to maintain work (e.g., contacts, job seeking, leave of absence, ongoing business) in that area in the U.S. during the time you worked abroad?
2. Are your living expenses duplicated at your U.S. and foreign homes because your work requires you to be away from your U.S. home?
3. Do you have a family member or members living at your U.S. home, or did you frequently use your U.S. home for lodging during the period you worked abroad?

If the answer to two of the questions is “no,” the taxpayer is considered to be indefinitely assigned to the new location abroad and is eligible for the foreign earned income exclusion.

If the answer to all three questions is “yes” and the job duration is for less than one year with the taxpayer returning to the U.S. home, the taxpayer is considered “temporarily away” from home. In this case, the taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct *away-from-home* expenses.

If the answer to two of the three questions is “yes,” with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on the facts and circumstances.

example

Henry is a member of the Armed Forces. He was assigned to a post in Japan in 2011. This assignment was for an indefinite period that exceeds one year. Margaret, his wife, accompanied him to Japan and has foreign earned income. They have not used their home in the U.S. as a place of residence for over a year. Therefore, their tax home for 2011 is Japan.



EXERCISES (continued)

Question 7: Stan is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the U.S. during his off periods. Does Stan’s employment satisfy the tax home test? Yes No

What is the period of stay requirement?

The period of stay is the amount of time the taxpayer stays in the foreign country. To meet the period of stay requirement, the taxpayer must be either:

- A U.S. citizen or U.S. resident alien from a tax treaty country who is a **bona fide** resident of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
- A U.S. citizen or U.S. resident alien who is **physically present** in a foreign country or countries for at least 330 full days during any period of 12 consecutive months

What is the bona fide residence test?

To meet the bona fide residence test, taxpayers must show that they have set up permanent quarters in a foreign country for an entire, uninterrupted tax year. Simply going to another country to work for a year or more is not enough to meet the bona fide residence test. A taxpayer must establish a residence in the foreign country.

A brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention to return to the foreign country is clear.

example

Charles is a military spouse who has lived and worked in England since 2005. His mother still lives in the U.S. Charles came to the U.S. for two weeks in 2011 to be with his mother after she had surgery. Charles’ trip to the U.S. does not affect his status as a bona fide resident of a foreign country.



EXERCISES (continued)

Question 8: Zach, a U.S. citizen, has homes in the U.S. and in Spain, where he has worked for the last two years. Zach’s wife, who is also a U.S. citizen, lives with him in Spain. Zach visits the U.S. frequently. Does Zach meet the bona fide residence test in Spain? Yes No

What is the physical presence test?

If the taxpayers do not meet the bona fide residence test, then they may qualify under the physical presence test rules. To qualify, the taxpayers must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country or to another foreign country without losing full days. If any part of the taxpayer's travel is not in any foreign country and takes less than 24 hours, you are considered to be in a foreign country during that part of travel. See Publication 54, Physical Presence Test column for additional information.

example

If a taxpayer left England by ship at 10:00 p.m. on July 6 and arrived in Lisbon at 6:00 a.m. on July 8, the taxpayer would lose July 6, 7, and 8 as full days because the trip took more than 24 hours. In this example, if the taxpayer remained in Lisbon, the first full day would be July 9.

Figuring the 12-Month Period

Any 12-month period may be used if the 330 full days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. See Publication 54 for clarification on the physical presence rules.

What is qualifying income?

To qualify for the exclusion, income must be earned income.

How does earned income qualify for the exclusion?

To qualify for the exclusion, the earned income must be for services performed in a foreign country. Amounts paid by the United States or its agencies to its employees *do not qualify* for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Earned income **does not include:**

- Dividends
- Interest
- Capital gains
- Alimony
- Social security benefits
- Pensions
- Annuities

example

Alisa, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2009. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Tokyo. The income from her self-employment may qualify for the exclusion.

What are sources of earned income?

To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in determining the *source* of the income.

If a taxpayer works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total foreign earned income.

example

Earl works and lives in the Bahamas. During the tax year, he worked 50 weeks in the Bahamas. He attended a business meeting in Florida for one week, and was on vacation for one week. One-fiftieth or 2% of his wages are not foreign earned income because of the week spent working in Florida.

example

Ron and his wife Amy, both U.S. citizens, have lived in England for two years. Ron is in the military and Amy works in a pastry shop in a nearby town. Ron's military income does not qualify for the foreign earned income exclusion but Amy's wages from the company in England does qualify. The source of Amy's income is England.



EXERCISES (continued)

Question 9: Juanita lives in Scotland. She is retired and her income consists of U.S. social security, a pension, and several stock dividends. Does she qualify for the foreign earned income exclusion?

Yes No

When do I complete and file Form 2555 or Form 2555-EZ?

If the taxpayer qualifies to exclude foreign earned income, Form 2555 or Form 2555-EZ must be completed. Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad has an illustration of a tax return with Form 2555 completed for the husband and Form 2555-EZ completed for the wife.

To be able to use Form 2555-EZ, the taxpayer must:

- Be a U.S. citizen or resident alien who has wages and salaries, but not self-employment income
- Have total foreign earned income of \$92,900 or less
- Have no business or moving expense deductions

Taxpayers who do not meet these requirements must use Form 2555 to claim the exclusion. For example, a taxpayer who receives self-employment income and is eligible for the exclusion must use Form 2555.

example

Michael and his wife, Eva, have been stationed in Australia since 2008. Michael is a member of the Armed Forces and Eva operates a home day-care business. Their tax home is Australia, and they meet the bona fide residence test. Eva wants to exclude her self-employment income from U.S. taxation.

Because her income is from self-employment, she will need to complete Form 2555 instead of Form 2555-EZ to exclude the income, and must complete Schedule SE to pay social security and Medicare taxes.



EXERCISES (continued)

Question 10: Mallory is a U.S. citizen who has \$34,000 of foreign earned income (wages). She has no other income. Which form should she file?

- A. Form 2555
- B. Form 2555-EZ

How do I complete Form 2555-EZ?

Taxpayers who are eligible to file Form 2555-EZ should complete Parts I, II, and IV of the form. Complete Part III if the taxpayer was in the United States or any of its possessions during the tax year.

How do I complete Form 2555?

Use the following guidelines when completing Form 2555.

- Part I is completed by all taxpayers
- Part II is completed by taxpayers who qualify under the bona fide residence test
- Part III is completed by all taxpayers who qualify under the physical presence test
- Part IV is completed by all taxpayers – list all foreign earned income
- Part V is completed by all taxpayers
- Part VI is completed by taxpayers claiming the housing exclusion and/or housing deduction
- Part VII is completed by taxpayers claiming the foreign earned income exclusion
- Part VIII is completed by taxpayers claiming the foreign income exclusion, the foreign housing exclusion, or both.
- Part IX is completed by taxpayers claiming the housing deduction if line 33 is more than line 36, and line 27 is more than line 43



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).

Taxpayer Interview and Tax Law Application

Look at the following sample interview for taxpayers Hudson and Hope Howard.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

HOPE SAYS...

Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made \$24,000 in U.S. dollars. I heard that you don't have to pay taxes on income earned in a foreign country and I've never done this before.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

HOPE SAYS...

That is possible. First, we will have to determine if you meet the requirements. Were you working as a military or civilian employee of the U.S. government?

No, Bavaria Advertising is a foreign company owned by a family right there in Munich.

Great. That would qualify, but Hudson's military pay won't. [Volunteer links to Form 2555-EZ on the tax software.] Let's see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than \$92,900. You have no self-employment income or business/moving expenses and since you lived on base, you won't have a foreign housing exclusion. OK, we can use Form 2555-EZ.

Yeah, that all sounds right.

Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country.

It sounds complicated to me.

Don't worry, I just need to ask you a few questions. How long did you say you were in Germany?

We moved on base in Germany on March 3, 2010 and just returned to the states on January 10, 2012.

No problem then. You were living in Germany for the entire year so you are considered a bona fide resident in 2011. Since your home and place of employment were both in Germany, you meet the tax home test. Now, what was your address while you were living in Germany?

1567 Albion Street, Munich.

What did you do for Bavaria Advertising?

I was a copywriter.

Do you have Bavaria Advertising's address?

I sure do; it is right here on this statement.

Were you present in the U.S. during 2011? I have to enter the dates on this form.

Not in 2011. But we did come home for the holidays in 2010.

Summary

Total income from all sources is entered on Form 1040, line 22 (the sum of lines 7-21).

Taxpayers are sometimes alarmed at how high their total income is. If this happens, reassure the taxpayer that the return is not finished yet! It is very likely that adjustments, deductions, and credits will considerably reduce the total tax owed.

Line 21, Other Income, includes any taxable income for which there is not a specific line identified on Form 1040, lines 7-20b.

U.S. citizens and resident aliens are taxed on worldwide income. They must file a U.S. tax return even if all the income is from foreign sources, and even if they pay taxes to another country.

When taxpayers living abroad receive income in foreign currency, the amounts reported on the return must be converted into U.S. dollars. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. If there is more than one exchange rate, use the one that most properly reflects the income.

If the taxpayers are eligible to exclude some or all of their foreign earned income, then Form 2555 or Form 2555-EZ will be completed. The excludible amount will be entered as a negative number on line 21 to offset the income reported on line 7 or line 12.

There are optional specialty courses on cancellation of debt and health savings accounts on Link & Learn Taxes. Volunteers should check with their Site Coordinator to determine if certification in one or both of these courses is needed for their site.

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

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

Distributions from Educational Savings Accounts in which the:

- Funds were not used for qualified education expenses, or
- Distribution was more than the amount of the qualified expenses



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: B. Marta's gross income includes her wages and interest, both of which should be reported on her tax return.

Answer 2: C. Mary's gross income includes her wages, interest, and alimony, all of which should be reported on her tax return. Her child support payments are her only nontaxable income.

Answer 3: A. Dividing 200 Euros by the .75514 exchange rate comes to \$264.85.

Answer 4: C. Dividing 36,000 Euros by the .7000 exchange rate comes to \$51,428.57.

Answer 5: No. Miranda is not eligible for the foreign earned income exclusion because Puerto Rico is not a foreign country.

Answer 6: True. Generally, the tax home is the country in which taxpayers maintain their place of business. Because Alan works in China, it is considered to be his tax home. For taxpayers who do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Answer 7: No. Stan is considered to have an abode in the United States and does not satisfy the tax home test in the foreign country. He is not eligible for the foreign earned income exclusion.

Answer 8: Yes. Since Zach went to Spain to work and has established a permanent residence there with his wife, he meets the bona fide residence test.

Answer 9: No. Social security benefits, pension, and dividends do not qualify as earned income; therefore, Juanita does not qualify for the foreign earned income exclusion.

Answer 10: B. Since Mallory's earned income is wages (not self-employment) and is less than \$92,900, she can file Form 2555-EZ.



Lesson 16: Military Income



Introduction

This lesson will help you determine which income items received by current and former members of the U.S. Armed Forces are reportable on the return, and the status of any medical separation pay or pay related to service in a combat zone.

Community property laws may impact the income reported by some military members on their returns.

To identify these types of income, use the interview techniques and tools discussed in the Screening and Interviewing lesson.

Objectives

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

- Which income items received by members of the U.S. Armed Forces are reportable on the tax return and
- The status of any medical separation pay or pay related to service in a combat zone

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 3
- Publication 525
- Publication 555
- Publication 4491-W

What are the types of income?

U.S. Armed Forces members receive many different types of pay and allowances. Some are includible in gross income while others are excludible from gross income.

Refer to the Volunteer Resource Guide (Tab D) for detailed lists of these types of military pay and to determine if they are included in gross income, or excluded.

What income is includible?

Includible items are subject to tax and must be reported on the tax return. The items listed in Publication 3, Table 1, and the Volunteer Resource Guide (Tab D) are included in gross income, unless the pay is for service in a combat zone or in a qualified hazardous duty area. All includible military income will generally be shown in Form W-2, box 1, and reported on Form 1040, line 7.

What income is excludible?

Excludible income does not have to be reported as income on the tax return. The exclusion applies whether the item is furnished in kind or is a reimbursement or an allowance.

For example, the Basic Allowance for Housing (BAH) can be excluded from gross income as a qualified military benefit. Excludible income will not be included in the amount in Form W-2, box 1.



If the amount shown in Form W-2, box 1, differs from the last Leave and Earnings Statement for 2011, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

TIP

If U.S. Armed Forces members were provided a commuter highway vehicle (such as a van) by their employer, refer them to Publication 525, Taxable and Nontaxable Income, and to a professional tax preparer.

**EXERCISES**

Answers follow the lesson summary.

Question 1: You need to account for enlistment and reenlistment bonuses separately when preparing a service member's tax return because the income information is not shown on Form W-2. Refer to Publication 3. True False

Question 2: Which of the following items is excludible from U.S. Armed Forces members' income?

- A. Student loan repayments
- B. Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) income
- C. Basic pay
- D. Hardship duty pay

Homeowners Assistance Program (HAP)

HAP was created to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market or when they are required to permanently relocate during the home mortgage crisis. These payments for qualified military base realignments and closures are excluded from income. For additional information go to <http://hap.usace.army.mil/overview.html>.

What is military separation with disability severance pay?

Disability severance pay has varying effects on a service member's income and taxes.

What is severance pay?

U.S. Armed Forces members who have been separated from the military after years of service or for medical reasons are given severance pay, which is generally taxable as wages. If the member receives disability severance pay and is later awarded Veteran's Affairs (VA) disability benefits, 100% of the disability severance benefit may be excluded from income. The VA makes the determination that the member is entitled to medical disability benefits, and the determination process can take several months, and sometimes years.

What is VA disability compensation?

VA disability compensation is a monetary benefit paid to veterans who are disabled because of injury or disease incurred or aggravated during active military service. The veteran's service must have been terminated through separation or discharge under honorable conditions. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax. The VA does not issue Form W-2, Form 1099-R, nor any other document for nontaxed veteran's disability benefits.

What happens after a service member receives a letter of determination?

Once the VA sends a letter of determination, all future pension payments from the government are offset by the disability amount paid directly from the VA. Disability payments received directly from the VA are not taxable and are not included in Form W-2 or Form 1099-R.

Although pension payments made before the letter of determination was issued have already been taxed, the letter exempts from taxes the same amount of previous pension payments. U.S. Armed Forces members who have already filed a tax return and reported that pension income should file Form 1040X, Amended U.S. Individual Income Tax Return and attach a copy of the letter of determination.



EXERCISES (continued)

Question 3: Disability payments sent directly from the VA to the discharged service member _____.

- A. Are taxable
- B. Appear on the taxpayer's Form W-2 or 1099-R
- C. Are not included on the taxpayer's Form W-2 or 1099-R
- D. May begin before the VA issues the letter of determination

example

Anita Zapata was an active duty service member who was separated due to a medical condition, and began receiving her military pension in February 2010. Here are the payments she reported on her 2010 tax return:

<i>Payments</i>	<i>Amount</i>
• Disability severance pay	\$10,000
• Service pension	\$33,000
• Active duty pay	\$ 5,000

In 2011, the VA determined that she was retroactively entitled to a VA disability pension of \$837 each month from the date of her discharge (February 2010). She can amend her 2010 tax return to exclude \$9,207 ($\837×11 months) of the pension she received plus the entire \$10,000 disability severance payment.

She must attach a copy of her letter of determination to the amended return. Her 2011 Form 1099-R will not include the nontaxable VA disability retirements received during 2011.

What is a combat zone?

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Publication 3 lists the specific areas and dates.

TIP

A taxpayer serving in a combat zone may qualify for relief from certain IRS compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may notify the IRS directly of their status through a special e-mail address: combatzone@irs.gov. They should provide name, stateside address, date of birth and date of deployment to the combat zone. They should not include any social security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative. For more information visit www.irs.gov.

Hazardous duty areas are determined by Congress. Members of the Armed Forces deployed overseas, away from their permanent duty station, in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone for federal income tax purposes.

What is the combat zone exclusion?

Members of the U.S. Armed Forces who serve in a combat zone may exclude certain pay from their income. The entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized due to wounds, disease, or injury incurred while serving in the combat zone. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone.

The following section is to help you understand when pay is considered excludable as combat pay. You will not be making any decisions about what is excludable. The information on the military member's Form W-2 indicates the amount of combat pay with a code Q. If military members feel the amount is incorrect, refer them to the local accounting and finance or payroll office for clarification. Do not change any amounts on Form W-2 when entering them in the tax software.

What qualifies as service in a combat zone?

Service in a combat zone includes periods that military members are absent from duty because of illness, wounds, or leave. If, as a result of serving in a combat zone, military members become prisoners of war or are missing in action, they are considered to be serving in the combat zone as long as they remain in that status for military pay purposes.

When does service outside a combat zone qualify as service inside a combat zone?

Military service outside a combat zone is considered to be performed in a combat zone if the service:

- Is in direct support of military operations in the combat zone, and
- Qualifies a member for hostile fire/imminent danger pay due to dangers or risks from the combat zone

Pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

What is nonqualifying presence in a combat zone?

The following military service does not qualify as service in a combat zone:

- Presence in a combat zone while on leave from a duty station located outside the combat zone
- Passage over or through a combat zone during a trip between two points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience

example

Sgt. Bobby Osage was not assigned to a combat zone but he performed duty that qualified for hostile fire pay. He can exclude that income.



U.S. service members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.



EXERCISES (continued)

Question 4: Which of the following may qualify as service in a combat zone?

- A. Temporary duty in a combat zone
- B. Traveling through a combat zone between two points outside of the combat zone
- C. Presence in a combat zone while on leave from a duty station located outside the combat zone
- D. Direct support of a qualified hazardous duty area but not entitled to hostile fire/imminent danger pay

What is the amount of the combat zone exclusion?

- Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month (even one day) can exclude all of that month's military pay, including awards and re-enlistment bonuses for which the member becomes eligible while in the combat zone. Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded.
- Commissioned officers (including limited duty officers) may exclude pay according to the rules for enlisted members. However, the amount of the exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay received for each month during any part of which they served in a combat zone or were hospitalized as a result of their combat zone service.

Combat pay is not included in box 1 wages on the service member's Form W-2, but the amount is shown in box 12, with code Q. If service members believe the taxable wages on Form W-2 are incorrect, they should contact the finance office to request a corrected Form W-2.

Nontaxable combat pay may increase the Child Tax Credit or Earned Income Tax Credit. Enter all fields from Form W-2 when preparing the tax return. Be sure to consider the combat pay amount when calculating these credits. Compare the credits with and without the inclusion of combat pay; choose the one that is most beneficial to the taxpayer.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 1), Main Information Sheet, and the entries related to combat zone.

Taxpayer Interview and Tax Law Application

The Military Comprehensive Problem in the workbook has an example of Form W-2 with combat pay excluded. Here's how a volunteer might help taxpayers with combat pay:

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Let's talk for a minute about where your husband was stationed.

The combat pay is not taxable, but it's shown on your husband's W-2, here in box 12, with code Q. I will enter that into the system with the rest of the W-2 information, because combat pay can increase some tax credits. I can show on the tax return that he was in the combat zone, but I don't need to know the exact dates. Is he serving in Iraq?

MRS. FANNIN RESPONDS...

My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything?

That's right.

What are the laws regarding community property?

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Special rules apply to married taxpayers who file separately or who were divorced during the tax year and their **domicile** is in a community property state. For military members residing in these states, the key word is domicile, which describes someone's legal, permanent residence. It is not always where the person presently lives.

Married taxpayers who choose to file separately, when subject to community property rules, have to figure community income and separate income for state and federal income tax.

How do community property laws affect Armed Forces pay?

State community property laws apply to active military pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the service member was/is in active military service.

Whether an item is subject to community property laws depends on whether the payment is classified as active pay or retired/retainer pay:

- State community property laws apply to active military pay. Generally, the character of the pay as separate from community income is determined by the marital status and domicile of the service member and spouse while the member is on active military service.
- Armed Forces retired or retainer payments may be subject to community property laws. For more information see Publication 555, Community Property.

Summary

Special rules may govern whether certain income received by members of the U.S. Armed Forces is includable or excludable from taxable income reported on the return:

- Homeowners Assistance Program (HAP)
- Medical separation with disability severance pay
- Combat zone exclusion
- Community property laws

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

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

- U.S. Armed Forces members who were provided a commuter highway vehicle (such as a van) by their employer



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: False. The payments and withholdings for the enlistment and reenlistment bonuses are reflected on the service member's Form W-2.

Answer 2: B. The Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) are both nontaxable income.

Answer 3: C. Once the VA sends the letter of determination, all pension payments are offset by the disability amount paid directly from the VA, which is not taxable and not included in any Form W-2.

Answer 4: A. Military members are considered to be serving in a combat zone if they are either assigned on official duty to a combat zone or they qualify for hostile fire/imminent danger pay while serving in direct support of a combat zone.



Lesson 17: Adjustments to Income



Introduction

This lesson covers the Adjusted Gross Income (AGI) section of the tax return. Taxpayers can subtract certain expenses, payments, contributions, fees, etc. from their total income. The adjustments, subtracted from total income on Form 1040, establish the AGI.

Line items under the Adjusted Gross Income section of the tax return are Basic, Intermediate, Military, or out-of-scope topics. This lesson will cover the Basic and Intermediate topics.

	22	Combine the amounts in the far right column for lines 7 through 21. This is your gross income				
Adjusted Gross Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE	27			
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid b Recipient's SSN ▶	31a			
	32	IRA deduction	32			
	33	Student loan interest deduction	33			
	34	Tuition and fees. Attach Form 8917	34			
	35	Domestic production activities deduction. Attach Form 8903	35			
		36	Add lines 23 through 35		36	
		37	Subtract line 36 from line 22. This is your adjusted gross income		37	

Objectives

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

- Identify which adjustments are within the scope of the VITA/TCE Program
- Calculate and accurately report the adjustments to income that are within the scope of the VITA/TCE Program

How do I determine if the taxpayer has adjustments to income?

To identify the adjustments to income that taxpayers can claim, you will need to ask the taxpayers if they had the types of expenses listed on the Adjusted Gross Income section of the tax return. To determine the taxpayers' adjustments to income, use the interview techniques and tools discussed in the Screening and Interviewing lesson. Review the taxpayers' answers on their intake and interview sheet.

During the tax year did the taxpayer or spouse:

- Have any expenses as an educator?
- Receive income from self-employment?

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Publication 504
- Publication 590
- Publication 970
- Form 1040 Instructions
- Form 1040 (Sch SE)
- Form 1098-E
- Form 1099-INT
- Form 1099-OID
- Form 8606
- IRA Deduction Worksheet
- Student Loan Interest Deduction Worksheet

- Pay a penalty for early withdrawal of savings?
- Pay alimony?
- Make contributions to a traditional IRA?
- Pay student loan interest?
- Pay college tuition?
- Receive income from jury duty that was turned over to an employer?

There are other adjustments to income on Form 1040, such as self-employed health insurance deduction, self-employed SEP, SIMPLE, and qualified plans and domestic production activities deductions. These are beyond the scope of the VITA/TCE program. If you believe a taxpayer could benefit from one of these other adjustments, encourage the taxpayer to consult a professional tax preparer.

There is a specialty course on health savings accounts on Link & Learn Taxes for volunteers with an Intermediate certification or higher. To access this online course and earn a certification for this specialty topic, go to www.irs.gov and use the keyword/search “Link & Learn.” This specialty course on health savings accounts is optional. Check with your Site Coordinator to determine whether you should be certified in this topic.



Tax Software Hint: To review the tax software entry screen for Adjustments to Income, go to the Volunteer Resource Guide (Tab 3).



How do I handle educator expenses?

Who is eligible?

Eligible educators can deduct up to \$250 of qualified expenses paid in 2011. If the taxpayer and spouse are both eligible educators, they can deduct up to \$500, but neither can deduct more than their own expenses up to \$250. Any expenses exceeding \$250 for either spouse may be treated as an itemized employment-related deduction on Schedule A.

At this point in the interview, you will know if the taxpayer and/or spouse are educators. Probe a little deeper to see if they qualify for this adjustment. Ask questions such as:

- Are you or your spouse a teacher, instructor, counselor, principal, or aide in a school? (Cannot be a home school)
- What grade or grades do you teach? (Must be K-12)
- Were you employed for at least 900 hours during the school year? (Required minimum)

What expenses qualify?

If the taxpayer or spouse is an eligible educator, ask for documentation of qualified expenses. Advise taxpayers who do not have receipts with them, they must have receipts for verification if they get audited. Expenses that qualify include books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. Expenses that do *not* qualify are home schooling, nonathletic supplies for physical education, or health courses.

example

Gloria is a 5th and 6th grade teacher who works full-time in a year-round school. She had 1800 hours of employment during the tax year. She spent \$262 on supplies for her students. Of that amount, \$212 was for educational software. The other \$50 was for supplies for a unit she teaches sixth graders on health. Only the \$212 is a qualified expense. She can deduct \$212.

example

Debbie is a part-time art teacher at an elementary school. She spent \$185 on qualified expenses for her students. Because she has only 440 hours of documented employment as an educator during the tax year, she cannot deduct her educator expenses.

What other rules apply?

Continue to probe to learn if the taxpayer or spouse received reimbursement that would reduce the amount of their educator expenses. For example, ask:

- Did you receive reimbursement that is not listed on Form W-2?
- Did you redeem tax-free interest on U.S. Series EE and I Savings Bonds, such as redeeming savings bonds to pay educational expenses?
- Did you receive excludable payments from a Qualified Tuition Program (QTP) or Coverdell Education Savings Account (ESA)?

Educator expenses are reduced by any of these applicable reimbursements.

example

Evelyn managed to work 1000 hours as an educator during the tax year while completing graduate studies. She spent \$200 to buy qualified school supplies for her students. She covered \$400 of her own educational expenses from her Coverdell ESA. She cannot take the deduction for educator expenses.

How do I report this?

Educator expenses are reported on Form 1040, line 23. Don't forget to reduce the total educator expenses by any reimbursements, nontaxable savings bond interest, or nontaxable distributions from an ESA or QTP.

Taxpayer Example

Bob teaches elementary school. His wife Janet teaches high school chemistry. Here is how a volunteer helped them determine if they can take the deduction for educator expenses.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

You've already mentioned that you both work full-time as teachers, so you may be able to deduct some of the money you spent on qualified educator expenses. Did you bring your receipts?

Can you tell me what you purchased? Janet, maybe you could go first.

Your receipts add up to \$382. Now, we can count only the first \$250 of educator expenses, but because you are married and filing jointly, we can count up to \$250 for Bob. Bob, tell me about your expenses.

Yours total \$263. Now, did either of you receive any reimbursement that is not listed on Form W-2?

That would bring your total down to \$213.

No, I'm sorry, each person's expenses have to stand alone. However, the amount over \$250 can be claimed on Schedule A and is subject to 2% of AGI. Did either of you receive any reimbursement that is not listed on a Form W-2, from any other source?

Did you redeem U.S. series EE and I Savings Bonds in 2011?

We would complete a form to see what percentage of the tax-free interest should be applied as a reimbursement. One more thing: did you receive distributions from a qualified tuition program or a Coverdell education savings account?

Okay, we can claim \$213 for Bob and the maximum \$250 for Janet. That gives you a total of \$463 on your joint return as a deduction for educator expenses. Any questions before we go on?

[On the intake and interview sheet, indicate that the taxpayers are entitled to the educator expense adjustment.]

[Schedule A itemized deductions are discussed in a later lesson.]

JANET & BOB RESPOND...

[Janet] Yes, all teachers keep careful records of their expenses. Here are my receipts and here are Bob's.

Sure. Three are for quick reference cards for my chemistry students. And two are for special reagents the department doesn't stock.

[Bob] These four are for art supplies – paint and brushes, as you can see – and these two are for special papers and sculpting clay.

[Janet] No, we paid these expenses out of our own pockets.

[Bob] Wait, now that I think about it, I got reimbursed \$50 for the clay.

[Janet] Can't we apply some of my excess expense to Bob and bring his total up to \$250?

No.

No, we didn't. What if we had?

[Bob] No, neither of those.

[Janet] No, I think we understand.

How do I handle self-employment tax?

Self-employed taxpayers can subtract a deductible portion of their self-employment tax from their income. As a result of the reduction in the self-employment tax rate for 2011, there is a slight difference from past years in the calculation for the adjustment to income. Self-Employment Tax is covered in Lesson 27, Other Taxes.



Tax Software Hint: The deductible portion of the self-employment tax is automatically calculated from Schedule SE. To review information related to the software, go to the Volunteer Resource Guide (Tab 3).



How do I handle penalties for early withdrawal?

Taxpayers can adjust their income to deduct penalties they paid for withdrawing funds from a deferred interest account before maturity. Ask if the taxpayer and/or spouse made any early withdrawals during the tax year. If so, ask to see Form 1099-INT, Interest Income, or Form 1099-OID, Original Issue Discount, documenting the penalty.



Tax Software Hint: The early withdrawal penalty amount is entered on the electronic Interest Statement, Schedule B. The penalty amount will carry over to Form 1040, line 30.

example

Gloria withdrew \$5,000 early from a one-year, deferred-interest certificate of deposit. She had to pay a penalty of three months' interest. She can claim this penalty amount as an adjustment to income.



How do I handle alimony paid?

Alimony is a payment to a spouse or former spouse under a divorce or separation instrument. The payments do not have to be made directly to the ex-spouse. For example, payments made on behalf of the ex-spouse for expenses specified in the instrument, such as medical bills, housing costs, and other expenses can qualify as alimony. Alimony does not include child support or voluntary payments outside the instrument. The person paying alimony can subtract it as an adjustment to income; the person receiving alimony must treat it as income. A summary of the alimony requirements can be found in the Adjustments section of the Volunteer Resource Guide (Tab E).

When you conduct the interview, ask if the taxpayer paid alimony under a divorce or separation instrument. If so, explain that you need the exact amount, as well as the social security number of the recipient, because the recipient must report the payment to the IRS as income and the two amounts must agree.

For additional information on alimony, refer to the Alimony chapter in Publication 17 and Publication 504, Divorced or Separated Individuals.

example

Anthony has been divorced for three years. Under his divorce instrument, he paid his ex-wife \$12,600 during the tax year. As a favor, he also made \$2,400 in payments to cover part of her vehicle lease, so she could keep steady employment. He can take the \$12,600 as an adjustment to income. He cannot count the lease payments because those were payments not required by the divorce instrument.



EXERCISES

Answers are at the end of the lesson summary.

Question 1: Victoria divorced in 2007. Her divorce settlement states that she must pay her ex-husband \$16,000 a year. She is also required to pay his ongoing medical expenses for a condition he acquired during their marriage. During the tax year, the medical expenses were \$9,500. How much can she deduct as an adjustment to income?

- A. \$16,000
- B. \$9,500
- C. \$25,500
- D. \$6,500

How do I handle IRA contributions?

“IRA” stands for “Individual Retirement Arrangement.” It is a personal savings plan that offers tax advantages to set aside money for retirement. This section discusses “traditional” IRAs. A traditional IRA is any IRA that is not a Roth or SIMPLE IRA. See the Individual Retirement Arrangements (IRAs) chapter in Publication 17, and Publication 590, Individual Retirement Arrangements, for more information on all types of IRAs.

Some of the features of a traditional IRA are:

- Taxpayers may be able to deduct some or all of their contributions to the IRA (depending on circumstances).
- Generally, amounts in an IRA, including earnings and gains, are not taxed until distributed.
- Contributions may be eligible for the retirement savings contributions credit.

Although contributions to a Roth IRA cannot be deducted, the taxpayer may be eligible for the retirement savings contributions credit, discussed in the lesson on Miscellaneous Credits.

example

Fred has a traditional IRA account and a Roth IRA account. During the tax year, Fred contributed \$2,200 to his traditional IRA and \$1,000 to his Roth IRA. The most Fred will be able to deduct is the \$2,200 contribution to his traditional IRA.

What are the eligibility requirements for an IRA contribution?

The taxpayer, and the taxpayer’s spouse if applicable, must meet these eligibility requirements in order to make an IRA contribution:

- Types of IRAs: Verify the types of IRAs to which the taxpayer and spouse contributed. Only contributions to traditional IRAs are deductible.

- **Age limit:** Taxpayers can contribute to a traditional IRA only if they are less than 70½ years of age at the end of the tax year. Check the taxpayer's birth date (and spouse's if applicable) indicated on the intake and interview sheet. To meet the age requirement for 2011, a taxpayer must have been born on, or after, July 1, 1941.
- **Compensation:** Individuals must have taxable compensation (i.e., wages, self-employment income, commissions, taxable alimony, or taxable scholarships or fellowships).
- **Time limits:** Contributions must be made by the due date for filing the return, not including extensions. Verify with the taxpayer and spouse that they made the contribution(s) (or will make them) by April 17, 2012.

TIP

Be sure the taxpayer knows that if a contribution is reported on the 2011 return but is not made by the deadline, the taxpayer must file an amended return.

How much can a taxpayer contribute to an IRA?

There is a limit to the amount that a taxpayer can contribute to an IRA each year. The total contribution (combined contributions to all accounts, including Roth and traditional IRAs) cannot be more than the *smaller of*:

- \$5,000 (\$6,000 for a person who is age 50 or older by the end of the tax year)
- The individual's taxable compensation

What is the compensation requirement?

Compensation is generally the income a taxpayer has earned from working; it also includes alimony, and other forms of earned income. (See Publication 17 for more information on compensation.) Taxpayers cannot make IRA contributions that are greater than their compensation for the year.

If taxpayers file a joint return, and one spouse's compensation is less than the other spouse's compensation, the most that can be contributed for that spouse is the lesser of:

- \$5,000 (\$6,000 if age 50 or older) or
- The total compensation includible in the gross income of both spouses for the year, reduced by:
 - Traditional IRA contributions for the spouse with the greater compensation
 - Any contribution for the year to a Roth IRA for the spouse with the greater compensation

In other words, as long as they file a joint return, married taxpayers' combined IRA contributions cannot exceed their combined compensation, and neither spouse can contribute more than \$5,000 (or \$6,000 for 50 and older) to their own IRA.

example

Gene and Sue are married and are both over 50 years old. Gene earned \$70,000 and Sue earned \$1,500. During the tax year, Gene contributed \$3,500 to his traditional IRA and \$2,000 to a Roth IRA, making his total contributions \$5,500. To figure the maximum contribution to Sue's IRA, use a total compensation of \$66,000 (i.e., \$71,500 – \$5,500). If Gene and Sue file jointly, they can contribute up to \$6,000 to Sue's IRA even though her own compensation was just \$1,500.

Although a person may have IRA accounts with several different financial institutions, the tax law treats all of their traditional IRA accounts as one single IRA.

example

Bill is 29. He has a traditional IRA account at City Home Savings Bank and another traditional IRA account through his stockbroker. He also opened a Roth IRA through his stockbroker. Bill can contribute to any or all of his accounts this year, but the combined contributions for the tax year cannot exceed \$5,000.



EXERCISES (continued)

Question 2: Stan is 47; he contributed \$1,000 to a Roth IRA. What is the maximum he can contribute to a traditional IRA?

- A. \$3,000
- B. \$4,000
- C. \$1,000
- D. \$2,000

Question 3: Bob and Carol are married and both are 55 years old. They both work, and each has a traditional IRA. During the tax year, Bob earned \$2,000, and Carol earned \$50,000. If they file separate returns, what is the maximum that Bob can contribute to his IRA? \$ _____

Question 4: If Bob and Carol (from Question 3) file jointly, what is the maximum they can contribute to Bob's IRA? \$ _____ What is the maximum they can contribute to both of their IRAs? \$ _____

Are there special rules for certain military personnel?

Current or former members of the Armed Forces may qualify for additional retirement benefits. Under the Heroes Earned Retirement Opportunities (HERO) Act, taxpayers can count tax-free combat pay when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the Armed Forces whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

When can IRA contributions be deducted?

Deductions cannot be taken for contributions to other types of IRAs. The taxpayer's deduction for IRA contributions may be "phased out" (i.e., reduced or eliminated) depending on their income, filing status, and whether the taxpayer is covered by a retirement plan at work. The difference between the permitted contributions and the IRA deduction, if any, is the taxpayer's nondeductible contribution. Form 8606, Nondeductible IRAs, must be completed for any nondeductible contributions.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as having been deducted. This means all distributions will be taxed when withdrawn unless the taxpayer can show, with satisfactory evidence, that non-deductible contributions were made.

Form 8606 requires basis information in IRAs from prior years and can be complex. If Form 8606 is required, refer the taxpayer to a professional tax preparer.

How do I determine the deduction amount?

The factors that affect whether traditional IRA contributions are deductible include:

- Whether the taxpayer (or spouse, if filing a joint return) is covered by a retirement plan at work. Review the tables in the Adjustment tab of the Volunteer Resource Guide (Tab E). These tables are also in the IRA chapter of Publication 17.

- The taxpayer's Modified Adjusted Gross Income (MAGI) before taking the deduction. If the taxpayer or spouse is covered by a retirement plan, the deduction amount will be reduced or eliminated if the MAGI on the tax return is above a certain limit. Use the IRA Deduction Worksheet from Form 1040 Instructions to figure their MAGI without the deduction.

How do I complete the IRA Deduction Worksheet?

If the taxpayer and spouse meet the general eligibility requirements, continue the interview by using the IRA Deduction Worksheet, in the tax software, as your guide.

Retirement coverage at work

Ask if the taxpayer and/or spouse were covered by a retirement plan at work at any time during the tax year. If so, their deduction may be limited. Employees covered by a retirement plan will have box 13 on Form W-2 checked.

Filing status and income

If the taxpayer or spouse is covered by a retirement plan, the worksheet will show the income limits for deducting IRA contributions, based on the filing status of the return. The worksheet will also help you calculate the MAGI, by subtracting certain other adjustments to income from the total income on the return. Notice that the income limitation amount may be different for each spouse on a joint return, but that the MAGI computation is the same. This is because if one spouse is covered by a retirement plan but the other is not, the noncovered spouse will have a higher income limit before their IRA deduction is phased out.

If the MAGI is greater than the income limits, the deduction cannot be taken. If this is the case, explain to the taxpayers and answer any questions they may have about why the deduction cannot be taken. The contribution may still be made, it is just not deductible.

If the deduction is allowed, continue the calculation to determine if the taxpayer is entitled to a full deduction or a partial deduction.

Enter the total contributions to traditional IRAs that were made (or will be made) for each spouse (on a joint return) by April 17, 2012. The worksheet in the tax software calculates the amount that can be deducted from income.



If the taxpayers' IRA contribution is more than the lesser of \$5,000 (\$6,000 if age 50 or older) or their compensation, advise the taxpayers that their excess contributions (and all related earnings) should be withdrawn from the IRA before the due date. If the excess contributions are not withdrawn, an additional tax will be assessed. This tax on excess contributions is discussed in the lesson on Other Taxes.

How do I report the IRA deduction?

Report the deduction on line 32 of Form 1040.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 3), Form 1040 - Adjustments to Income.

What if the taxpayer has excess IRA contributions?

An excess IRA contribution is an amount contributed to a traditional IRA that is more than whichever of the following is the smaller amount:

- The taxable compensation for the year or
- \$5,000 (\$6,000 if age 50 or older)

The taxpayer may not know that a contribution qualifies as “excess” until the tax return is completed. When this situation is identified, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, the taxpayer will be subject to an additional 6% tax on this amount. This additional tax is covered in the Other Taxes lesson, but is out of scope for the VITA/TCE program. Taxpayers subject to the additional 6% tax should be referred to a professional tax preparer.

The withdrawn excess contribution is not included in the taxpayer’s gross income if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn

Taxpayers must include in gross income the interest or other income that was earned on the excess contribution. Taxpayers must report it on their return for the year in which the excess contribution was made. The withdrawal of interest or other income may be subject to an additional 10% tax on early distributions.

Form 1099-R

Taxpayers will receive Form 1099-R indicating the amount of the withdrawal. If the excess contribution was made in a previous tax year, the form will indicate the year in which the earnings are taxable.

example

Maria, age 35, made an excess contribution in 2011 of \$1,000, which she withdrew by April 17, 2012, the due date of her return. At the same time, she also withdrew the \$50 income that was earned on the \$1,000. She must include the \$50 in her gross income for 2011 (the year in which the excess contribution was made). She must also pay an additional tax of \$5 (the 10% additional tax on early distributions because she is not yet 59½ years old), but she does not have to report the excess contribution as income or pay the 6% excise tax. Maria receives a Form 1099-R showing that the earnings are taxable for 2011.

How do I handle student loan interest?

The student loan interest deduction is generally the smaller of \$2,500 or the interest payments paid that year on a qualified student loan. This amount is gradually reduced (phased out) or eliminated based on the taxpayer’s filing status and MAGI.

These limits are shown under the Adjustments tab of the Volunteer Resource Guide (Tab E).

example

Robert has taken his first job after completing law school. His filing status is Single. He paid \$3,000 in interest on his student loans during the tax year. With all adjustments to income (except student loan interest adjustment), his MAGI is \$49,000. He can deduct \$2,500 of his student loan interest as an adjustment to income.

example

Veronica and her husband are filing jointly. Their MAGI is \$120,000. She completed her doctoral degree in 2010 and paid \$2,400 in student loan interest in 2011. Due to their high MAGI, their deduction must be calculated; it will be less than the full amount of interest that she paid.

What type of interest qualifies?

Generally, student loan interest is paid during the year on a loan for qualified higher education expenses. The loan must meet all three of these conditions:

- It was for the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was obtained
- It was paid within a reasonable period of time before or after obtaining the loan
- It was for an eligible student

Interest does not qualify if the loan was from a related person, a qualified employer plan, or if the taxpayer is not legally liable for the loan.



EXERCISES (continued)

Question 5: Todd and Janet have a MAGI of \$45,000. They are filing jointly. Two years ago, they took out a loan so Todd's mother could earn her RN degree at night school. Todd could not claim her as a dependent on his return. This year, they paid \$1,000 in interest on the loan. How much can they deduct from their income?

- A. \$0
- B. \$1,000
- C. \$1,500
- D. \$2,500

Who is eligible for the deduction?

Generally, a taxpayer can claim the deduction if all the following are true:

- The taxpayer is not using the Married Filing Separately filing status
- The taxpayer will not be claimed as a dependent on someone else's return
- The taxpayer is legally obligated to pay interest on a qualified student loan
- The taxpayer paid interest on a qualified student loan
- The interest is on a loan to pay tuition and other qualified higher education expenses for the taxpayer, the taxpayer's spouse, or someone whom the taxpayer could claim as a dependent when the loan was taken out
- The education expenses were paid or incurred within a reasonable period of time before or after the loan was taken out
- The person for whom the expenses were paid or incurred was an eligible student

Conduct a probing interview to verify that the taxpayer meets all these tests for the deduction.

What are qualified higher education expenses?

Qualified expenses include: tuition and fees; room and board; books, supplies and equipment; and other necessary expenses (such as transportation).

Qualified expenses must be reduced by certain other educational benefits. Ask the taxpayer if the expenses were offset by any of the following:

- Employer provided educational assistance benefits
- Tax-free distributions from a Coverdell ESA or from a qualified tuition program

- U.S. savings bond interest excluded from income because it is used to pay qualified higher education expenses
- Certain scholarships and fellowships
- Veteran's educational assistance benefits
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses

No double benefit allowed

Taxpayers cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (e.g., as home mortgage interest).

What is an eligible educational institution?

An eligible educational institution is generally any accredited public, nonprofit, or private post-secondary institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and privately owned profit-making post-secondary institutions. If the taxpayers do not know if an educational institution is an eligible institution, they should contact the school. A searchable database of all accredited schools is available on the U.S. Department of Education web site at <http://ope.ed.gov/accreditation/>.

Who is an eligible student?

An eligible student is someone enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. The standard for what is half the normal full-time work load is determined by each eligible educational institution.

example

This year, Jeremy paid interest on a loan that allowed his 21-year-old daughter, Kate, to complete a program in holistic medicine as a full-time student at the Southwestern College of Synergistic Therapy. Although she qualifies as his dependent, and the loan paid for books, supplies, and equipment, the college is not accredited. Therefore, Jeremy cannot deduct the interest on the student loan.

Where can I get the information?

If the taxpayer paid \$600 or more in interest to a single lender, the taxpayer should receive Form 1098-E, Student Loan Interest Statement, or another statement from the lender showing the amount of interest paid. This information will assist you in completing the student-loan interest deduction.

The taxpayer should keep documentation of all qualified student-loan interest paid during the tax year.

See Publication 970, Tax Benefits for Education, for more information on the Student Loan Interest Deduction.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 3), Adjustments to Income.

Taxpayer Interview and Tax Law Application

Here is how a volunteer helped Brenda determine if she can take the deduction for her student loan interest.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

In reviewing your intake and interview sheet, I see you did not indicate if you had any educational expenses. Did you pay any student loan interest this year?

Well, you might be able to take a deduction for that. You are filing as Single, and your income before adjustments is not more than the limit for your filing status. Can you show me a statement from the lender?

The interest amounts add up to \$2,600. Now, if your interest payments qualify for the deduction, the most we can claim is \$2,500. Do you have any questions about that?

I just need to ask a few questions to see if you qualify, okay? Earlier we decided that you can't be claimed as a dependent on someone else's return, so that's no problem. Can you tell me what you used the loan to pay for?

Did you receive any educational assistance, like from your employer or the Veteran's Administration?

How about tax-free withdrawals from a Coverdell educational savings account, another qualified tuition program, or from U.S. savings bonds?

Did you get any other nontaxable payments, not counting gifts, bequests, or inheritances, which were specifically for educational expenses?

It looks like you can claim the maximum deduction of \$2,500.
[Indicate on the intake and interview sheet whether Brenda is eligible for this adjustment.]

BRENDA RESPONDS...

Yes, I just graduated a year ago and I'll be paying those loans for a while.

I have two loans; here are the statements.

No, I understand.

My tuition and fees, and my books.

No.

No, none of those.

Heavens, no, I wish I had!

How do I handle tuition and fees?

What is the deduction?

Taxpayers can deduct up to \$4,000 in qualified tuition and related expenses paid during the tax year. The amount of the deduction is determined by the taxpayer's filing status, MAGI, and other factors. For the amount of the allowable deduction see the Effect of MAGI on Maximum Tuition and Fees Deduction chart in the Adjustments section of the Volunteer Resource Guide (Tab E).

example

Leonard, a single taxpayer who had a total income of \$24,000, meets all the requirements to take the deduction. He paid \$4,427 in tuition and fees. Because his gross income is well below the MAGI limit, he would be able to deduct the maximum amount (\$4,000) for his tuition and fees payments.

example

Juanita is married but uses the Married Filing Separately status. She cannot deduct tuition and fees.

Who is eligible for this deduction?

The deduction can be claimed for the taxpayer, the taxpayer's spouse (if filing a joint return), and any dependent (for whom the taxpayer claims a dependency exemption) who attended an eligible educational institution during the tax year.

The tuition and fees deduction *cannot* be claimed by married taxpayers who file as Married Filing Separately or by an individual who is a dependent of another taxpayer.

In order to claim a deduction for expenses paid for a dependent who is the eligible student, the taxpayer must have paid the qualified expenses and claim an exemption for the dependent. If the student is eligible to be claimed as a dependent (even if not actually claimed) and paid his or her own expenses, *no one* can take the adjustment. However, if the student would not qualify as a dependent, he or she can claim the deduction even if tuition and fees were paid by another person. In that case, the student can treat the amounts paid for tuition and fees as a gift.

Taxpayers who are not eligible for the tuition and fees adjustment because of the dependency issue may be eligible for an education tax credit, covered in the Education Credits lesson.

example

Joseph is 30. Although he lives at home and goes to school full time, he earns about \$5,000 each year, so his parents cannot claim him as a dependent. Only Joseph can take the tuition and fees adjustment, even if his parents pay his education expenses.

example

Carly is 18 and claimed by her parents as a dependent. She took out student loans and paid all of her own tuition and fees. Carly cannot take the deduction because she is a dependent. Carly's parents can't claim the deduction either because they did not pay the education expenses. Carly's parents should look into the education credits.

What are qualified tuition and fees expenses?

Generally, qualified education expenses are amounts paid for tuition and fees required for the student's enrollment or attendance at an eligible educational institution. It does not matter whether the expenses were paid in cash, by check, credit card, or with borrowed funds.

Qualified education expenses do not include payments for:

- Insurance, room and board, medical expenses (including health fees), transportation, or similar personal, living, or family expenses.

- Course-related books, supplies, nonacademic activities and equipment unless it is paid as a condition of enrollment or attendance
- Any course or other education involving sports, games, hobbies, and noncredit courses unless the course or other education is part of the student's degree program

Ask the taxpayer if the qualified tuition and expenses were offset by distributions from qualified state tuition programs, Coverdell ESAs, or interest from savings bonds used for higher education expenses. Subtract these from the total payments for tuition and fees.

To help you figure the tuition and fees deduction, the taxpayer should have received Form 1098-T, Tuition Statement. Generally, an eligible education institution must send Form 1098-T or a substitute to each enrolled student by January 31. However, the form only reports "amount billed" or "payments received."



Form 1098-T may have incomplete information. You must question the taxpayer to determine the amount of qualified expenses actually paid and adjust this amount by any non-taxable items, such as scholarships or tuition program distributions.

What is an eligible educational institution?

An eligible educational institution is generally any accredited public, nonprofit, or private post-secondary institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited public, nonprofit, and privately owned profit-making post-secondary institutions. Taxpayers who do not know if an educational institution is an eligible institution should contact the school.

How do I determine the amount of the deduction?

Use Form 8917, Tuition and Fees Deduction, to figure the MAGI and the resulting deduction amount.



Tax Software Hint: Form 8917, Tuition and Fees Deduction, is automatically completed from data input to the Student Loan Interest, Coverdell ESA and QTP, Tuition and Fees worksheet (1040-Wkt2).

How do I determine the best education benefit for the taxpayer?

If taxpayers claim the tuition and fees adjustment to income, they cannot claim the education tax credit. The education credits include the American Opportunity and Lifetime Learning Credits, discussed in more detail in the Education Credits lesson.

For most taxpayers, the tax credit is more beneficial than the adjustment. However, it is important to calculate and compare the education benefits to determine which one is better for the taxpayer.

Complete the entire tax return separately using first the tuition and fees deduction, then the education credit. Compare the returns and choose the best one for the taxpayer.

To compare the benefits see the Highlights of Education Tax Benefits chart in the References section of the Volunteer Resource Guide (Tab 13).

Taxpayer Scenario

Glenda's Education Expenses

Here is how a volunteer helped Glenda deduct the tuition and fees she paid for a class.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

GLENDIA RESPONDS...

Let's talk about your education-related expenses. Were you or someone else in your family going to school?

I took one class in the fall.

You're filing as Head of Household and your income is below the limit for taking the full deduction. Do you have a receipt for the tuition payment?

Yes, these are the receipts from City College.

I see \$450 for tuition and \$80 for books. Were you required to purchase the books through City College or could you have bought them elsewhere?

Those books were written specifically for the course; I had to purchase them through the school when I registered and they were an enrollment requirement in the course.

OK, then we can include the books. That totals \$530. I just need to ask a few more questions. Did you receive any funds from an educational assistance program from your employer?

Yes, the Educational Assistance Program provided \$100.

Did you make any tax-free withdrawals from a Coverdell educational savings account or another qualified tuition program, or from U.S. savings bonds?

No.

Did you get any other nontaxable payments, not counting gifts, bequests, or inheritances, that were specifically for educational expenses?

Well, my mom gave me \$100 to help with tuition.

The \$100 was a gift, so we don't count it. Your total payments were \$530 and then we must subtract the \$100 employer benefit. You can deduct \$430 for tuition and fees. Do you have any questions about all this?

No, I'm really glad I can deduct that.

There is also a credit for people who are paying for college expenses. You can take one or the other, but not both. When we get to the end of the return, I will ask you some more questions to figure out if the credit would be better for you than this deduction.

Okay, I'd appreciate that.

[Note on the intake and interview sheet that you have addressed this adjustment.]

Is pay for jury duty an adjustment to income?

As you learned earlier, jury duty pay received by taxpayers is included in Other income on Form 1040, line 21. Some employees receive their regular wages from their employers while they are serving on a jury instead of working at their jobs.

Often, employees must turn their jury duty pay over to their employers. This may be claimed as an adjustment to income.

How do I determine Adjusted Gross Income?

The taxpayer's total Adjusted Gross Income (AGI) is the amount that is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses. To find the taxpayer's AGI:

1. Add the Income section (lines 7 through 21) and the result is on line 22. This is the taxpayer's total income.
2. Add the Adjustments to Income section (lines 23 through 35) and the result is on line 36. These are the total Adjustments.
3. Subtract line 36 from line 22 and the total is on line 37. This is the AGI.

Taxpayer Interview and Tax Law Application

Here is how a volunteer helped Daniela with the adjustments to income covered in this lesson.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

DANIELA RESPONDS...

Daniela, we've totaled your income, so we can go on to Adjustments to Income. We might find ways to reduce the income that you're taxed on. Do you have any questions before we go on?

No, it all makes sense.

Now, let's review the expenses listed on your intake and interview sheet and the deductions listed in the Adjustments to Income section of Form 1040. Do you have a Health Savings Account?

No, I don't.

Okay. We can skip moving expenses because you haven't moved for your job. That brings us to self-employment tax. As you can see, tax software has calculated the deductible portion of your self-employment tax and shows it here as an adjustment to income. The same with the penalty for an early withdrawal, right? Since I put that in when I entered your interest income, it already shows up as an adjustment.

Cool!

Did you pay any alimony?

No, I've never even been married.

Now, did you contribute to an IRA?

I put in \$2,000 right after Christmas.

Good for you. You can contribute up to \$5,000 this year—will you be contributing any more? You can put money in your IRA before the deadline for filing the return.

I don't think so, but that's good to know.

Was it a traditional, Roth IRA, or a SIMPLE IRA?

It was just a plain old IRA. Here's the statement.

There we go; it is what we call a traditional IRA. You certainly are under 70½ years of age. Were you covered by any kind of employer retirement plan at any time during 2011?

No, none.

Because you weren't covered by a retirement plan, you will be able to deduct the full \$2,000 you contributed.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

DANIELA RESPONDS...

[The volunteer reviews all expenses listed on the intake and interview sheet and moves down each line of the Adjustments section of Form 1040, asks more questions, and determines that Daniela does not qualify for the remaining adjustments.]

We've entered all the adjustments that apply to you. Here is your total income . . . here are your total adjustments . . . and here is what we call your Adjusted Gross Income, that will carry over to the second page of the return where we will determine your deductions and exemption amounts.

[On the intake and interview sheet, note that you have addressed this adjustment.]

That's great! This program makes it really easy!

Practice - Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to any adjustments to income that she can claim. Return to this lesson after you have reviewed this information.

Summary

In this lesson, you learned how to identify and work with these adjustments to income:

- Educator expenses
- Deductible portion of self-employment tax
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Student loan interest deduction
- Tuition and fees deductions
- Jury Duty Pay turned over to the taxpayer's employer

There is an optional specialty course on health savings accounts on Link & Learn Taxes for volunteers with an Intermediate certification or higher.

If you believe a taxpayer could benefit from an adjustment that is out of scope and was not covered in this lesson, encourage the taxpayer to consult a professional tax preparer.

In this lesson, you saw that tax software makes it much easier to work with adjustments by providing easy access to electronic worksheets and by doing many calculations for you.

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

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

- Other adjustments to income on Form 1040, such as:
 - Self-employed health insurance deduction
 - Self-employed SEP, SIMPLE, and qualified plans
 - Domestic production activities deduction
- Form 8606, Nondeductible IRAs



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: C. She can deduct the full \$25,500 because it is all required by the divorce instrument.

Answer 2: B. He can deduct no more than the \$4,000 contribution to the traditional IRA.

Answer 3: If Married Filing Separately, Bob can contribute no more than \$2,000, the amount of his compensation.

Answer 4: They can contribute up to \$6,000 to Bob's IRA account. If Married Filing Jointly, they can contribute a maximum of \$12,000.

Answer 5: A. Because Todd's mother is not their dependent, they can deduct \$0 of the interest they paid.



Lesson 18: Military Moving Expenses



Introduction

This lesson will help you determine which members of the U.S. Armed Forces are entitled to an adjustment to income for moving expenses. To do this, you will need to determine qualifying moves, allowances and reimbursements, and deductible moving expenses.

To determine if the taxpayer has incurred moving expenses, use the interview techniques and tools discussed in the Screening and Interviewing lesson. Although the intake and interview sheet may not list moving expenses, it is important to ask probing questions to see if the taxpayer may have some deductible moving expenses.

To deduct moving expenses as an adjustment to income, the taxpayer generally must meet certain time and distance tests. However, a member of the Armed Forces on active duty who moves because of a permanent change of station does not have to meet these tests.

Unreimbursed moving expenses are deducted using Form 3903, *Moving Expenses*. Armed Forces members receive a variety of moving reimbursements and allowances that must be considered when determining if the expenses are deductible. The travel voucher will contain much of the information needed to compute the deduction.

See Publication 521, *Moving Expenses*, for additional information on the topics discussed in this lesson.

Objectives

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

- Determine if a move qualifies as a permanent change of station (PCS)
- Identify deductible moving expenses
- Determine when allowances and reimbursements must be included in income

What do I need?

- Intake and Interview Sheet
 - Publication 4012, *Volunteer Resource Guide*
 - Publication 17
 - Publication 4491-W
 - Form 3903
- Optional:**
- Publication 3
 - Publication 521
 - Form 1040 Instructions

What is a permanent change of station?

Only expenses incurred as a result of a permanent change of station (PCS) are deductible. A permanent change of station includes a move from:

- Home to the area of the first post of duty.
- One permanent post of duty to another.
- The last post of duty to home or to a nearer point in the U.S. The Armed Forces member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

What does a permanent change of station include for spouses and dependents?

If the Armed Forces moves service members and their spouses or dependents to or from separate locations, the moves are treated as a single move and the qualified expenses of both moves are combined and deducted on the same tax return.



EXERCISES

Answers are at the end of the lesson summary.

Question 1: Which of the following is a permanent change of station?

- A. A move by an Air Force pilot to an airbase for a six-month detail
- B. A move by an Army sergeant to his home two years after he ended active duty
- C. A move by a new enlistee from her home to her first post of duty
- D. A temporary move by a U.S. Marine to attend a six-month training program

What expenses are included in the moving expense adjustment?

Qualifying military moving expenses fall into the following two categories, the cost of:

- Moving household goods and personal effects
- Reasonable travel and lodging expenses

To qualify as “reasonable,” the route taken must be the shortest, most direct route available, from the former home to the new home. Additional expenses for stopovers or side trips are not deductible as moving expenses.

Qualifying expenses that exceed government allowances and reimbursements are deductible.

Use Publication 521 as a resource for additional information. This publication has detailed information on deductible and nondeductible moving expenses. It also contains a special section on members of the Armed Forces.



For 2011, two rates are in effect for move-related mileage:

- 19 cents per mile from January 1 through June 30
- 23.5 cents per mile from July 1 through December 31

How do I handle military reimbursements?

Determine whether any moving allowances or reimbursements provided by the government should be included in a service member’s income, and how to accurately report the deduction on Form 1040.

What is a DITY move?

Typically, Armed Forces members move their own household items in a personal or rented vehicle; this is called a Do It Yourself (DITY) move. The Armed Forces provides an incentive payment equal to 95% of the estimated cost to the government for DITY moves. When the move is completed, the Armed Forces member provides receipts and paperwork to substantiate authorized expenses. The net financial profit is taxable, and is reported on a separate Form W-2.

How do I report a DITY move?

DITY payments are entered as income on Form 1040, line 7.

Armed Forces members may not take a moving expense deduction based on the expenses approved by the finance office when settling the DITY move, as they have already been used to reduce taxable income.

example

Captain Cook receives orders for a PCS. He chooses to pack and drive his household goods to the new duty station in his own vehicle. The Air Force estimates that the move would have cost the government \$2,500. Captain Cook's actual expenses for the move were \$1,750. He receives a payment for \$2,375 (95% of the government's estimate), but Form W-2, box 1, will show only \$625 (\$2,375 minus \$1,750) for the DITY move. Captain Cook cannot deduct any of his expenses, since he's already been reimbursed.

What forms of reimbursement are *not* included as income?

Certain forms of reimbursement provided by the government are *not* to be included as income on the Armed Forces member's tax return.

- Moving or storage services furnished to the Armed Forces member
- Nontaxable allowances such as:
 - Dislocation allowance
 - Temporary lodging allowance
 - Mileage allowance in lieu of transportation
 - Per diem allowance



EXERCISES (continued)

Question 2: Sgt. Bishop received Form W-2 for \$1,000 as a result of a DITY move to a new Permanent Duty Station (PDS). In addition, the government paid her a mileage allowance of \$300, a lodging allowance of \$200, and a dislocation allowance of \$1,200. How much should Sgt. Bishop include in her gross income on Form 1040, line 7?

- A. \$1,500
- B. \$1,000
- C. \$300
- D. \$200

How do I calculate the adjustment?

Deductions can only be claimed for expenses not covered by a nontaxable reimbursement or moving allowance. If the taxpayers have allowable expenses that exceed the amount they were reimbursed, Form 3903 should be completed. Form 3903 is not needed if all the taxpayers' reimbursements were nontaxable allowances that were greater than their expenses.



Tax Software Hint: The tax software addresses the Armed Forces PCS move and calculates the standard mileage amount based on miles traveled for the move. For software entries, go to Form 1040, *Adjustments to Income* in the Volunteer Resource Guide (Tab 3).

Taxpayer Interview and Tax Law Application

Here's how a volunteer could help Mrs. Fannin determine if she had any deductible moving expenses:

SAMPLE INTERVIEW

VOLUNTEER SAYS...

You said you just moved here during June of this year. Was this a PCS move?

If your expenses were more than the Armed Forces reimbursement, you may be able to use the difference to reduce your gross income. We'll complete Form 3903 to see how it comes out. Did you bring your travel voucher with you?

Did you drive directly here, or did you take any side trips?

The IRS will let you use the standard mileage rate for a military move of 19 cents per mile from 1/1/11–6/30/11, and 23.5 cents per mile from 7/1/11–12/31/11, or we can use actual expenses if you kept track. The standard rate would be \$190, since your trip took place between 1/1/11–6/30/11.

The IRS allows lodging costs, but not food. So your total allowable expenses would be \$490, which includes \$300 for the motels and \$190 for your mileage expenses. The travel voucher shows a total of \$400 in reimbursements – did you receive any other reimbursements or allowances?

Then you'll get to deduct \$90, the amount you spent that was more than your reimbursement.

[On the intake and interview sheet, be sure to note that you've addressed this adjustment.]

MRS. FANNIN RESPONDS...

Yes, my husband was transferred here in March 2001, shortly before he deployed. I have family close by, so I'd rather stay here while he's overseas.

It's right here. We drove our own car 1,000 miles to get here, and paid \$120 for gas. We paid \$300 for motels and \$135 for meals on the way. The military moved our household goods, and we didn't have any overweight.

We came right here so we could settle in before he deployed.

I only kept the gas receipts, so the standard rate would probably be best.

No, that's it.

When should an Armed Forces member claim the deduction?

Armed Forces members who use the cash method of accounting (the most common) and have qualified expenses exceeding their reimbursement can deduct the expenses either in the year they paid them, in the year reimbursement was received, or immediately after the year of reimbursement but by the due date, including extensions, for filing the return for the reimbursement year.

If expenses are deducted and reimbursement is received in a later year, the reimbursement must be included in income.



EXERCISES (continued)

Question 3: In November 2011, Petty Officer Wharton moved from California to Washington. The move qualified as a PCS. He incurred \$800 in mileage expenses and \$1,600 in lodging. He paid \$1,400 to ship household goods over the allowed weight limit, and \$500 to ship his dog. The following year, he filed his travel voucher and received \$2,400 mileage and travel allowance. He also received a \$1,500 dislocation allowance.

For what tax year(s) can Petty Officer Wharton claim his moving expenses on Form 3903?

- A. 2012 only
- B. 2011 only
- C. Either 2011 or 2012

Taxpayer Interview and Tax Law Application

Amanda was relocated to another Air Force base. Here's how a volunteer could help Amanda determine if she had any deductible moving expenses:

SAMPLE INTERVIEW

VOLUNTEER SAYS . . .

AMANDA RESPONDS...

So, you were transferred from Maxwell Air Force Base to Scott Air Force Base last year, right?

Yes, I was reimbursed \$400 for travel expenses on the way to Scott Air Force Base.

Did you receive any other allowances?

Yes, I also received a \$1,000 dislocation allowance.

Well the reimbursements were not reported on your W-2. You can only deduct expenses that are larger than your combined reimbursements and allowances. First, let's add all your qualified expenses. How much was your travel and lodging?

I spent \$575 on travel and lodging and another \$200 for meals along the way.

Any other expenses?

Yes, I gave a \$350 security deposit to my new landlord.

Only the travel and lodging en route can be claimed on Form 3903, line 2. The security deposit and meals are not deductible expenses. Your reimbursement and dislocation allowances add up to \$1,400. Since that's more than your expenses, you don't have anything to deduct. But, you don't have to include any of the excess reimbursement as income, either.

Summary

This lesson described the types of Armed Forces moves that qualify for tax benefits, what kinds of expenses are deductible, and how to use Form 3903 to compute the moving expense deduction. These expenses are deductible as an adjustment to income on Form 1040, line 26.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you covered all the technical topics.



EXERCISE ANSWERS

Answer 1: C. A move by a new enlistee from her home to her first post of duty is considered a PCS.

Answer 2: B. The \$1,000 DITY payment should be included as gross income on line 7. However, nontaxable allowances such as dislocation allowances, temporary lodging allowances and mileage allowances provided by the Armed Forces should not be included as gross income on the service member's tax return, even if they exceed allowable expenses.

Answer 3: C. Because Petty Officer Wharton paid for moving expenses in the year prior to the year of reimbursement, he can claim all of his moving expenses on Form 3903 in either the year he paid or the year he was reimbursed.



Lesson 19: Standard Deduction and Tax Computation



Introduction

This is the first of eight lessons covering the Tax and Credits section of the taxpayers' return. After completing this lesson on standard deductions and the Itemized Deductions lesson, you will be able to subtract the appropriate deduction from the taxpayers' adjusted gross income to figure their taxable income.

Some taxpayers may need to use the standard deduction worksheet in the Form 1040 Instructions.

Form 1040 (2017)		Page 2
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38
	39a Check <input type="checkbox"/> You were born before January 2, 1947, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a <input type="checkbox"/>	
	if: <input type="checkbox"/> Spouse was born before January 2, 1947, <input type="checkbox"/> Blind. checked ▶ 39a <input type="checkbox"/>	
Standard Deduction for—	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>	
	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40
	41 Standard deduction from line 38	41

Objectives

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

- Determine the standard deduction amount for most taxpayers
- Determine the standard deduction amount for taxpayers claimed as dependents
- Identify how taxable income and income tax are computed and reported

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040
- Optional:** Publication 501

What are deductions?

Deductions are subtractions from a taxpayer's adjusted gross income (AGI). They reduce the amount of income that is taxed. Most taxpayers have a choice of taking a standard deduction or itemizing their deductions. When taxpayers have a choice, they should use the type of deduction that results in the lower tax. Use the interview techniques and tools discussed in earlier lessons to assist you in determining if the standard deduction will result in the largest possible deduction for the taxpayer.

What is a standard deduction?

A standard deduction for most taxpayers is a predefined dollar amount based on the taxpayer's filing status. An increased standard deduction is available to taxpayers who are 65 or older or blind. There are limitations on the standard deduction for taxpayers who can be claimed as a dependent on someone else's return. The Volunteer Resource Guide (Tab F) includes references for calculating the standard deduction.



EXERCISES

Use the Standard Deduction for Most People chart in the Volunteer Resource Guide (Tab F) to complete the following exercises. Answers are at the end of the lesson summary.

Question 1: Sara and James are both 25, and they have been married for two years. What is their standard deduction?

- A. \$11,600
- B. \$8,500
- C. \$5,800

Question 2: Brenda is 22, single, and recently graduated from college. Her parents will not claim her as an exemption this year. What is her standard deduction for the tax year?

- A. \$5,800
- B. \$8,500
- C. \$3,700

What is an itemized deduction?

Itemized deductions allow taxpayers to reduce their taxable income based on specific personal expenses. If the total itemized deductions are greater than the standard deduction, it will result in a lower taxable income and lower tax. In general, taxpayers benefit from itemizing deductions if they have mortgage interest, very large unreimbursed medical or dental expenses when compared to their income, or other large expenses such as charitable contributions. Itemized deductions will be covered in the next lesson.

Who cannot take the standard deduction?

Some taxpayers cannot take the standard deduction and must itemize. During the interview, find out if the taxpayer is:

- Filing as Married Filing Separately and the spouse itemizes
- A nonresident or dual-status alien during the year (and not married to a U.S. citizen or resident at the end of the year)

If either situation applies, the taxpayer must itemize personal deductions and the box on Form 1040, line 39b, page 2, must be checked.

example

Chase is Married Filing Separately. Her spouse, Grant, will be itemizing his deductions. Chase cannot use the standard deduction; she will have to itemize her deductions.



Tax Software Hint: The standard deduction is automatically calculated based on entries on the Main Information Sheet. If the taxpayer cannot take the standard deduction, the tax software will prompt the preparer to itemize deductions.

How does age or blindness affect the standard deduction?

The standard deduction is higher if the taxpayer or spouse is 65 or older, and if one or both are blind. This information is reported in the check boxes located on Form 1040, page 2. The more check boxes marked, the higher the standard deduction. Be sure to verify the taxpayer's and spouse's age and level of blindness as described below.



Tax Software Hint: These boxes are automatically checked based on entries on the Main Information Sheet. For software entries, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.

example

Sherman is 73 years old and blind. He files as Single using Form 1040. On page 2, line 38, you enter his AGI of \$37,800 from line 37. Because Sherman is over 65 and blind, enter 2 on line 39a.

Who qualifies as 65 or older?

Taxpayers are entitled to a higher standard deduction if they are 65 or older at the end of the year. They are considered to be 65 on the day before their 65th birthday. In other words, a person born on January 1 is considered to be 65 on December 31 of the previous year. Therefore, taxpayers born before January 2, 1947 are entitled to a higher standard deduction for 2011.

The standard deduction for decedents is the same as if they had lived the entire year, however, if taxpayers die before their 65th birthday, the higher standard deduction does not apply.

example

Armando died on November 24, 2011. He would have been 65 if he had reached his birthday on December 12, 2011. He does not qualify for a higher standard deduction for being 65, even though he was born before January 2, 1947.

Who qualifies as blind?

Taxpayers are entitled to a higher standard deduction if they are considered blind on the last day of the year and they do not itemize their deductions. A taxpayer who is not totally blind must have a certified statement from an eye doctor (ophthalmologist or optometrist) that:

- The taxpayer cannot see better than 20/200 in the better eye with glasses or contact lenses or
- The field of vision is not more than 20 degrees

If the eye condition is not likely to improve beyond these limits, the statement should include that fact. Taxpayers should keep the statement in their records.

TIP

If vision can be corrected beyond those limits only by contact lenses and the taxpayer can only wear the lenses briefly because of pain, infection, or ulcers, the taxpayer can take the higher standard deduction for blindness.

What if only one spouse is over 65 or blind?

Taxpayers can take the higher standard deduction if one spouse is 65 or older, or is blind, and if:

- The taxpayer files a joint return, or

- The taxpayer files a separate return and can claim an exemption for the spouse because the spouse had no gross income and an exemption for the spouse could not be claimed by another taxpayer

What is the standard deduction based on age or blindness?

The standard deduction for taxpayers who are 65 or older or are blind increases by \$1,150 (\$1,450 if Single or Head of Household), for each box checked for age or blindness. This amount can also be computed using the Standard Deduction Chart for People Born Before January 2, 1947 or Who Are Blind, in the Volunteer Resource Guide (Tab F).



These amounts do not apply if the taxpayer (or spouse if Married Filing Jointly) can be claimed as a dependent on someone else's return.

example

Tim is 67 and is filing as Single. He is not blind and he cannot be claimed as a dependent on someone else's return. His standard deduction is \$7,250.

example

Kevin and Jane are both 60, and Jane is blind. They are filing as Married Filing Jointly. Neither can be claimed as a dependent on someone else's return. Their standard deduction is \$12,750.



EXERCISES (continued)

Use the Standard Deduction Chart for People Born Before January 2, 1947 or Who Are Blind in the Volunteer Resource Guide (Tab F) to complete the following exercises. Answers are at the end of the lesson summary.

Question 3: Roderick was born December 30, 1947. Does he qualify as being 65 or older?

Yes No

Question 4: Brianne and her husband Clark are both over the age of 65 and are legally blind. They will file their returns as Married Filing Separately and will not itemize their deductions. What is Brianne's standard deduction?

A. \$8,500

B. \$8,100

C. \$15,800

Question 5: Leticia died May 1, 2011. She was born on April 3, 1946. Does she qualify as age 65?

Yes No

What about individuals who can be claimed as dependents?

The standard deduction is generally lower for an individual who can be claimed as a dependent by another taxpayer. The deduction is generally limited to the greater of:

- \$950 or
- The individual's earned income for the year, plus \$300 (but not more than the regular standard deduction amount)



Tax Software Hint: A dependent's standard deduction will be automatically calculated, as long as the box indicating they can be claimed as a dependent by another taxpayer has been checked on the Main Information Sheet. For software entries, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.

example

Janet is single, 22, a full-time student, and not blind. Her parents claimed her as a dependent on their 2011 tax return. She has no itemized deductions, so she will take the standard deduction. She has interest income of \$120, taxes withheld of \$35, and wages of \$780. Her standard deduction is \$1,080 (\$780 + \$300).

How do I determine which deduction is best for the taxpayer?

If taxpayers are not required to itemize, they should take the higher of the standard deduction or the itemized expenses deduction. In general, taxpayers will benefit from itemizing their deductions if they have mortgage interest, qualified charitable contributions, or if unreimbursed medical/dental expenses are large compared to their income. During the interview, ask the taxpayer if any of the following were applicable during the tax year:

- Large out-of-pocket medical and dental expenses
- State and local income taxes, real estate taxes, and/or personal property taxes
- Mortgage interest
- Gifts to charity
- Casualty, theft, and certain other miscellaneous deductions

If the taxpayer's expenses qualify, itemizing may be a better choice.



Casualty and theft losses are outside the scope of the VITA/TCE program and are mentioned here for awareness only. Taxpayers with these issues should be referred to a professional tax preparer.



Tax Software Hint: The taxpayer's standard deduction is automatically calculated and displayed on page 2 of the Form 1040 screen. The software automatically selects the deduction method that gives the taxpayer the best result. For software entries, go to the Volunteer Resource Guide (Tab 4), Form 1040, Page 2 – Deductions.

How are taxable income and tax determined?

Tax is based on the amount of taxable income, which is determined by the taxpayer's AGI, exemption amount, and standard deduction or itemized deductions. Taxable income is determined by subtracting from the AGI:

- Personal and dependency exemptions and
- Standard or itemized deductions



Tax Software Hint: Tax is automatically calculated based on previous entries. It is important to enter all income, deduction, and credit information correctly for the tax to be computed accurately. The tax software also calculates the exemption amount and applies any limitations in determining the tax.



A separate worksheet is used to calculate the tax (instead of the tax tables) for taxpayers with certain types of income, such as capital gains, qualifying dividends, or foreign earned income.

Practice – Vanessa Franklin



Take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to deductions and tax computation.

Summary

You should be able to identify those who can take the standard deduction, and how the deduction is affected by their filing status, age, blindness, and status as a dependent. All of this will make it easier for you to help taxpayers understand how their deduction is computed and its impact on their tax.

You should also understand that the tax computation is based on taxable income. The tax may be further reduced by tax credits to be covered in an upcoming lesson.

You are now ready to work with itemized deductions in the next lesson.

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

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

- Casualty and theft losses



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: A. \$11,600

Answer 2: A. \$5,800

Answer 3: No. Roderick is only 64. To qualify for the higher standard deduction, his birthday must be before January 2, 1947.

Answer 4: B. \$8,100. This is calculated by multiplying \$1,150 by 2 (she is blind and 65) to get \$2,300, which is added to her standard deduction of \$5,800.

Answer 5: Yes. Leticia qualifies for the higher standard deduction given to those 65 or older because she was 65 when she died in 2011.



Lesson 20: Itemized Deductions



Introduction

This lesson will assist you in determining if a taxpayer should itemize deductions. Generally, taxpayers should itemize if their total allowable deductions are higher than the standard deduction amount.

Objectives

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

- Determine if a taxpayer should itemize deductions
- Determine the type of expenses that qualify as itemized deductions
- Report accurately itemized deductions on Schedule A, Itemized Deductions
- Explain the recordkeeping requirements for claiming charitable contributions

What are itemized deductions?

Itemized deductions are subtractions from a taxpayer's Adjusted Gross Income (AGI) that reduce the amount of income that is taxed. Most taxpayers have a choice of taking a standard deduction or itemizing deductions. Taxpayers should use the type of deduction that results in the lowest tax.

Who should itemize?

Taxpayers who have a standard deduction of zero should itemize their deductions. Taxpayers who normally fall within this category are:

- Married, filing a separate return, and their spouse is itemizing
- Filing a return for a short tax year due to a change in the annual accounting period
- Considered to be nonresident aliens or dual status aliens during the year
- Donating property that was previously depreciated

How do I decide if a taxpayer should itemize deductions?

In general, taxpayers who have mortgage interest or a very large amount of unreimbursed medical/dental expenses compared to their income would benefit from itemizing their deductions.

Use the Interview Tips in the Volunteer Resource Guide (Tab F) to determine if itemizing deductions would be more beneficial for the taxpayer. If you think the taxpayer may benefit from itemizing, enter the qualified expenses on Schedule A. The tax software will automatically select the larger of itemized versus standard deduction.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4012
- Publication 4491-W
- Form 1040
- Schedule A

Optional:

- Publication 502
- Publication 526
- Publication 529
- Publication 530
- Publication 936

Itemized deductions include amounts paid for qualified:

- Medical and dental expenses
- Taxes paid
- Mortgage interest
- Gifts to charity
- Casualty and theft losses
- Miscellaneous deductions



Casualty and theft losses are outside the scope of the VITA/TCE program. Refer taxpayers with these losses to a professional tax preparer.



For taxpayers using the Married Filing Separately status, if one spouse itemizes, the other must also itemize (even if their itemized deduction amount is zero).



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Form 1040, Page 2, Deductions.

What medical and dental expenses are deductible?

Taxpayers must be able to itemize in order to deduct medical and dental expenses. Taxpayers can deduct only the amount of unreimbursed medical and dental expenses that exceeds 7.5% of their Adjusted Gross Income (AGI).



Tax Software Hint: Review the Itemized Deductions Detail Worksheet for Schedule A, Itemized Deductions in the Volunteer Resource Guide (Tab 4).

Whose expenses are covered?

Qualified medical and dental expenses paid by the taxpayer during the tax year can be included for:

- The taxpayer
- The taxpayer's spouse
- Dependents claimed at the time the medical services were provided or at the time the expenses were paid
- Individuals who could be the taxpayer's dependent except:
 - They do not meet the gross income test, or
 - They do not meet the joint return test, or
 - The taxpayers, or their spouse if filing jointly, could be claimed as a dependent on someone else's return

Review *Whose Medical Expenses Can You Include?* in the Medical and Dental Expenses chapter of Publication 17.



The standard mileage rate allowed for out-of-pocket expenses for a car when used for medical reasons is 19 cents per mile from January 1, 2011, through June 30, 2011, and 23.5 cents per mile from July 1, 2011, through December 31, 2011. Taxpayers can also deduct parking fees and tolls.



If a child of divorced or separated parents is claimed as a dependent on either parent's return, each parent may deduct the medical expenses that they individually paid for the child.

example

Stewart and Carmen are divorced. Their son, Raymond, lives with Carmen, who claims him as a dependent. Carmen paid for and deducted Raymond's standard medical and dental bills. Stewart deducted the emergency bill he paid when Raymond broke his arm.

What types of expenses are covered?

Unreimbursed medical and dental expenses and eligible long-term care premiums paid during the tax year are deductible. Be sure the expenses were not paid with pretax dollars or reimbursed by an insurance company.



Retired public safety officers cannot include as medical expenses any health or long-term care premiums they elected to have paid with tax-free distributions from their retirement plan.



If you and a taxpayer disagree as to whether a particular expense is deductible, politely refer the taxpayer to the Site Coordinator. The taxpayer may be correct, but you should not deduct an expense unless you are sure it is deductible.



EXERCISES

Answers are at the end of the lesson summary.

Question 1: Bill and Kathy Ferris file a joint return. They paid the medical and dental bills listed below. The total of Bill and Kathy's qualified medical expenses is \$_____.

Medical Expenses	Amount	Deductible
Unreimbursed doctors' bills	\$500	?
Unreimbursed orthodontist bill for braces	\$1,200	?
Hospital insurance premiums	\$300	?
Life insurance premiums	\$500	?
Unreimbursed prescription medicines	\$100	?
Vitamins	\$70	?
Hospital bill (before insurance company's reimbursement of \$1,000)	\$2,000	?
Smoking-cessation program	\$150	?
Total	\$4,820	?

What taxes may be deductible?

Taxpayers can deduct certain taxes if they itemize. To be deductible, the tax must have been imposed on and paid by the taxpayer during the current tax year. Taxes that are deductible include:

- State and local taxes – Taxpayers can choose one of the following taxes but not both:
 - Income taxes – This includes withheld taxes, estimated tax payments, or other tax payments (such as a prior year state or local income tax refund that the taxpayer chose to credit to their estimated tax for the following year) are deductible.
 - Sales taxes (from the optional sales tax tables or actual) – Taxpayers may be able to add the state and local general sales taxes paid on certain specified items to the tax table amounts.
- Real estate taxes
 - State, local, or foreign real estate taxes based on the assessed value of the taxpayer's real property, such as the taxpayer's house or land, are deductible.
 - Real estate taxes, which are generally reported on Form 1098, Mortgage Interest Statement, or a similar statement from the mortgage holder, are deductible. If the taxes are not paid through the mortgage company, the taxpayer should have a record of what was paid during the year.
 - Some real estate taxes are not deductible, including taxes for local benefits and improvements that tend to increase the value of the property, itemized charges for services, transfer taxes, rent increases due to higher real estate taxes, and homeowners' association fees.
- Personal property taxes are deductible if they are:
 - Charged on personal property
 - Based only on the value of the personal property, and
 - Charged on a yearly basis, even if collected more or less than once a year
- Other taxes – Any other qualified deductible taxes that are not included above, such as qualified foreign income taxes

**TIP**

State and local taxes withheld are shown on Form W-2 in either box 17 or 19.

**CAUTION**

Real estate taxes reported on Form 1098 may include nondeductible amounts. Use the interview techniques with taxpayers to determine if nondeductible amounts such as sanitation pickup and water fees are included in their Form 1098. These items should not be included on Schedule A.

Which taxes are not deductible?

Not all taxes are deductible and some items aren't actually classified as taxes. Some examples include employment taxes, federal income taxes, and license fees.

How do I handle taxes that are deductible?

Deductible taxes are reported on Form 1040, Schedule A in the Taxes You Paid section.

State and local income taxes

Include tax withheld, estimated tax payments to a state or local government, and tax payments for an earlier year paid during the current tax year. Do *not* include penalties or interest.

Foreign income taxes

Generally, income taxes that were paid to a foreign country can be taken as an itemized deduction on line 8 of Schedule A, or as a credit against U.S. income tax on Form 1040. More information will be provided on this credit in subsequent lessons. You should compare claiming the foreign taxes paid as a nonrefundable credit to taking it as an itemized deduction and use whichever results in the lowest tax.

TIP

See the Taxes chapter in Publication 17 for more information.



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Schedule A, Itemized Deductions.



EXERCISES (continued)

Question 2: Which of the following taxes are deductible on Schedule A?

- A. Federal income tax
- B. State, local, and foreign income tax and real estate tax
- C. Tax on alcohol and tobacco
- D. Foreign sales tax

Question 3: For a tax to be deductible, a tax must be _____. (Select all that apply.)

- A. Imposed during the tax year
- B. Imposed on the taxpayer
- C. Paid during the tax year
- D. Paid by the taxpayer

How do I handle interest paid?

Certain types of interest payments qualify as itemized deductions. Home mortgage interest, points (paid as a form of interest), and investment interest can be deducted on Schedule A. Investment interest is outside the scope of the volunteer program and should be referred to a professional tax preparer.

Home Mortgage Interest

Generally, home mortgage interest is any interest paid on a loan secured by the taxpayer's home, line of credit, or a home equity loan. The flow chart *Is My Home Mortgage Interest Fully Deductible?* in Publication 17 will help you determine if interest paid by the taxpayer should be included on Schedule A.

TIP

Members of the clergy and military can subtract qualified mortgage interest even if they receive a nontaxable housing allowance.

Generally, the deductible amount of home mortgage interest paid by a taxpayer is shown on Form 1098, Mortgage Interest Statement. Only taxpayers who are legally liable for the debt can deduct the interest in the year it is paid. Remember that taxpayers may have more than one mortgage or may have refinanced during the year and may have multiple Mortgage Interest Statements.



A taxpayer may be able to deduct interest on a main home **and** a second home. A home can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities.

Review “Home Mortgage Interest” in Publication 17, Interest Expense chapter, for details of determining deductible amounts of mortgage interest.

example

From 1991 through 1998, Alfredo and Cindy Kendall obtained home equity loans totaling \$91,000. Alfredo and Cindy used the loans to pay off gambling debts, overdue credit payments, and some nondeductible medical expenses.

The current balance of Alfredo and Cindy’s home equity loan is \$72,000. The fair market value of their home is \$230,000, and they carry \$30,000 of outstanding acquisition debt (the amount used to buy, build, or improve their home).

If Alfredo and Cindy file a joint return, they can deduct the interest on their loans because:

- The total of these loans throughout 2011 (\$72,000) does not exceed \$100,000 and
- The total amount of the home equity (\$72,000) is not more than the home’s fair market value minus any outstanding acquisition debt ($\$230,000 - \$30,000 = \$200,000$)

What are points?

Points are the charges paid by a borrower and/or seller to a lender to secure a loan. They are also called:

- Loan origination fees (including VA and FHA fees)
- Maximum loan charges
- Premium charges
- Loan discount points
- Prepaid interest

When are points deductible?

Only points paid as a form of interest (for the use of money) can be deducted on Schedule A. Generally, points must be spread over the life of the mortgage. However, if the loan is used to buy or build a taxpayer’s main home, the taxpayer may be able to deduct the entire amount in the year paid. See the Interest Expense chapter of Publication 17 for more information.

Points paid to refinance a mortgage are generally not deductible in full the year they were paid, unless the points were paid in connection with the improvement of a main home and certain other conditions are met.

Beware of certain charges that some lenders call points. Points paid for specific services, such as appraisal fees, preparation fees, VA funding fees or notary fees, are *not* interest and are *not* deductible.



Use the flow chart in the Interest Expense chapter of Publication 17 to help determine if points are fully deductible.

What about qualified mortgage insurance premiums?

Taxpayers can deduct Private Mortgage Insurance (PMI) premiums paid or accrued during 2011 on Form 1040, Schedule A, Line 13. The insurance must have been in connection with home acquisition debt, the insurance contract must have been issued after 2006, and the taxpayer must have paid the premiums before 2012 for coverage in effect during 2011. Mortgage insurance amounts may be reported to the taxpayer on Form 1098, box 4.

What qualifications are required to deduct PMI?

- Paid or accrued January 1, 2011, to December 31, 2011
- Borrower bought or refinanced home
- AGI is \$100,000 or less (\$50,000 if Married Filing Separately): full deduction
- AGI is more than \$100,000 (\$50,000 if Married Filing Separately): reduced deduction
- AGI is more than \$109,000 (\$54,500 if Married Filing Separately): no deduction

What types of interest are *not* deductible?

Interest that *cannot* be deducted includes:

- Interest on car loans where the car is used for nonbusiness purposes
- Other personal loans
- Credit investigation fees
- Loan fees for services needed to get a loan
- Interest on a debt the taxpayer is not legally obligated to pay
- Finance charges for nonbusiness credit card purchases



EXERCISES (continued)

Question 4: Joe and Angela file a joint return. During the year, they made the interest payments listed below. The total of Joe and Angela's fully deductible interest for the tax year is \$_____.

Interest Payments	Amount	Deductible
Qualified interest on their home mortgage, reported on Form 1098	\$2,180	?
Credit card interest	\$400	?
Points paid to refinance their mortgage for a better interest rate (None of the points qualify as interest.)	\$1,500	?
Interest on a car loan	\$2,000	?
Total	\$4,880	?

How do I handle gifts to charity?

A charitable contribution is a donation or gift to a **qualified organization**, which may be deductible if the taxpayer itemizes. Cash, check, and noncash contributions should be reported on Schedule A, line 16 and line 17, respectively. Deductions may be taken for contributions to:

- Organizations that operate exclusively for religious, charitable, educational, scientific, or literary purposes
- Organizations that work to prevent cruelty to children or animals
- Organizations that foster national or international amateur sports competition if they do not provide athletic facilities or equipment
- War veterans' organizations
- Certain nonprofit cemetery companies or corporations
- The United States, or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions

TIP

To be deductible, contributions must be made to a qualifying organization, not an individual.

TIP

Qualified organizations are listed in Publication 78, Cumulative List of Organizations. An online version is offered to help taxpayers efficiently search organizations that are eligible to receive tax-deductible charitable contributions.

To find out if the organization is a qualified charity, call the IRS at 1-877-829-5000 or go to www.irs.gov/app/pub-78/.

Deductible items include:

- Monetary donations
- Dues, fees, and assessments paid to qualified organizations above the value of benefits received
- Fair market value of used clothing and furniture in good condition
- Cost and upkeep of uniforms that have no general use but must be worn while performing services donated to a charitable organization
- Unreimbursed transportation expenses that relate directly to the services the taxpayer provided for the organization
- Part of a contribution above the fair market value for items received such as merchandise and tickets to charity balls or sporting events
- Transportation expenses, including bus fare, parking fees, tolls, and either the cost of gas and oil or a standard mileage deduction of 14 cents per mile

Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes, is out of scope. Taxpayers who have made these contributions should be referred to a professional tax preparer.

Which gifts to charity are *not* deductible?

Contributions to the following types of organizations do *not* qualify as deductible:

- Business organizations, such as the Chamber of Commerce
- Civic leagues and associations
- Political organizations and candidates
- Social clubs
- Foreign organizations

- Homeowners' associations
- Communist organizations

Amounts that may *not* be deducted include:

- Cost of raffle, bingo, or lottery tickets
- Tuition
- Value of a person's time or service
- Blood donated to a blood bank or Red Cross
- Car depreciation, insurance, general repairs, or maintenance
- Direct contributions to an individual
- Sickness or burial expenses for members of a fraternal society
- Part of a contribution that benefits the taxpayer, such as the fair market value of a meal eaten at a charity dinner

example

Susan ran a 10K organized by the Chamber of Commerce to benefit a qualified charitable organization. She paid the race organizers a \$30 entry fee and received a "free" T-shirt and pancake breakfast after the race.

Susan did not make a contribution to the qualifying organization. She paid the Chamber of Commerce, which allotted funds to the benefiting organization. Therefore, none of Susan's entry fee is tax deductible. If the race had been organized by the qualifying organization itself, part of her entry fee may have been deductible.

What limits apply to charitable deductions?

Taxpayers whose charitable contributions total more than 20% of their AGI may be able to deduct only a percentage of their contributions and must carry over the remainder to a later tax year. The percentage varies depending on the type of gift and the type of charitable organization. More information on these limitations is available in Publication 17. Individuals affected by limits on charitable deductions should be referred to a professional tax preparer.

What records should the taxpayer keep for charitable contributions?

Taxpayers must keep records to verify the cash and noncash contributions they make during the year. Advise taxpayers that they cannot deduct a cash contribution, regardless of the amount, unless one of the following records of the contribution is kept:

- A bank record, such as a canceled check, a bank copy of a canceled check, or a bank statement containing the name of the charity, the date, and the amount
- A written communication from the charity, which must include the name of the charity, date of the contribution, and amount of the contribution

Out-of-pocket expenses

For unreimbursed expenses related to donated services, the taxpayer must have:

- Adequate records of the expenses
- Organization's written acknowledgment and description of the taxpayer's services

Only out-of-pocket expenses that are directly related to the donated services can be deducted. The value of time or services donated cannot be deducted. See Publication 17, Contributions chapter, for the rules applicable to out-of-pocket expenses incurred when rendering services to a qualifying organization.

What records should the taxpayer keep for noncash contribution deductions?

Noncash contributions less than \$250

For each single contribution of less than \$250, the taxpayer must keep:

- A receipt or other written communication from the organization or the taxpayer's own reliable written records for each item, showing:
 - Name and address of organization
 - Date and location of the contribution
 - Reasonably detailed description of the donated property
 - Fair market value of the donated property

TIP

Deductions are not allowed for the charitable contribution of clothing and household items if the items are not in good used condition or better.

TIP

If the taxpayer is donating capital gain property or property that was previously depreciated, refer them to a professional tax preparer.

Noncash contributions of at least \$250 but not more than \$500

For each single contribution of at least \$250 and not more than \$500, the taxpayer must have all the documentation described for noncash contributions less than \$250. In addition, the organization's written acknowledgment must state whether the taxpayer received any goods or services in return and a description and good faith estimate of any such items.

Noncash contributions of more than \$500

Taxpayers must report noncash contributions of more than \$500 on Form 8283 and the taxpayer should be referred to a professional tax preparer.



EXERCISES (continued)

Question 5: Julia made the following contributions last year:

- \$600 to St. Martin's Church (The church gave her a letter verifying the amount.)
- \$32 to Girl Scouts (not for cookies!)
- \$40 to a family whose house burned
- \$50 for lottery tickets at a fundraiser
- \$100 for playing bingo at her church

The amount that Julia can claim as deductible monetary contributions is \$_____.

What about casualty and theft losses?

The deduction for casualty and theft losses is complex, with many rules and exceptions. Taxpayers with deductible casualty and theft losses should be referred to a professional tax preparer.

What are miscellaneous deductions?

What types of miscellaneous expenses are deductible?

Miscellaneous itemized deductions are expenses a taxpayer incurs to:

- Produce or collect income
- Manage, conserve, or maintain property held for producing income
- Determine, contest, pay, or claim a refund of any tax

For some miscellaneous deductions, only the portion that exceeds 2% of the taxpayer's AGI can be deducted. Other miscellaneous deductions are deductible regardless of AGI.

Which deductions are subject to the 2% limit?

Deductions subject to the 2% limit are reported on lines 21 through 27 of Schedule A. Examples include:

- Credit or debit card convenience fees incurred when paying income tax, charged by the card processor
- Union dues and fees
- Professional society dues
- Uniforms not adaptable to general use (See the Miscellaneous Deductions chapter in Publication 17 for more information.)
- Small tools and supplies used for business
- Professional books, magazines, and journals
- Employment-related educational expenses (Review Does Your Work-Related Education Qualify? in the Tax Benefits for Work-Related Education chapter in Publication 17.)
- Expenses of looking for a new job in your present occupation
- Investment counsel fees
- Investment expenses
- Safe deposit box rental for investment documents
- Tax counsel and assistance
- Fees paid to an IRA custodian



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Schedule A – Itemized Deductions.

Which deductions are exempt from the 2% limit?

Deductions that are *not* subject to the 2% limit are reported on line 28 of Schedule A. Examples include:

- Gambling losses to the extent of gambling winnings (taxpayers must have a record of their losses)
- Work-related expenses for disabled individuals that enables them to work, such as attendant care services at their workplace



Gambling losses in excess of winnings are not deductible. The full amount of winnings must be reported as income and the losses (up to the amount of winnings) can be claimed as an itemized deduction.

What types of miscellaneous expenses are not deductible?

The types of miscellaneous expenses that are not deductible include:

- Commuting expenses, including mileage to and from a taxpayer's regular place of work
- Political contributions
- The cost of entertaining friends
- Lost or misplaced cash or property
- Travel as a form of education

TIP

An attorney's fee for a will is considered a personal legal expense, so it is not deductible.



EXERCISES (continued)

Question 6: Philip had the expenses shown below. What is the total of Philip's qualified miscellaneous itemized expenses? \$_____.

Expense	Amount	Deductible
Income tax preparation fee	\$100	?
Safe deposit box rental (to store bonds)	\$75	?
Life insurance premiums	\$300	?
Credit card convenience fee for income tax payment	\$70	?
Loss on sale of personal home	\$1,800	?
Investment journals and newsletters	\$250	?
Investment expenses	\$200	?
Attorney fees for preparation of a will	\$100	?
Total	\$2,895	?

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interviews with Vanessa related to Lesson 20.

Return to this lesson after you have reviewed this information.

Summary

Medical and Dental Expenses

Unreimbursed medical and dental expenses exceeding 7.5% of the taxpayer's AGI are deductible; they are reported on lines 1 through 4 of Schedule A.

Qualified medical and dental expenses are those paid during the tax year for the taxpayer, spouse, and dependents.

Taxes

Deductible taxes are reported on lines 5 through 9 of Schedule A and include the following:

- State and local income taxes
- State and local sales taxes

- State, local, or foreign real estate taxes
- Personal property taxes
- Other qualified taxes

Interest

Deductible interest is reported on lines 10 through 15 of Schedule A.

Generally, the taxpayer receives Form 1098, Mortgage Interest Statement, which shows the deductible amount of interest paid. To be deductible, the interest must be paid by the taxpayer during the tax year. Only taxpayers who are legally liable for the debt can deduct the interest.

Only points paid as a form of interest (for the use of money) can be deducted on Schedule A. Generally, points must be spread over the life of the mortgage. However, if the loan is used to buy or build a taxpayer's main home, and certain other conditions are met, the taxpayer may be able to deduct the entire amount in the year paid.

Taxpayers can deduct mortgage insurance premiums paid or accrued during the tax year if the insurance was in connection with home acquisition debt, the insurance contract was issued after 2006, and the taxpayer paid the premiums before 2012 for coverage in effect during 2011.

Gifts to Charity

Qualified charitable contributions are reported on lines 16 through 19 of Schedule A.

The contributions to **qualifying organizations** that taxpayers can deduct include:

- Monetary donations
- Dues, fees, and assessments paid to qualified organizations above the value of benefits received
- Fair market value of used clothing and furniture
- Cost and upkeep of uniforms that have no general use but must be worn while performing donated services for a charitable organization
- Unreimbursed transportation expenses that relate directly to the services the taxpayer provided for the qualifying organization
- Part of a contribution above the fair market value for items received such as merchandise and tickets to charity balls or sporting events



Taxpayers are required to keep receipts and records of all their contributions.

Miscellaneous Deductions

For some miscellaneous deductions, only the portion that exceeds 2% of the taxpayer's AGI can be deducted. Other miscellaneous deductions are deductible regardless of AGI.

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

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

- Casualty and theft losses
- Investment interest
- Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes
- Taxpayers affected by limits on charitable deductions
- Taxpayers that file Form 8283 to report noncash contributions of more than \$500
- If the taxpayer is donating property that was previously depreciated
- If the taxpayer is donating capital gain property



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: *The total of qualified medical and dental expenses is \$3,250, which does not include life insurance premiums, vitamins, or reimbursed hospital expenses.*

Answer 2: *B. State, local, foreign income tax, and real estate taxes are all deductible on Schedule A.*

Answer 3: *B, C, and D. Taxpayers cannot deduct a tax they did not owe, did not pay, or that they paid during another year. However, the tax may have been imposed in a prior year.*

Answer 4: *\$2,180. The only interest that is fully deductible for the tax year is Joe and Angela's home mortgage interest. The points they paid to refinance are not paid as a form of interest, and the other interest paid was personal interest and is not deductible.*

Answer 5: *The amount that Julia can claim as deductible cash contributions is \$632 (donations to her church and to the Girl Scouts). Bingo, lottery tickets, and donations to individuals in need are not deductible.*

Answer 6: *\$695, which includes tax preparation fee, safe deposit box rental, credit card convenience fees, investment journals and newsletters, and investment expenses.*



Lesson 21: Military Employee Business Expenses



Introduction

This lesson will help you determine and claim qualified employee business expenses for members of the Armed Forces, such as uniforms, education and travel. These expenses, with one exception, may be reported on Form 2106 or Form 2106-EZ or may be deducted on Schedule A as a Miscellaneous Itemized Deduction subject to the 2% limit or in certain cases as an adjustment to income.

Objectives

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

- Determine if the taxpayer has military business expenses that can be deducted
- Identify which form to use to report military business expenses

What are military employee business expenses?

Military employee business expenses are necessary work-related expenses incurred by active and reserve members of the U.S. Armed Forces. The U.S. Armed Forces includes commissioned officers, warrant officers, and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, Air Force, and Coast Guard. It does not include members of the Merchant Marines or the American Red Cross.

What are qualified uniform expenses?

Qualified uniform expenses are the cost and upkeep of uniforms and certain articles that are:

- Specifically required as a condition of employment and
- Not adaptable to general use as regular clothing

Members of the Armed Forces are required to wear uniforms when they are on duty, and they are generally allowed to wear their uniforms in place of regular civilian clothing when they are off duty. In this case, members of the military cannot claim a deduction for the uniform cost and upkeep.

However, when military regulations *prohibit* off-duty wear of certain uniforms, service members can deduct the cost and upkeep of those uniforms. Service members must reduce the deductible expenses by any nontaxable uniform allowance or reimbursement they receive.

In addition, costs for required items, such as insignia of rank, corps devices, epaulets, aiguillettes, and swords, can be deducted.



Although the intake and interview sheet does not list military employee business expenses, service members should take advantage of deductions to which they are entitled. Ask taxpayers if they had any unreimbursed military work-related expenses.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 3
- Publication 4491-W
- Form 2106
- Form 2106-EZ
- Schedule A

Optional:

- Publication 463
- Publication 970
- Form 2106 Instructions



The same rules apply for active duty personnel and reservists.

Are professional dues deductible?

Dues paid to professional societies that are directly related to their trade or business can be deducted by service members.

However, service members cannot deduct amounts paid to an officers' club or a noncommissioned officers' club.

example

Lt. Walker, an electrical engineer at Maxwell Air Force Base, can deduct professional dues paid to the American Society of Electrical Engineers.



EXERCISES

Answers are after the lesson summary.

Question 1: Which of the following expenses can be deducted?

- A. The cost of a dress blue uniform (without shoulder boards or gold stripe on pants), including cape; off-duty wear allowed
- B. The cost of a full Army green uniform (without braid) that can be worn anytime
- C. The cost of battle dress uniforms and utility uniforms that can be worn only while on duty or while traveling to and from duty
- D. None of the above

Question 2: Which of the following expenses can be deducted?

- A. Cost of epaulets
- B. Cost and upkeep of a reservist's uniform that can be worn off duty (no uniform allowance received)
- C. All of the above

Question 3: Lt. Edwards is on active duty for the U.S. Navy. He specializes in the installation and maintenance of sonar detection systems on Navy ships. As a volunteer, he also draws illustrations and cartoons for his base's internal newsletter. He receives no compensation for his illustrations. Is the membership fee he pays to the Professional Illustrators' Society a deductible expense? Yes No

Can service members claim work-related educational expenses?

Service members can claim educational expenses as an employee business expense if the education:

- Is required by their employer, the law, or regulations to keep their current salary, status, or job if these requirements serve a business purpose of the employer or
- Maintains or improves the skills required in their present work

These expenses are deductible whether or not the education may lead to a degree.



This section relates only to expenses that may be deductible on Schedule A subject to the 2% AGI limitation. Service members can determine whether the expenses also qualify as an education credit, then claim them where they are most beneficial.

However, service members cannot claim an employee business expense for education that is:

- Needed to meet the minimum educational requirements for their trade or business or
- Part of a program of study that will qualify them for a new trade or business

example

Col. Wilson, an Army pilot, incurred educational expenses to obtain an accounting degree. He cannot deduct his accounting degree expenses on Schedule A because the degree will qualify him for a new trade or business.



EXERCISES (continued)

Question 4: True or False? For educational expenses to be claimed as an employee business expense deduction, the education must help the service member qualify for a degree.

True False

Question 5: Which of the following can be classified as a work-related education expense?

- A. Cost of a laptop and desk lamp for studying
- B. Expenses incurred by a flight operations officer to take an advanced piloting course
- C. Cost of civilian clothes to wear to a course taken off base
- D. Expenses incurred by a Navy disbursing clerk to learn television repair

What about travel and transportation expenses incurred for educational expenses?

Service members who have qualified deductible educational expenses may deduct the cost of travel and transportation for that education. This includes the cost of going from work to school, or travel expenses if the service member travels overnight mainly to obtain work-related education. Service members cannot deduct the round-trip cost of going from home to school unless they are regularly employed and go to school on a temporary basis (not reasonably expected to last more than one year) for work-related education.



See Publication 970 for additional information regarding Educational Expenses.



Service members cannot deduct the cost of travel that is itself a form of education, even if it is directly related to their duties.



EXERCISES (continued)

Question 6: Major Manchester is stationed in Manila. On weekends, she drives to Taal to take lessons in traditional Philippine dance. Can Major Manchester deduct these travel expenses? Yes No

What are travel expenses?

Travel expenses are unreimbursed work-related expenses incurred while service members are traveling away from home. They must be ordinary and necessary expenses such as airfare, car rental, taxi fare, lodging, and meals. Expenses for personal travel, leave, or liberty cannot be deducted.

When are travel expenses deductible?

For travel expenses to be deductible:

- There must be a work-related purpose for the travel
- They must be deemed as the “ordinary and necessary” costs of traveling away from home
- The expenses must be greater than the total of any advances, allowances, or reimbursements service members received

TIP

If Armed Forces members do not claim reimbursement for expenses they are entitled to, no deduction for those expenses may be claimed.

What is meant by “away from home”?

“Away from home” has a slightly different meaning for military than for civilian taxpayers. For service members, “home” is the duty station to which they are permanently assigned, which can be a ship or a base. It includes the entire city or general area where the post of duty is located.

Service personnel are considered to be away from home if they are away from their permanent duty stations for a period substantially longer than an ordinary day’s work. Service members may deduct business-related travel expenses incurred while traveling away from home.

TIP

For Navy personnel assigned to permanent duty aboard a ship that has regular eating and living facilities, the ship is considered to be “home” for travel expense purposes.

Examples of work-related travel expenses for members of the Armed Forces include:

- Expenses incurred while on temporary duty (**TDY**) or temporary additional duty (**TAD**) if “away from home” (i.e., ship, base, or station)
- Expenses of a reservist away from home overnight to attend drills
- Meals and lodging of a reservist temporarily called to active duty
- Travel expenses, including meals and lodging, incurred in connection with deductible educational activities
- Travel expenses incurred when carrying on official business while on “no cost” (to the government) orders



EXERCISES (continued)

Question 7: Which of the following individuals is entitled to deduct travel expenses?

- A. Sgt. Bullock, who commutes from his home to his permanent post of duty in the same city
- B. Capt. Hinds, who takes a taxi to work from his home to his permanent post of duty
- C. Major Forrest, a reservist who is called to temporary duty and must attend an overnight meeting away from home
- D. PFC Jenkins, who is assigned to permanent duty aboard a ship that provides meals and lodging

What are temporary active duty reservists' expenses?

Military reservists temporarily called to active duty who must remain away from home to perform their duties may claim unreimbursed travel expenses such as meals and lodging. This applies:

- As long as the duty occurred under competent orders and
- Whether or not the reservist was compensated

To claim unreimbursed travel expenses, reservists must:

- Be stationed away from the general area of their job or business and
- Return to their regular jobs once released

Expenses are deductible only if the reservists pay for meals and lodging at their official military post and only to the extent the expenses exceed Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS).

What is the 100-mile rule for reservists?

Military reservists who must travel more than 100 miles away from home and stay overnight to attend a drill or reserve meeting may be able to deduct their travel expenses as an adjustment to income rather than as a miscellaneous itemized deduction. The amount of expenses that can be deducted is limited to the:

- Federal rate for per diem (for lodging, meals, and incidental expenses)
- Standard mileage rate (for car expenses) plus any parking fees, ferry fees, and/or tolls

NEW For 2011, the standard mileage rate for miles driven for business purposes is:

- 51 cents per mile from January 1, 2011 through June 30, 2011, and
- 55.5 cents per mile from July 1, 2011 through December 31, 2011

Any expense in excess of these rates and expenses that do not qualify for the adjustment to gross income deduction can be claimed only as a miscellaneous itemized deduction subject to the 2% limit.

TIP

Military reservists include members of the U.S. Armed Forces (i.e., Army, Navy, Marine Corps, Air Force, and Coast Guard Reserve), the U.S. Army National Guard, the U.S. Air National Guard, or the Reserve Corps of the U.S. Public Health Service.

TIP

The 100-mile rule is an exception to Form 2106 requirements and qualifies as an adjustment to income, which is an above-the-line deduction.

example

Mary is in the Army Reserve. She lives in a town that is 120 miles from Base A, where she normally reports for Reserve drills or meetings. During 2011, she occasionally traveled to Base B, which was only 40 miles from her home.

Mary may claim the travel expenses she incurred going to Base A as an adjustment to income. Mary's remaining expenses for travel to Base B may qualify as an itemized deduction on Schedule A. This deduction will be subject to the 2% AGI limitation.



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Schedule A - Itemized Deductions (continued).

What is the deduction for meals?

U.S. service personnel can deduct the cost of meals and business-related entertainment incurred during business travel away from their permanent duty station.

Meals and entertainment expenses are figured separately from other business travel expenses. They are multiplied by a percentage: 50% for most taxpayers and 80% for those subject to Department of Transportation hours of service.

Taxpayers may report the actual amounts for meals, entertainment, and incidental expenses or they may use a standard amount to claim meals and incidental expenses. In either case, the service member must provide records to prove the time, place, and business purpose of the travel.

For service personnel who are fully reimbursed by the government for meals under an accountable plan that excludes reimbursement from gross income, there is no amount to deduct and, therefore, no amount subject to the 50% limit.

TIP

For information on using the standard meal allowance instead of actual expenses, see Publication 463, Travel, Entertainment, Gift, and Car Expenses.

What are local transportation expenses?

Local transportation expenses are typically defined as the ordinary and necessary costs incurred in getting from one place to another to perform work-related duties while *not* traveling away from home. This can include traveling from one job to another. However, the expenses of getting to and from the taxpayer's regular place of work are not deductible.

Allowable local transportation expenses include:

- The cost of driving and maintaining one's own vehicle
- Travel by rental cars, bus, rail, or taxi

TIP

The standard mileage rate can be found on Form 2106, Part II, Section B, and Form 2106-EZ, Part II.

Are car expenses deductible?

Service personnel who use their own vehicles to travel for work are entitled to deduct actual expenses or the standard mileage rate to figure the deductible costs of operating their vehicles for business purposes.

Actual expenses include the cost of gas, oil, repairs, insurance, and depreciation on the vehicle. If a taxpayer chooses to use actual expenses instead of the standard mileage rate, refer them to a professional tax preparer.



EXERCISES (continued)

Question 8: Which of the following costs are considered to be a local transportation expense?

- A. Daily meals taken during a week-long training session while on duty
- B. Gasoline used to drive to and from one's regular place of work
- C. Taxi fare to travel while on duty to a local work-related convention
- D. Elaborate lunch to treat top-ranking military official visiting base

Are expenses related to temporary work locations deductible?

Expenses incurred while commuting to work are not deductible. However, service members who are on temporary assignments in the same trade or business as their regular place of business can deduct the expenses of the daily round trip between their home and the temporary location, if not reimbursed by their employer.

Service members can deduct ordinary and necessary costs of traveling to temporary work assignments:

- Traveling from one workplace to another within the city or general area that is their tax home
- Visiting clients or customers
- Going to a business meeting away from their regular workplace

Expenses incurred while traveling away from home overnight are deductible as travel expenses, not local transportation expenses.

example

Sgt. Purdue attended a meeting of an Armed Forces reserve unit. The meeting is considered to be a second place of business because it is held on one of Sgt. Purdue's regular work days. He can deduct the expense of traveling from his home and regular work location to the meeting location.

Who needs to complete Form 2106?

If the service member has job-related travel, meals, or local transportation expenses, or other expenses that are greater than reimbursements, Form 2106 must be used to calculate the itemized deduction.

Form 2106 is not required if the taxpayer is claiming only job-related expenses for uniforms, professional dues, or education, and no reimbursement was received.

To determine whether service members need to complete Form 2106, consider the following factors:

- Did the service member have work-related travel, meals, or local transportation expenses?
- Did the service member receive an allowance or a reimbursement from the military?
- Did the amount of travel expenses exceed the amount of the reimbursement or allowance?

For service members who are not required to file Form 2106, enter miscellaneous deductions subject to 2% of AGI directly on Schedule A, line 21.



Form 2106-EZ can only be used by employees who received no reimbursement from their employer and who use the standard mileage rate. In most cases, military members with work-related travel expenses will have received reimbursement and will need to use Form 2106.

example

Capt. Glendale traveled from his duty station in California to Washington, DC, for a conference. He was away for five days. The Army advanced \$700 to Capt. Glendale for the trip. His actual expenses were \$625. When he filed his travel voucher with the Army, he returned the extra \$75. He does not have to complete Form 2106.

Taxpayer Interview and Tax Law Application

Let's see how a volunteer helps Mary, an Army Reservist, determine how to deduct her employee business expenses.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

You were in the Reserves, as well as working your full-time civilian job. Did you have any expenses associated with that?

Oh, good. The expenses you have for traveling more than 100 miles away as a reservist can be deducted, even if you can't itemize. Did you have to pay for lodging or meals or parking?

Did you get any reimbursement?

The most we'll be able to deduct on the meals is 50%, but you can take all of the lodging, plus your mileage. The standard mileage rate for business travel from 1/1/11 through 6/30/11 is 51 cents per mile, and 55.5 cents per mile for business travel from 7/1/11 through 12/31/11.

It's different for the drills at the other base, since they're not as far from your home. I have two questions about these trips: when did you make them, and did you leave from your regular job to go to Baker, or was it on a day off?

Since you are driving from one job to another, that's deductible too. But only if you can itemize, and it's over 2% of your AGI. Did you have any other work-related expenses?

Did you get reimbursed for any part of that?

Then you'll be able to deduct the \$100 you paid out of pocket—but only if you can itemize and exceed that 2% limit.

All right, we will calculate the expenses for traveling more than 100 miles for reserve duties like this: five trips at 51 cents a mile equals \$612 plus four trips at 55.5 cents a mile equals \$533; the total is \$1,145. Add the hotel rooms at \$648, and half the meals at \$90 totals \$1,883. We'll deduct that right on the front of the return.

The other mileage from trips to Baker add up to \$163, and the \$100 out of pocket for the class will give you a total of \$263 for your Schedule A if you can itemize. Now let me ask you some questions about your car so I can complete this form...

[On Mary's intake and interview sheet, indicate that you've addressed these items.]

MARY RESPONDS...

Well, my unit usually meets at Anderson, which is about 120 miles from here. I had nine round trips during the year, plus we met at Baker four times. That's only 40 miles away. Here's my mileage record.

I paid \$72 for a hotel room each time, and I ate at the mess for about \$20 each trip.

No, I have to pay for it myself.

Well I went to Anderson five times before June 30 and four times after.

All four trips to Baker were in the first part of the year, before June 30, 2011. They were short meetings on week-nights, so I just drove straight from work.

I'm a trauma nurse, and I have to take continuing education courses each year to stay certified. The classes cost \$500 once I paid for the books.

The military gives me an allowance, but that only covered \$400.

Your name	Occupation in which you incurred expenses	Social security number
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Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses

	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 \$1,308	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3 \$648	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4 \$500	
5 Meals and entertainment expenses (see instructions)		5 \$180
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 \$2,456	6 \$180

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions).	7 \$400	
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Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8 \$2,056	8 \$180
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	9 \$2,056	9 \$90
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 21 (or on Schedule A (Form 1040NR), line 7). (Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10 \$2,146	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11700N

Form **2106** (2011)



Of the \$2,146 on Form 2106, line 10, \$1,883 will be entered on Form 1040, line 24, and the remaining \$263 will be entered on Schedule A, line 21.

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)		(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11 03 / 15 / 2010	/ /
12	Total miles the vehicle was driven during 2011	12 10,000 miles	miles
13	Business miles included on line 12	13 2,480 miles	miles
14	Percent of business use. Divide line 13 by line 12	14 25 %	%
15	Average daily roundtrip commuting distance	15 10 miles	miles
16	Commuting miles included on line 12	16 5,000 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17 2,520 miles	miles
18	Was your vehicle available for personal use during off-duty hours?		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
19	Do you (or your spouse) have another vehicle available for personal use?		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
20	Do you have evidence to support your deduction?		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
21	If "Yes," is the evidence written?		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)		(a) Vehicle 1	(b) Vehicle 2
22	Multiply line 13 by 51¢ (.51) for miles driven before July 1, 2011, and by 55.5¢ (.555) for miles driven after June 30, 2011. Add the amounts, then enter the result here and on line 1.	22	\$1,308

Section C—Actual Expenses		(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, tires, repairs, and other expenses for the vehicle		

Summary

This lesson explained business expense deductions of special interest to the military and how to claim them. Travel expenses must be ordinary and necessary expenses of temporarily traveling away from home for a person’s job and must be greater than the total of any advances, allowances, and reimbursements received for such expenses.

- Travel and transportation expenses can be taken as miscellaneous itemized deductions on Schedule A, subject to the 2% AGI limit.
- Travel expenses for meals, lodging, and incidentals are only deductible if they are incurred while temporarily away from home on business. Assignments that last, or are realistically expected to last, more than one year are not considered temporary.
- Commuting and other personal expenses are not deductible.
- Travel costs associated with deductible educational expenses are treated like other business travel costs.

Form 2106 and Schedule A are used to figure and claim the itemized deductions for employee business expenses that exceed reimbursement. Service members are required to file Form 2106 to claim job-related travel, transportation, meals, or entertainment expenses, or when they have been paid by their employer for any expenses being deducted on Schedule A, line 21.

National Guard and Reserve members who travel more than 100 miles away from home and stay overnight to attend drill or reserve meetings can deduct travel expenses as an adjustment to income. All other deductible miscellaneous itemized deductions discussed in this lesson are deducted on Schedule A as a Miscellaneous Itemized Deduction, subject to the 2% AGI limit.

To claim these expenses, a service member must itemize using Form 1040, Schedule A, Itemized Deductions.

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

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

- Taxpayers who choose to use actual expenses instead of the standard mileage rate (vehicle-related deductions)



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: C. The cost of battle dress uniforms and utility uniforms that can be worn only while on duty or while traveling to and from duty.

Answer 2: A. The cost of items not replacing regular clothing such as insignia of rank and epaulets are deductible.

Answer 3: No. Lt. Edwards' illustrations are not part of his official duties and cannot be deducted as an employee business expense.

Answer 4: False. The education does not have to lead to a degree as long as it helps maintain or improve skills or knowledge needed for the taxpayer's current job.

Answer 5: B. Educational expenses may be claimed as miscellaneous itemized deductions if the education improves the skills used in the service member's current job.

Answer 6: No. Major Manchester cannot deduct the cost of traveling to Taal on weekends because the travel is not work-related.

Answer 7: C. Only Major Forrest can deduct the costs of traveling overnight to attend a reservists' meeting.

Answer 8: C. Taxi fare to travel on work-related business while not away from home is an allowable local transportation expense.



Lesson 22: Credit for Child and Dependent Care Expenses



Introduction

This lesson covers the credit for child and dependent care expenses. Some taxpayers may not be aware of this credit. Your time and effort may result in a lower tax for the taxpayers.

To determine if a taxpayer is eligible for the credit, use the interview techniques and tools discussed in the interview lesson. Whether the taxpayer is filing Form 1040 or Form 1040A, calculate the credit using Form 2441.



Don't confuse this credit with the child tax credit!

Objectives

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

- Determine if a taxpayer is eligible for the credit
- Calculate the amount of the credit

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 2441 and instructions

Optional:

- Publication 503
- Form 1040 Instructions

What is a nonrefundable credit?

A nonrefundable credit is a dollar-for-dollar reduction of the tax liability. A nonrefundable credit can only reduce the tax liability to zero. The credit discussed in this lesson is a nonrefundable credit. Generally, nonrefundable credits are applied against federal tax in the order they are listed on Form 1040, page 2, in the Tax and Credits section.



Tax Software Hint: The software will calculate these credits, but the correct information must be input. The volunteer tax preparer must make the correct determinations by using the intake and interview sheet and resource materials.

What is the child and dependent care credit?

This credit allows taxpayers to reduce their tax by a portion of their child and dependent care expenses. The credit may be claimed by taxpayers who, in order to work or look for work, pay someone to take care of their qualifying person. A qualifying person is a:

- Dependent child under 13
- Spouse who is incapable of self-care
- Dependent who is incapable of self-care

The credit ranges from 20 to 35% of the taxpayer's expenses. The percentage is based on the taxpayer's earned income and adjusted gross income. The amount of the credit cannot be more than the amount of income tax on the return. It can reduce an individual's tax to \$0, but it will not give the taxpayer a refund.

Some taxpayers receive dependent care benefits from their employers, which may also be called "flexible spending accounts" or "reimbursement accounts." Taxpayers may be able to exclude these benefits from their income. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, box 10.

Because the child and dependent care credit is a nonrefundable credit, only taxpayers with taxable income can claim the credit. However, all taxpayers who receive employer-provided dependent care benefits are required to complete Form 2441, Part III to determine if they can exclude all or part of these benefits from their taxable income.

How do I determine if a taxpayer is eligible?

The information gathered from the intake and interview sheet, along with the decision tree in the Volunteer Resource Guide (Tab G), will help you determine the taxpayer's eligibility. Be sure to ask whether the taxpayer has paid for *any* type of dependent care, for example, for a spouse or another dependent.

The Volunteer Resource Guide decision tree covers the five eligibility tests the taxpayer must meet to qualify for the credit:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

Use the decision tree questions in the Volunteer Resource Guide (Tab G) as a guide for your interview with the taxpayer. Keep in mind that the taxpayer must pass all five of the tests to qualify for the credit.

What is the qualifying person test?

The taxpayer's child and dependent care expenses must be for the care of one or more qualifying people. Refer to the Volunteer Resource Guide (Tab G), Child and Dependent Care Credit Expenses, to determine who is a qualifying person. Any of the following are qualifying persons:

- A qualifying child who is the taxpayer's dependent and under age 13 when the care was provided. If the child is being claimed as a dependent by the noncustodial parent under the special rules for children of divorced and separated parents, only the custodial parent may treat the child as a qualifying person for this credit.
- Someone who was physically or mentally incapable of self-care who the taxpayer claims as a dependent or for whom the taxpayer could claim a dependency exemption, except that:
 - the person had \$3,700 or more of gross income
 - the person filed a joint return
 - the taxpayer or spouse, if Married Filing Jointly, could be claimed as a dependent on someone else's 2011 return.
- Spouses who were physically or mentally unable to care for themselves and lived with the taxpayer more than half the year.

TIP

See the rules for Qualifying Child and the special rules for children of divorced or separated parents or parents who live apart in Publication 17, Personal Exemptions and Dependents.

example

Jim paid someone to care for his wife, Janet, so he could work. Janet is physically unable to care for herself. Jim also paid to have someone prepare meals for their 12-year-old daughter, Jill. Both Janet and Jill are qualifying persons for the credit.

What questions should I ask?

Ask the questions from the decision tree in the Volunteer Resource Guide (Tab G) and the intake and interview sheet. The sample interview shown uses these questions.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	DOROTHY RESPONDS...
<i>I see you indicated on your intake sheet that you had child and dependent care expenses.</i>	Yes, I did.
<i>You may qualify for the child and dependent care credit. Let me ask you a few questions about that. Which of your dependents received the care?</i>	My daughter.
<i>Now, she is 16 years old, correct?</i>	Yes, but she has what the doctors call profound mental retardation. She just can't take care of herself.

Even though Dorothy's daughter is over 13, she meets the qualifying person test because she cannot care for herself.

Once you've determined if the taxpayer had eligible expenses for the child and dependent care credit, confirm the appropriate box on the intake and interview sheet is checked.

What is the earned income test?

The taxpayer (and spouse, if married) must have earned income during the year. Earned income includes:

- Wages
- Salaries
- Tips
- Other taxable employee compensation
- Net earnings from self-employment
- Strike benefits
- Disability pay reported as wages

Refer to the Volunteer Resource Guide (Tab H), Earned Income Table, for the list of earned income.

What if spouses are full-time students or are unable to care for themselves?

A taxpayer's spouse is treated as having earned income for any month the spouse is physically or mentally incapable of self-care, or is a full-time student. The spouse's income is considered to be \$250 for each month if there is one qualifying person in the home or \$500 each month if there are two or more qualifying people. A full-time student is defined as enrolled and attending a school for the number of hours or classes the school considers full time. The spouse must be a student for some part of five calendar months during the year.

If, in the same month, both the taxpayer and the taxpayer's spouse are full-time students or are not able to care for themselves, only one spouse can be considered to have earned income of either \$250 for one qualifying person or \$500 for two qualifying persons for that month.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Form 2441, Credit for Child and Dependent Care Expenses.

What questions should I ask?

Ask the questions from the decision tree in the Volunteer Resource Guide (Tab G) and the intake and interview sheet. Here is how a volunteer might interview a taxpayer about this test.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	DOROTHY RESPONDS...
<i>I believe you mentioned earlier that you and your husband both work, is that correct?</i>	Yes.
<i>Did you both work while your daughter was in day care?</i>	Yes and no. My husband just changed careers. He went to school the first half of the year, but he began working full time within a month of finishing his program in July.
<i>So, he was a full-time student for the first six months of the tax year?</i>	Yes. Does that disqualify us?
<i>No. That does not disqualify you.</i>	

Dorothy and her husband meet the earned income test because her husband was a full-time student for at least five months and is considered to have earned income for those months.

What is the work-related expense test?

Expenses are considered work-related only if both of the following are true:

- The expenses allow the taxpayer (and spouse, if married) to work or look for work and
- The expenses are for a qualifying person's care, and to provide for that person's well-being and protection

For married taxpayers, generally both must work or be looking for work. Taxpayers' spouses are treated as working during any month the spouses were full-time students or were physically or mentally unable to take care of themselves.

There is a limit on the amount of work-related expenses that can be used to figure the credit. The limit is \$3,000 for one qualifying person and \$6,000 for two or more qualifying persons.

What are examples of work-related expenses?

The following expenses count as work-related:

- Cost of care outside the home for dependents under 13, for example, preschool or home day care, before- or after-school care for a child in kindergarten or higher grade
- Cost of care for any other qualifying person, for example, dependent care
- Household expenses that are at least partly for the well-being and protection of a qualifying person, for example, the services of a housekeeper or cook

example

Roger takes his 10-year-old child to a private school. In addition to paying for the cost of the education, Roger also pays an extra fee so that his child can attend a before- and after-school program while he is at work. Roger can count the cost of the before- and after-school program when figuring the credit, but not the cost of the education.

What expenses do not qualify as work-related?

Expenses that do not qualify as work-related include amounts paid for food, clothing, education, or entertainment. However, small amounts paid for these items can be included if they are incident to and cannot be separated from the cost of care. Examples of childcare expenses that do **not** qualify as work-related include:

- Education, for example, expenses to attend kindergarten or a higher grade
- The cost of sending a child to an overnight camp
- The cost of transportation not provided by a care provider

example

Krista takes her 3-year-old child to a nursery school that provides lunch and educational activities as part of its preschool childcare service. She can count the total cost when she figures the credit.

What about taxes paid for household employees?

Taxpayers who paid someone to come into their home to provide care for their dependent or spouse may be required to pay household employment taxes. These taxes may be considered a work-related expense. Refer to Publication 17, Employment Taxes for Household Employers section, for more information.

Generally, if the household employee earned less than \$1,700 for the tax year, and the taxpayer did not withhold any income tax, the taxpayer is not required to pay employment taxes or provide the employee with Form W-2. Refer taxpayers who did not pay employment taxes for their household employees, and are unsure about these requirements, to Publication 926, Household Employer's Tax Guide, or to a professional tax preparer.

What if the taxpayer makes payments to a relative?

Payments to relatives may qualify as work-related expenses if the taxpayer does not claim the relative as a dependent. Do not count amounts paid to:

- A dependent whom the taxpayer (or spouse, if married) can claim as an exemption
- The taxpayer's child who is under age 19 at the end of the year, even if the child is not the taxpayer's dependent
- A person who was the taxpayer's spouse at any time during the year
- The other parent of the taxpayer's qualifying child who is under age 13

What questions should I ask?

Continue asking questions from the decision tree in the Volunteer Resource Guide (Tab G) and the intake and interview sheet. Here is how a volunteer might interview a taxpayer about the work-related test.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Did the caregivers assist your daughter only when you and your husband were at work?

Do you pay your mother to care for your daughter?

That's wonderful. You're all very fortunate. So all your expenses were only to allow you to work – or in your husband's case to go to school or look for work prior to becoming employed.

DOROTHY RESPONDS...

That's right. We couldn't afford any more help than that. All last year, they arrived just before we left for work and they left when my mother came at 2 p.m.

No, we don't. She just does it because she loves her granddaughter.

Yes, exactly.

Dorothy passes the work-related expense test because the expenses are paid so that she and her husband can work and are not paid to a dependent relative.

What is the joint return test?

Generally, *married couples* who wish to take the child and dependent care credit must file a joint return. However, taxpayers can be considered unmarried if they file a separate return and:

- Are legally separated on the last day of the tax year or
- Lived apart from their spouse for the last 6 months of the year and paid more than half of the cost of providing a home that was also the main home of the qualifying person for more than half the year

TIP

Generally, married persons who are considered unmarried will use the filing status, Head of Household.

A taxpayer whose spouse died during the tax year, and who has not remarried, must generally file a joint return to claim the credit.

At this point, you will have already determined the filing status and can rely on that to determine if the taxpayer passes the joint return test.

What is the provider identification test?

The provider identification test requires that taxpayers provide the name, address and Taxpayer Identification Number (TIN) of the person or organization who provided the care for their child or dependent.

If the care provider is an individual, the TIN is the same as the provider's social security number. If the provider is an organization, then it is the Employer Identification Number (EIN). Certain tax-exempt organizations are not required to have an EIN. See Publication 17 for more details.

Taxpayers who cannot provide all of the provider's information or who have incorrect information may still be able to take the credit if they can show that they used due diligence in trying to obtain the correct information. Refer to the sections titled Due Diligence and Provider Refusal in Publication 17, Child and Dependent Care chapter, for more information. Returns that do not include the provider information cannot be filed electronically.



EXERCISES

Use the decision tree in the Volunteer Resource Guide (Tab G) to answer the following questions. The answers appear at the end of the lesson.

Question 1: Audrey is a stay-at-home mom. Her husband works and had earned income for the tax year. They have a young son with autism who must be supervised at all times. Audrey volunteers at a local autism information hotline 12 hours a week. She and her husband pay a caregiver to stay with their son during those hours.

Do they qualify for the child and dependent care credit? Yes No

Question 2: Why don't Audrey and her husband qualify for the credit? (Select all answers that apply.)

- A. The caregiver expense is not work-related
- B. Their son is not a qualifying person
- C. The caregiver's duties qualify as work-related
- D. They do not pass the earned income test

Taxpayer Interview and Tax Law Application

Bill, 61, and Helen, 62, are married and have lived together for twenty years. Earlier in the interview with Bill, you learned that Helen is too sick to work and needs 24-hour care. Bill is claiming his granddaughter as a dependent, as noted in the Marital Status and Household Information section of his intake and interview sheet. She is 18 and takes care of herself. You wonder whether Bill can take the child and dependent care credit.

Apply the questions from the credit for child and dependent care expenses decision tree in the Volunteer Resource Guide (Tab G) to find out whether Bill can take the credit, as shown in the sample interview to follow.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

BILL RESPONDS...

For the credit for child and dependent care, I'd like to ask you some questions about the care provided for your wife, Helen. You may qualify for the credit.

Oh, okay.

Why don't you tell me about your wife's illness and care?

Well, she has chronic lung disease; she can't take care of herself at all. We need to have someone in the home 24 hours a day.

I'm sorry that she is so ill. That must be difficult for both of you. [The volunteer has already determined earlier in the tax return preparation process that Bill has earned income from his full-time teaching job. So he skips these questions in the decision tree and moves ahead to the next relevant question.]

Yes, it is ... well, sometimes she has good days, and I'm thankful for that.

Did you pay someone to take care of your wife so that you could go to work?

Yes, I pay my granddaughter Lucy, who just graduated from high school, to take care of Helen.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

Oh, I see. Well unfortunately, you won't be able to take the credit for your wife because you are claiming Lucy as a dependent.

You're welcome. Just trying to help!

[On the intake and interview sheet, indicate that the taxpayer doesn't qualify for this credit, and why.]

BILL RESPONDS...

Oh, that's okay. Thanks for looking into it for me.

Bill does not pass the work-related expenses test because his expenses were paid to a dependent relative.

How do I determine the amount of the credit?

To determine the amount of the credit, multiply the work-related expenses (after applying the earned income and dollar limits) by a percentage. The percentage depends on the taxpayer's adjusted gross income.



Tax Software Hint: The tax software performs much of the credit computation for you. To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Form 2441, Credit for Child and Dependent Care Expenses.

How do I complete Form 2441?

Form 2441 is divided into three parts:

- Part I is for general information about the care provider
- Part II is where the child and dependent care credit is calculated
- Part III is where information is entered if the taxpayer reports employer-provided dependent care benefits

All taxpayers complete Part I first. Taxpayers who did not receive dependent care benefits from their employers then complete Part II. Taxpayers who did receive these benefits complete Part III and then Part II.

What about employer-provided dependent care benefits?

Some taxpayers receive dependent care benefits from their employers. Taxpayers may be able to exclude these benefits from their income. Dependent care benefits include amounts the employer pays either directly to the taxpayer or to the care provider. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, box 10.

The taxpayer may still be able to claim a child and dependent care credit, but the amount of excluded benefits is not included in work-related expenses and also reduces the dollar limit for the credit. Taxpayers who receive dependent care benefits **must** complete Part III of Form 2441, even if they are not eligible for a child and dependent care credit.

example

Paula has one dependent child, Jenny, who is 6 years old. She paid \$2,900 in qualified expenses. Paula's Form W-2, box 10, shows she received \$1,400 during the year from her employer's dependent care assistance program. Because she received dependent care benefits, Form 2441, Part III, must be completed before completing Part II.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Form 2441, Credit for Child and Dependent Care Expenses.

What limits apply to this credit?

The taxpayer's expenses are subject to an earned income limit. The amount of work-related expenses used to figure the credit cannot be more than:

- The taxpayer's earned income for the year or
- If Married Filing Jointly, the smaller of the taxpayer or spouse's earned income for the year

In addition to the earned income limit, there is a dollar limit on the amount of work-related expenses that can be used to figure the credit. This limit is \$3,000 for one qualifying person or \$6,000 for two or more qualifying persons. If the taxpayer received dependent care benefits from an employer, the amount of the benefits excluded from income must be subtracted from the dollar limit.

example

Mary has three qualifying children. She received \$4,800 in dependent care benefits through her employer. When Mary figures her credit, her work-related expenses will be limited to \$1,200 (\$6,000 – \$4,800).



Tax Software Hint: The tax software guides you through applying the limits and computing the credit. If the taxpayer received employer-paid benefits, be sure to complete Form 2441, Part III, before calculating any credit on Part II. The tax software calculates the credit by multiplying the work-related expenses by a percentage determined by the taxpayer's adjusted gross income.

How do I avoid common errors?

When Form 2441 is complete, double-check your entries for the provider's name, ID number, and amounts paid. If the taxpayer had an amount in any Form W-2, box 10, be sure that you have completed Form 2441, Part III.

On the intake and interview sheet, make sure the Part IV box is checked to indicate that the taxpayer was eligible for the dependent care credit. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return.

Practice–Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to Lesson 22.

Summary

The credit for child and dependent care expenses is a nonrefundable credit that allows taxpayers to reduce their tax liability by a portion of the expenses.

The maximum expense amounts are \$3,000 for one qualifying person and \$6,000 for two or more qualifying persons.

The maximum credit rate is 35% of the taxpayer's expenses. A taxpayer must satisfy the five eligibility tests to qualify for the credit. The tests are the:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

The credit is calculated on Form 2441.

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

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

- Taxpayers who need assistance in determining if employment taxes are owed for household employees



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: *No, they do not qualify.*

Answer 2: *A and D. Audrey is not using the caregiver's services to look for work or to perform work. In addition, both spouses must have earned income during the year to qualify. Only the husband had earned income for the tax year.*



Lesson 23: Education Credits



Introduction

This lesson covers tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of income tax. This lesson suggests probing questions you can ask based on the intake and interview sheet, the Volunteer Resource Guide (Tab G), and on the rules for claiming education credits.

During the interview, ask taxpayers if they are aware of the education credits, and give a brief description. Next, gather information to determine if any credits can be claimed.

Objectives

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

- Determine who qualifies for an education credit
- Determine which credit the taxpayer can claim

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 8863 and Instructions
- Form 1040 Instructions
- Optional:** Publication 970

What are education credits?

Education credits are amounts that will reduce the amount of tax due. The amount is based on qualified education expenses that the taxpayer paid during the tax year.

There are two different education credits: the American opportunity credit and the lifetime learning credit. The American opportunity credit allows 40% of the credit to be refundable. There are general rules that apply to these credits, as well as specific rules for each credit.

For an overview of the various education tax benefits, review the Volunteer Resource Guide, (Tab 13), References – Highlights of Education Tax Benefits.

Who can take an education credit?

Taxpayers can take education credits for themselves, their spouse, and/or dependents (claimed on the tax return) who were enrolled at or attended an eligible post-secondary educational institution during the tax year.

What basic requirements must the taxpayer meet?

To claim an education credit, verify that the following are true for the taxpayers:

- They cannot be claimed as a dependent on someone else's tax return
- They are not filing as Married Filing Separately
- Their adjusted gross income (AGI) is below the limitations for their filing status
- They were not nonresident aliens for any part of the tax year, or if they were, they elected to be treated as resident aliens

Refer to the Volunteer Resource Guide (Tab G), Education Credits, for the basic requirements.

How do I handle dependents?

The taxpayer must claim the student as a dependent to receive the credit for the student's qualified expenses. Refer to the Education Credits Tips in the Volunteer Resource Guide (Tab G), demonstrated by the following example:

example

Erma Bradley has a grandson named Kevin. He is claimed as a dependent on his parent's joint return. Erma paid Kevin's tuition directly to the university. For purposes of claiming an education credit, Kevin is treated as receiving the money as a gift and paying for the qualified tuition and related expenses. Since his parents are claiming him on their return, they may be able to use the expenses to claim an education credit. Alternatively, if he is claiming himself on his return, he might be able to claim the expenses as if he paid them to the school.

What is an eligible institution?

An eligible institution is any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. The school should be able to tell the student if it is an eligible education institution. A searchable database of all accredited schools is available at <http://ope.ed.gov/accreditation/>.

What are qualifying expenses?

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. However, for the American opportunity credit, the definition for "certain related expenses" is different from the lifetime learning credit. This will be discussed later in the lesson.

Ask to see documentation, such as receipts or Form 1098-T, Tuition Statement, issued by the school. Identify the expenses that qualify for education credits.

example

When Janice enrolled for her freshman year of college, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Janice's college enrollment and attendance; therefore, it is a qualified expense.

Which expenses do not qualify?

Do **not** include expenses such as:

- Room and board, insurance, medical expenses (including student health fees), transportation costs, or other similar personal, living, or family expenses
- Any course of instruction or other education involving sports, games, or hobbies, unless the course is part of the student's degree program or (for the lifetime learning credit) helps the student to acquire or improve job skills

example

Jackie paid \$3,000 for tuition and \$5,000 for room and board at an eligible university. The \$5,000 paid for room and board is not a qualified expense for the education credits.

Are any amounts excluded from qualified expenses?

Certain tax-free funds used to pay tuition cannot be used to figure the credit. Once you have identified each person claiming a credit and their qualified expenses, ask if the student received any of these untaxed educational benefits during the year:

- Pell grants.
- Employer-provided educational assistance.
- Veterans' educational assistance.
- Tax-free portions of scholarships and fellowships.
- Any other nontaxable payments received as educational assistance (other than gifts or inheritances). For example, distributions from a 529 plan reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530).
- Refunds of the year's qualified expenses paid on behalf of a student (e.g., the student dropped a class and received a refund of tuition).

Subtract the tax-free educational assistance, refunds, and benefits from the student's qualified expenses. These tax-free benefits are listed in the Education Credits Interview Tips in the Volunteer Resource Guide (Tab G).

Most students will receive Form 1098-T from the educational institution. The form should show the amounts the student paid for tuition and related expenses, the amounts of scholarships and grants received, and whether the student was at least a half-time student or a graduate student. Verify with the taxpayer that the amount in Form 1098-T, box 1 or 2, is actually the amount paid in the current tax year for qualified expenses.

CAUTION

Form 1098-T may have incomplete information. Question the taxpayer to determine the amount of qualified expenses actually paid and adjust this amount by any non-taxable items, such as tax-free scholarships and tuition program distributions.

CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone number City College 4011 College Dr Anchorage, AK 99508		1 Payments received for qualified tuition and related expenses \$ 9,500	OMB No. 1545-1574 2011 Form 1098-T	Tuition Statement
FILER'S federal identification no. 92-XXXXXXX		2 Amounts billed for qualified tuition and related expenses \$	3 If this box is checked, your educational institution has changed its reporting method for 2011 <input type="checkbox"/>	
STUDENT'S name Joan Smith		4 Adjustments made for a prior year \$	5 Scholarships or grants \$ 1,500	Copy B For Student This is important tax information and is being furnished to the Internal Revenue Service.
Street address (including apt. no.) 32 Pine Street		6 Adjustments to scholarships or grants for a prior year \$	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2012 <input type="checkbox"/>	
City, state, and ZIP code Anchorage, AK 99508		8 Checked if at least half-time student <input checked="" type="checkbox"/>	9 Checked if a graduate student <input type="checkbox"/>	
Service Provider/Acct. No. (see Instr.)		10 Ins. contract reimb./refund \$		
Form 1098-T (keep for your records)		Department of the Treasury - Internal Revenue Service		

example

Joan Smith received Form 1098-T, shown above, from the college she attends. It shows her tuition was \$9,500 and that she received a \$1,500 scholarship. She had no other scholarships or nontaxable payments. Her maximum qualifying expenses for the education credit would be \$8,000 (\$9,500 - \$1,500).

What about payments for the next academic year?

The taxpayers can claim payments prepaid for the academic period that begins in the first three months of the next calendar year. Refer to the Volunteer Resource Guide (Tab G), Education Credits.

example

Thomas pays \$1,500 in December 2011 for qualified tuition for the winter semester that begins in January 2012. He can use the \$1,500 paid in December 2011 to compute his credit for 2011. He cannot count it again in 2012.

What rules apply to each credit?

How do the credits compare?

There are several differences between the two credits.

The American opportunity credit:

- Is permitted for the first four years of post-secondary education
- Qualified tuition and related expenses include expenses for course materials – books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance
- Generally, 40% of the credit is a refundable credit, which means taxpayers can receive up to \$1,000 even if they owe no taxes

Lifetime learning credit:

- There is no limit on the number of years the lifetime learning credit can be claimed for each student
- Course-related books, supplies, fees, and equipment are included in qualified education expenses only if they must be paid to the institution as a condition of enrollment or attendance
- No portion of the credit is refundable

American Opportunity Tax Credit

Taxpayers can take the American opportunity credit for a student if they can answer all of these questions as indicated below:

- As of the beginning of the tax year, was the student still in the first four years of post-secondary study? *Yes*
- Was the student enrolled in 2011 in a program that leads to a degree, certificate, or other credential? *Yes*
- Was the student taking at least one-half the normal full-time workload for the course of study, for at least one academic period beginning in 2011? *Yes*
- Has the student been convicted of a felony for possessing or distributing a controlled substance? *No*

TIP

If the student does not meet all of the conditions for the American opportunity credit, the taxpayer may be able to take the lifetime learning credit for part or all of the student's qualified expenses.

example

Under current law, the American opportunity tax credit is for amounts paid through 2012. Mindy started college in 2009. She can claim the American opportunity tax credit for the first four years of her college education.

example

Mindy's brother, Jim, started college in 2008. He claimed the Hope credit for his first year of college (2008). Since the American opportunity expanded the education credit for the first four years of post-secondary education, he can claim the American opportunity tax credit for tax years 2009 through 2011.

The American opportunity credit can be up to \$2,500 per eligible student, depending on the amount of eligible expenses and the amount of tax on the return. The credit is 100% of the first \$2,000 and 25% of the second \$2,000 of eligible expenses per student, up to the amount of tax. Forty percent of the American opportunity credit is a refundable credit, which means the taxpayer can receive up to \$1,000 even if no taxes are owed. Taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met. See Form 8863 Instructions for details.

The American opportunity credit is available for the first four years of college per eligible student (generally, freshman through senior years of college).

example

Toby had receipts for books and supplies his first year at college. He spent \$1,291 for required books, lab supplies, and rock-hunting equipment he needed for his introductory chemistry and geology courses. The school has no policy requiring that these books and equipment be purchased from the college in order to enroll. These are qualified expenses for the American opportunity credit.

Lifetime Learning Credit

The lifetime learning credit can be taken if the taxpayer and the expenses meet the requirements described under "What basic requirements must the taxpayer meet?" Refer to the Volunteer Resource Guide (Tab G), Education Credits, for the basic requirements. The student need not be enrolled half-time or in a degree program, and a felony drug conviction does not disqualify the student.

The lifetime learning credit can be up to \$2,000 per tax return, depending on the amount of eligible expenses and the amount of tax on the return. The credit is 20% of the first \$10,000 of eligible expenses paid for all students, up to the amount of tax on the return.

example

Jill attends Wanda's School of Beauty, an eligible institution. She pays \$4,400 for the course of study, which includes tuition, equipment, and books required for the course. The school requires that students pay for the books and equipment when registering for the course. The entire \$4,400 would be an eligible educational expense.



EXERCISES

Use the Volunteer Resource Guide (Tab G), Education Credits, and Publication 17, Comparison of Education Credits, to answer the following questions. Answers are at the end of the lesson summary.

Question 1: Bob is a full-time student and is a fifth-year senior. Does he qualify for the American opportunity credit? Yes No

Question 2: Janice works full time and takes one course a month at night school. Some of the courses are not for credit, but they are meant to advance her career. Which credit is appropriate for her?

American opportunity Lifetime

Question 3: Clark is an older student who has gone back to college half time after serving 18 months in prison for felony drug possession. Which credit is appropriate for him?

American opportunity Lifetime

Can a taxpayer take multiple education benefits?

Taxpayers cannot receive multiple education benefits (either education credits or elsewhere in the return) for the same student's expenses. For example, do **not**:

- Figure the education credits based on expenses that have already been taken on Schedule A or Schedules C and C-EZ
- Take both an American opportunity credit and a lifetime learning credit for the same student in the same year
- Take the tuition and fees deduction with either education credit for the same student in the same year



Tax Software Hint: To review information related to software entries, go to the Volunteer Resource Guide (Tab 5), Form 8863, Education Credits.

How do I determine the amount of the credit?

Here are the general steps in figuring the amount of education credits:

1. Review the list of qualifying students and expenses and decide if the American opportunity credit or lifetime learning credit is more suitable (see the requirements discussed earlier).
2. In Form 8863, American opportunity or lifetime learning credits sections, enter each qualifying student and social security number. Be sure the student is the taxpayer, spouse, or dependent (and is declared as such on the return).
3. Enter each student's qualified expenses. Be sure that these:
 - Include only qualified expenses
 - Are reduced by untaxed benefits
 - Do not exceed the limit for the credit
4. Find the totals for each section and apply the limits, then transfer the amounts to Parts III and IV to determine the refundable and nonrefundable credits. Apply the income test and do the calculations. (Tax software does this step for you.)



Tax Software Hint: When completing the worksheet for an education credit, the software helps you create an accurate return. The program detects if the taxpayer is entered as a student but can be claimed as a dependent by someone else (as shown on the main information sheet).



The software will not catch other errors, such as taking more than one benefit for the same taxpayer.



If you find taxpayers claimed an education credit in a prior year and they were refunded part or all of the expenses they used to claim the American opportunity or lifetime learning credit, they may have to repay (recapture) all or part of the credit. Information can be found in Publication 970, but this is beyond the scope of the VITA/TCE program. Advise the taxpayer to consult a professional tax preparer.

Taxpayer Interview and Tax Law Application

Here is how our volunteer helped taxpayer, Barbara Smith, determine which education credits applied to her family.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Barbara, are you familiar with education credits?

Yes, they apply to certain expenses for post-secondary education. Did anyone in the family attend college or vocational school during the tax year?

There are two kinds of credits – here’s a chart comparing the two education credits. [Explains the differences.]

I think you’re right. You both meet the basic requirements, since you are both on the return and meet the income limits. Did you bring any receipts for education expenses?

We don’t just count expenses that have to be paid to the school as a condition of enrollment, so her books will qualify but her field hockey costs will not. Did she receive any tax-free benefits from an employer, a scholarship, Pell grant, anything like that?

We don’t need to count the gift. The American opportunity credit is available for a student’s first four years of college, so that might be the best for you to claim. Now let’s look at your expenses.

Are these to improve your job skills?

Are all of these required expenses?

You’ll be eligible for the lifetime learning credit.

[On the intake and interview sheet, indicate that you’ve addressed education benefits.]

BARBARA RESPONDS...

They have something to do with tuition.

My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.

Looks like American opportunity for Carla and lifetime for me!

Yes, these are for Carla’s tuition, fees, and books for the tax year. These are for extracurricular field hockey.

Only \$5,000 from her grandfather.

All I have are tuition and fees for two classes in accounting, spring and fall semesters.

Yes, but my boss doesn’t reimburse me.

Yes.

I’m so glad you were here to help me!

Which education benefit is better for the taxpayer?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- American opportunity credit or lifetime learning credit
- Tuition and fees deduction
- Itemized deduction on Schedule A (employee-related expenses only)
- Business expenses on Schedules C and C-EZ

Generally, taxpayers will benefit the most from claiming the education credits. However, you should compute any of the other benefits for which taxpayers are eligible to determine which gives them the lowest tax. Do not claim multiple benefits for the same education expense; use the benefit most advantageous to the taxpayer.

Refer to the Volunteer Resource Guide, (Tab 13), References – Highlights of Education Tax Benefits for a comparison chart of some of the tax benefits for education.

How can I avoid common errors?

If you complete Form 8863, make sure that you have entered the names, SSNs, and education expense amounts correctly. Check that you have not claimed more than one tax benefit for the same taxpayer or taken a credit or deduction for expenses paid with a tax-free benefit like a scholarship.

On the intake and interview sheet, make sure that Part IV is checked to indicate that the taxpayer had education expenses. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return. For example, you could note if some expenses were paid with a nontaxable scholarship.

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped taxpayer Vanessa Franklin. Go to Appendix A to review the sample interview with Vanessa related to the Education Credits lesson. Return to the lesson after determining which credit is better for Vanessa.

Summary

You are now ready to help taxpayers determine which education tax benefits are best for them. When you get to this section of the return, always check the intake and interview sheet and ask probing questions based on the taxpayer's information and on the rules for claiming education credits.

There are two education credits that may reduce a taxpayer's tax:

- American opportunity credit
- Lifetime learning credit

Education expenses can be applied to those credits, applied to the tuition and fees deduction, deducted on Schedules C and C-EZ, or itemized on Schedule A. Choose the method that will give the taxpayer the lowest tax. The American opportunity credit can be claimed for students in their first four years of college and may be more beneficial than the lifetime learning credit. Remember, 40% of the American opportunity credit is a refundable credit, which means taxpayers can receive up to \$1,000 even if they have no tax liability.

One of your roles as a volunteer is to help taxpayers maximize the benefits that they are entitled to under the tax law. Stay alert to ways they can use their education expenses to lower their tax.

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

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

- Taxpayers who must repay (recapture) part or all of an education credit claimed in a prior year.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Question 1: *No, Bob does not qualify for the American opportunity credit because he is in his fifth year of post-secondary education*

Question 2: *Lifetime*

Question 3: *Lifetime*



Lesson 24: Foreign Tax Credit



Introduction

This lesson will show you how to help U.S. citizens and resident aliens file a claim for the foreign tax credit. This credit applies to those who have paid or accrued foreign taxes to a foreign country on foreign-sourced income and who are subject to U.S. tax on the same income.

To help these taxpayers, you must determine which taxes and types of foreign income are eligible for the foreign tax credit and accurately compute the credit using Form 1116.

If the foreign tax paid is reported on a Form 1099-INT or a Form 1099-DIV, completion of the entire Form 1116 may not be required.

If the foreign tax paid is a result of living and working outside the U.S., then all the questions on Form 1116 need to be addressed. In this situation, U.S. Armed Forces members may need to provide additional documents to the military legal assistance officer or seek assistance from a professional tax preparer.

To identify qualifying foreign income and taxes, use the interview techniques and tools discussed in the Screening and Interviewing lesson. Use the intake and interview sheet to ask taxpayers questions related to credits that may be reportable. Although the foreign tax credit is not specifically listed on the intake and interview sheet, ask taxpayers if they paid any tax to a foreign country.

Objectives

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

- Determine which taxes and types of foreign income are eligible for the foreign tax credit
- Accurately compute the credit using Form 1116
- Calculate and report the foreign tax credit as a nonrefundable credit

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 514
- Publication 4491-W
- Form 1116
- Form 1116 Instructions

What is the foreign tax credit?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens having to pay tax twice on the same income: first to the government of the foreign country where the income was earned and again to the U.S. government.

The foreign tax credit was created to help taxpayers avoid this double taxation. Taxpayers who paid income, war profits, or excess profits taxes to any foreign country or U.S. possession may be entitled to a credit on their U.S. taxes. Like other nonrefundable credits, the foreign tax credit allows taxpayers to take a dollar-for-dollar reduction in the amount of U.S. tax owed. However, in some cases, not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit.

Four tests must be met to qualify for the credit:

1. The tax must be imposed on the taxpayer
2. The taxpayer must have paid or accrued the tax
3. The tax must be a legal and actual foreign tax liability, and
4. The tax must be an income tax

What if the foreign tax credit is reported on Form 1099-INT or Form 1099-DIV?

Taxpayers who receive Form 1099-INT or Form 1099-DIV may have amounts reported in box 6, indicating that foreign taxes have been paid on their behalf by the issuer of the document.

Taxpayers can elect to report foreign tax on Form 1040, page 2 without filing Form 1116 as long as three conditions are met. The total qualified foreign taxes must be:

- \$300 or less (\$600 or less if using Married Filing Jointly status),
- Derived from passive income (e.g., interest, dividends, or royalties), and
- Reported on Forms 1099-INT/1099-DIV, or a similar substitute statement

TIP

A credit for foreign taxes can be claimed only for foreign tax imposed by a foreign country or U.S. possession.

Refer taxpayers who must complete Form 1116 because they cannot qualify for the election to a volunteer with an International certification or a professional tax preparer.

Additional information can be found in the Form 1040 Instructions, Form 1116 Instructions, Publication 17, and Publication 514.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Nonrefundable Credits.

example

Ryan, who is single, received a 2011 Form 1099-DIV that shows \$299 of foreign taxes paid (box 6). According to Ryan, he paid no other foreign taxes. He is eligible to claim the foreign tax credit and does not have to complete Form 1116.



EXERCISES

Answers are after the lesson summary.

Question 1: To claim the election without filing Form 1116, a taxpayer who is filing Single must have paid foreign taxes listed in Box 6 of 1099-DIV or 1099 INT that are equal to or less than \$300.

True False

Question 2: Clyde comes to your site seeking help with his foreign tax credit. He is single and his Forms 1099-DIV show a total of \$324 of foreign tax paid. Can Clyde make the election?

Yes No

Question 3: Judy and Mark are married and will file a joint return. Their Forms 1099-DIV show a foreign tax paid of \$590. Can they make the election? Yes No

The remaining sections of this lesson are directed at volunteers seeking an International certification. All others may proceed to Lesson 25, Child Tax Credit.



What are the rules for claiming the foreign tax credit on Form 1116?

If the amounts are more than \$300 (\$600 for the Married Filing Jointly filing status) and they do not meet the other conditions to make the election, taxpayers must file Form 1116.

In most cases, it is to the taxpayer's advantage to take the foreign tax credit. In general, if the credit is chosen, you must take the credit for all qualified foreign taxes. However, if taxpayers paid foreign taxes that do not qualify for the credit, they may be able to take the itemized deduction on the nonqualifying items as "Other Taxes" on Schedule A. In this situation, refer taxpayers to a professional tax preparer. For more information, see the Form 1116 Instructions and Publication 514, Foreign Tax Credit for Individuals.

TIP

The foreign earned income exclusion differs from the foreign tax credit; try both methods for taxpayers and choose the approach that results in the lowest tax.

- The exclusion allows a portion of the foreign earned income to be excluded from taxable income, so it is not taxed
- The credit adds the foreign income to the taxable income and then reduces the U.S. tax due by some portion of taxes paid to the foreign government(s)

What qualifies taxpayers for the credit?

To qualify for the credit, the following requirements must be met. A taxpayer must:

- Have income from a foreign country
- Have paid taxes on that income to the same foreign country
- Not have claimed the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of Lesson 15, Income – Other Income)

In addition, the foreign tax must:

- Be paid to a foreign country on income derived from that country
- Be similar to the U.S. income tax
- Provide no economic benefit to the taxpayer paying the tax

Foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties
- Annuities

Foreign taxes for which an individual may *not* take a credit include taxes:

- On excluded income
- On foreign oil–related income
- On foreign mineral income
- On foreign oil and gas extraction income



Taxpayers cannot take the foreign tax credit for foreign income taxes paid on income excluded under the foreign earned income exclusion.

- For which the taxpayer can take only an itemized deduction
- From international boycott operations, and
- Of U.S. persons controlling foreign corporations and partnerships
- Taxes paid to a foreign country that a taxpayer does not legally owe, including amounts eligible for refund by the foreign country



For more detailed information, see Publication 514, Foreign Tax Credit for Individuals and the Form 1116 Instructions.

example

Robb Kendall and his wife are U.S. citizens who reside in France. Their Form 1040, Schedule B, Interest and Ordinary Dividends, lists \$500 interest from a U.S. bank and \$600 interest from a French bank. They paid income taxes on both amounts to both countries. On their U.S. tax return, they can compute a foreign tax credit to offset the taxes they owe to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return to offset the taxes paid to the U.S. on the interest income earned in the U.S.

example

Eva is a U.S. citizen who lives in Hong Kong. Eva owns her home in Hong Kong and paid \$2,000 in real estate taxes and \$1,000 in personal property taxes. She also paid \$300 in income taxes to the government of Hong Kong. She cannot claim a foreign tax credit for either the real estate taxes or the personal property taxes because they are not income taxes. Eva can compute a foreign tax credit on the \$300 in income taxes paid to Hong Kong.

However, Eva can deduct the real estate taxes that she paid as an itemized deduction on her U.S. tax return. She can itemize the foreign personal property tax only if it is based on the value of the personal property.



EXERCISES (continued)

Question 4: Anne is a U.S. citizen living in Japan. She listed wages, interest income, and dividend income on her U.S. tax return. She paid taxes on each of these types of income to Japan. Anne can claim a foreign tax credit on which of the following types of income?

- A. Wages from her job in the U.S.
- B. Interest income from a U.S. bank
- C. Interest income from a Japanese bank
- D. Dividend income from a U.S. corporation

Question 5: Jean, a U.S. citizen, received an inheritance upon the death of an uncle in Spain and paid an inheritance tax to the Spanish government. Can Jean claim a foreign tax credit to offset the inheritance tax she paid in Spain? Yes No

What is “economic benefit”?

As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:

- Goods
- Services
- Fees or other payments
- The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
- Discharges of contractual obligations

TIP

According to Publication 514, Foreign Tax Credit for Individuals, taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.

example

Lawrence is a business owner who lives in China, which has a two-tier income tax system:

- Everyone is taxed according to their income
- Business owners pay additional tax on their profits

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return. However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

What are Sanctioned Country Restrictions and Section 901(j) Income?

Taxes paid to or accrued by certain countries do not qualify for the foreign tax credit. These are countries:

- That have been designated by the Secretary of State as repeatedly providing support for acts of international terrorism,
- With which the U.S. has severed or does not conduct diplomatic relations, or
- Whose government the U.S. does not recognize, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act

Income taxes paid to governments the U.S. does not recognize are not eligible for the foreign tax credit.

At the time of this writing, the following countries are not recognized:

- Cuba
- Iran
- North Korea
- Sudan
- Syria

Countries can be removed from the sanction list or granted a presidential waiver. See Publication 514 or visit www.irs.gov for the current list of sanctioned countries.

TIP

Foreign income earned in sanctioned countries is subject to U.S. tax. A separate Form 1116 must be completed for foreign income from a sanctioned country, using the “Section 901(j) income” category. This is beyond the scope of the volunteer program; refer taxpayers to a professional tax preparer.



EXERCISES (continued)

Question 6: Adele lived and worked in Iran until August 2011, when she was transferred to Italy. She paid taxes to each country on the income earned in that country. Can Adele take a foreign tax credit on her U.S. tax return for the taxes paid on income she earned in Iran? Yes No

Question 7: Write “Q” next to each tax that qualifies for the foreign tax credit or “NQ” next to those that do not. Assume the taxpayer is a U.S. citizen or resident living in a nonsanctioned foreign country and that the tax is being paid to a foreign government on foreign-sourced income.

- ___ Dividend taxes
- ___ Foreign oil related income tax
- ___ Interest income tax
- ___ Real estate taxes
- ___ Income tax on wages from a foreign country
- ___ Taxes paid on income earned in Syria

What categories of income qualify for the credit?

At the top of Form 1116, Part I, taxpayers are asked to indicate the type of foreign income they received. Two of these income categories fall within the scope of the volunteer program:

- Passive category income
- General category income

Passive Category Income

This category includes passive income and specified passive category income, assuming the income is from another country and the taxpayer has paid taxes on it.

Passive income generally includes the following:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

For example, a taxpayer who lives in a foreign country and pays taxes on interest income could claim the foreign tax credit and check box a, on Form 1116, “Passive Category Income.”

For additional information on passive income and specified passive category income, see Publication 514, Foreign Tax Credit for Individuals.



A separate Form 1116 must be completed for each type of income; each Form 1116 can include income earned in as many as three foreign countries.



Wages and salaries are considered to be general category income, which is discussed later in this topic. Passive category income may qualify as general category income if the foreign government taxes it at a rate higher than the highest U.S. tax rate; see “High-Taxed Income” later in this lesson.

General Category Income

General category income consists of wages earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion. Additionally, foreign income that does not come under any of the other categories on Form 1116 can typically be included as general category income.

example

Robert paid taxes to Spain for earned income and did not claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain.

What is high-taxed income?

Some passive category income can be included in general category income if it is taxed by a foreign government at a rate higher than the highest U.S. income tax rate. In 2011, the highest U.S. income tax rate was 35%. Therefore, if taxpayers pay more than 35% income tax on the foreign-sourced passive income for which they claimed the credit, the credit is computed under general category income.

example

Brenda is a U.S. citizen who lives in a foreign country and pays 45% income tax on her interest income in that country. She can list this as "General Category Income" on Form 1116, since the tax rate paid on this passive income is higher than the highest U.S. income tax rate.



EXERCISES (continued)

Question 8: Regina lives in Singapore and is a U.S. citizen. She has both dividend income and interest income from foreign countries. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income, at a rate of 40%. For the purposes of Form 1116, how should the following types of income be classified?

Interest Income: ____ Dividend Income: ____

- A. Passive category income
- B. General category income

Question 9: Bernard is a U.S. citizen who lives in Barbados. In 2011, he paid 17% income tax on interest income from his bank account in Barbados. For the purposes of Form 1116, Bernard's foreign interest income should be classified as:

- A. Passive category income
- B. General category income

Taxpayer Interview and Tax Law Application

There are several factors to consider when determining if taxes paid to a foreign government are eligible for the foreign tax credit. Ask the taxpayer:

- Was the income foreign-sourced?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

Here's how a volunteer helped Bonnie determine if she qualified for the foreign tax credit:

SAMPLE INTERVIEW

VOLUNTEER SAYS...

BONNIE RESPONDS...

The income you earned in Argentina does not qualify for the foreign earned income exclusion. Let's see if you can claim a credit on the income taxes you paid to Argentina.

Yes, I hope I can avoid paying taxes twice on that income!

That's why the foreign tax credit was created, and you may qualify to claim it.

That's a relief!

We must determine how much of the foreign tax is similar to U.S. income tax and whether you received an economic benefit in exchange for those taxes.

Okay.

Wages and bank interest are taxable on your U.S. income tax return. What type of tax does Argentina charge on that income?

It's the same kind of tax, a percentage of your income, except they withhold all of it right from your pay or bank account.

So it's similar to the U.S. tax. Did you receive any kind of benefit, such as goods or services, or the right to use properties, as a result of paying taxes on either your wages or your interest?

None at all.

Then we can include both in the claim for the credit.

How do I complete Form 1116?

If the taxpayer does not qualify for the election to report foreign tax on Form 1040, page 2, Form 1116 must be completed. The amount of the foreign tax credit is the portion of U.S. income tax liability based on gross taxable foreign income. Certain expenses can be deducted to reduce foreign gross income. Some of these situations are complicated and beyond the scope of the VITA/TCE program, such as:

- Expenses directly related to the foreign income, such as employee business expenses
- Investment interest expense
- Foreign losses, such as those from selling foreign assets or a loss from a business or partnership

If the taxpayers have any of these types of deductions, refer them to a professional tax preparer.

Use the following guidelines if you prepare Form 1116 for the taxpayer:

- Top portion: Only report one type of income on each Form 1116. Income from up to three foreign countries may be reported on the same form as long as it is the *same type* of income.
- Part I, line 1a: Enter all foreign income that is taxable by both the foreign countries and the U.S.
- Part I, line 3a: If the taxpayer is not itemizing deductions on Schedule A, enter the standard deduction amount on line 3a. If the taxpayer itemizes, enter the total of medical expenses, real estate taxes, and gifts to charity from Schedule A. The tax software will not automatically enter this field.
- Part II: Check the appropriate box, (h) or (i), to indicate whether the foreign tax was actually paid in 2011 ("paid") or if the tax was billed in one year but paid in another ("accrued"). A taxpayer can choose to use either the cash or accrual method to determine the foreign tax credit. However, if the accrual method is chosen, the taxpayer must continue to use the accrual method for the foreign tax credit on all future returns.

- Part II, column j: Enter date taxes were paid or accrued.
- Part II, columns k–n: Amounts are entered in foreign currency; columns o–r: amounts are entered in U.S. dollars; and column s: total U.S. dollar amounts only. Conversion rates are discussed in the Other Income lesson.
- Part III: Figure the credit in this section. If the taxpayers have a carryback or carryover, refer them to a professional tax preparer.
- Part IV: Only needed if the taxpayer files more than one Form 1116 to report more than one type of income and/or report funds from more than three countries.
- The tax software performs the calculations in Parts III and IV.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Nonrefundable Credits.

Summary

Taxpayers who paid taxes to any foreign country or U.S. possession may be able to take a nonrefundable foreign tax credit. Generally, to claim the credit, taxpayers are required to file Form 1116, Foreign Tax Credit (Individual, Estate, or Trust).

Taxpayers do not have to file Form 1116 if they meet certain requirements and can elect to claim the foreign tax credit on Form 1040, page 2. VITA/TCE volunteers must have International certification to help taxpayers who are required to file Form 1116.

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The credit is computed and reported on Form 1116; Part I is used to figure the taxable income from foreign sources in each income category. A separate Form 1116 must be completed for each category of income.

The foreign tax credit is different from the foreign earned income exclusion. If the taxpayer uses the foreign earned income exclusion, foreign tax paid on the excluded income cannot be used to claim the foreign tax credit. Taxpayers can choose the approach that results in the lowest tax.

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

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

- U.S. Armed Forces members who paid foreign tax as a result of living and working outside the U.S. may need to provide additional documents to the military legal assistance officer or seek assistance from a professional tax preparer
- Taxpayers who must complete Form 1116 because they cannot elect to report foreign tax on Form 1040, unless your site has a volunteer with an International certification
- Taxpayers who paid foreign taxes that do not qualify for the credit, and wish to deduct the taxes on Schedule A
- Certain expenses deducted to reduce foreign gross income
- Taxpayers who must report a carryback or carryover on Form 1116, Part III
- A separate Form 1116 is required for foreign income from a sanctioned country, using the “Section 901(j) income” category



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: True. Form 1116 is not required if the total foreign taxes paid are less than or equal to \$300 (\$600 if Married Filing Jointly).

Answer 2: No. Clyde needs to complete Form 1116 because his foreign taxes exceed \$300. Clyde will need to be referred to a volunteer with an International certification or seek the assistance of a professional tax preparer.

Answer 3: Yes. Judy and Mark do not have to complete Form 1116 because they file jointly and their foreign taxes are less than \$600.

Answer 4: C. On Anne's tax return, she can claim a foreign tax credit to offset taxes she paid to Japan on interest received from the Japanese bank.

Answer 5: No. An inheritance does not qualify as income from a foreign country. Under U.S. tax law, inheritances are not taxable to the beneficiaries. Jean is not eligible to claim a foreign tax credit for the inheritance taxes she pays to the Spanish government.

Answer 6: No. Adele cannot take a foreign tax credit for the taxes paid on income she earned in Iran. However, this income is taxable in the U.S., since she is a U.S. citizen.

Answer 7:

Q – Dividend taxes

NQ – Foreign oil-related income tax

Q – Interest income tax

NQ – Real estate taxes

Q – Income tax on wages from a foreign country

NQ – Taxes paid on income earned in Syria

Answer 8: Interest Income – A; Dividend Income – B (High-taxed income is considered general category income.)

Answer 9: A. Since 17% (the tax rate Bernard paid) is not more than 35% (the highest U.S. income tax rate), Bernard's income falls under Form 1116, "Passive Category Income."



Lesson 25: Child Tax Credit



Introduction

The child tax credit is unique because if a taxpayer cannot benefit from the nonrefundable credit, the taxpayer may be able to qualify for the refundable additional child tax credit on Form 8812. In this chapter, we will learn about both credits and their relationship to each other. Some taxpayers may not be aware of these credits. Your time, effort, and understanding of this credit may result in a lower tax for the taxpayer.

The child tax credit is entered in the Nonrefundable Credits section of the tax return; the additional child tax credit is entered in the Payments section. Form 1040EZ filers cannot take the credit.

The intake and interview sheet, along with the interview tips in the Volunteer Resource Guide (Tab G) are critical tools needed to determine eligibility for the credit.



Don't confuse these credits with the child and dependent care tax credit!

Objectives

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

- Determine the taxpayer's eligibility for the credit(s)
- Determine which taxpayer can claim the additional credits

What is the child tax credit?

The child tax credit is a nonrefundable credit that allows taxpayers to claim a tax credit of up to \$1,000 per qualifying child, which reduces their tax liability.

What is the additional child tax credit?

Taxpayers who are not able to claim the full amount of the child tax credit may be able to take the refundable additional child tax credit. Completing Form 8812, Additional Child Tax Credit, may result in a refund even if the taxpayer doesn't owe any tax.

Who can claim the child tax credit?

To be eligible to claim the child tax credit, the taxpayer must have at least one qualifying child. Refer to the Volunteer Resource Guide (Tab G) for the definition of a qualifying child for purposes of claiming the child tax credit.

example

Ed's son, Jeff, turned 17 on December 30, 2011, and has a valid SSN. He is a citizen of the United States. According to the Child Tax Credit rules, he is not a qualifying child for the child tax credit because he was not under the age of 17 at the end of 2011.

Does the child have to be the taxpayer's dependent?

To be a qualifying child for the child tax credit, the child must be claimed as the taxpayer's dependent.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 972
- Publication 4491-W
- Form 8812 and Instructions
- Optional:** Form 1040 Instructions

Are there special rules for children of divorced or separated parents or parents who live apart?

There are special rules for children of divorced or separated parents, as well as for children of parents who live apart. The custodial parent is the parent with whom the child lived for the greater number of nights during the year. The other parent is the noncustodial parent. In most cases the custodial parent may claim the dependency exemption for the qualifying child. The noncustodial parent, however, may be entitled to claim the dependency exemption for a child and thus the child tax credit and additional child tax credit. Review the Child Tax Credit Interview Tips in the Volunteer Resource Guide (Tab G) for additional information.

Remember, a custodial parent's release of the dependency exemption will also release the child tax credit and the additional child tax credit, if either applies, to the noncustodial parent. Noncustodial parents must attach Form 8332 or a similar statement to their return each year the exemption is claimed.



Taxpayers with divorce decrees or divorce agreements executed after 2008 must use Form 8332 or similar statement; they cannot simply substitute pages from the divorce decree.

example

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

Ralph, the noncustodial parent, can claim the dependency exemption and child tax credit only if Mary signs Form 8332. Mary can still claim the earned income credit, Head of Household, and child and dependent care credit for Amy assuming she qualifies for them.

What is the amount of the credit?

The maximum amount taxpayers can claim for the child tax credit is \$1,000 for each qualifying child. The amount actually claimed on Form 1040 depends on the taxpayer's tax liability, modified adjusted gross income (MAGI), and filing status. The amount of the credit may be reduced if the taxpayer's:

- Tax liability less the majority of the nonrefundable credits is less than the maximum child tax credit, or
- MAGI is above the limit for the taxpayer's filing status; review Publication 17, Child Tax Credit chapter for the limits on the credit

Review steps 6 and 7 in the Volunteer Resource Guide (Tab G) to determine which worksheet must be used to figure the credit. If the taxpayer answers yes to steps 6 and 7, then the worksheet in Publication 972 must be used to figure the credit.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.

example

Stan files as Head of Household and has three children who qualify for purposes of the child tax credit. Stan's MAGI is \$54,000 and his tax liability is \$4,680. Stan is eligible to take the full \$1,000 per child (\$3,000) because his MAGI is less than \$75,000 and his tax liability is greater than \$3,000.

example

May and Bob file as Married Filing Jointly and have two children who qualify for the child tax credit. Their MAGI is \$86,000 and their tax liability is \$954. Even though their AGI is less than the threshold limit of \$110,000, they can only claim \$954, reducing their tax to zero. As they could not claim the maximum child tax credit, May and Bob may also be eligible for the additional child tax credit.

What is MAGI?

Typically, the taxpayers' MAGI (Modified Adjusted Gross Income) is the same as their AGI from Form 1040, line 37. For more information on MAGI as it applies to the child tax credit, refer to Publication 17.



If the taxpayers' tax liability is zero, they cannot take the credit because there is no tax to reduce. However, the taxpayers may be able to take the additional child tax credit, discussed later in this lesson.



EXERCISES

Use the Child Tax Credit interview tips from the Volunteer Resource Guide (Tab G) and Publication 17 to complete the exercises. Answers are at the end of the lesson summary.

Question 1: Paul and Marie are married with two dependent children. They will file a joint Form 1040 for the year. The children are qualifying children for purposes of the child tax credit. Paul and Marie's MAGI is \$112,000, and their tax liability is \$6,200. Based on this information, Paul and Marie:

- A. Are not eligible for the maximum credit and can use the Child Tax Credit Worksheet in the Form 1040 Instructions to figure their child tax credit
- B. Will have to use Publication 972 to figure their child tax credit
- C. Are eligible to claim a full child tax credit
- D. Are not eligible to claim any amount for the child tax credit

Question 2: Laura's adopted son Jack is 12. He is a citizen of the United States and lived with Laura for the entire tax year, during which time Laura provided full financial support. Is Jack a qualifying child for the child tax credit? Yes No

Question 3: Which one of the following individuals (all of whom have two qualifying children for the purposes of the child tax credit) are eligible to claim the maximum \$1,000 per child for the child tax credit on their tax return?

- A. Fiona, who is Married Filing Separately with a MAGI of \$60,000
- B. Ken, a Qualifying Widower with a MAGI of \$30,000 and tax liability of \$490
- C. Nick, who is Single with a MAGI of \$70,000 and a tax liability of \$5,000
- D. Julie, who is Married Filing Jointly with a MAGI of \$116,000

How do I determine taxpayer eligibility for the credit?

To determine whether a child meets the criteria of qualifying child for the child tax credit or additional child tax credit, use the interview techniques and tools discussed in the Screening and Interviewing lesson. Begin by reviewing the Marital Status and Household Information section of the taxpayer's intake and interview sheet. Verify that the child:

- Is under 17 on December 31 of the tax year
- Lived with the taxpayer for more than six months of the year (remember the special rules for divorced or separated parents or parents who live apart)
- Did not provide over half of his or her own support
- Meets the relationship criteria
- Is a U.S. citizen, U.S. national, or resident of the United States

If the Marital Status and Household Information section is incomplete or the taxpayer is unsure of how to respond, you may want to use the Child Tax Credit Interview Tips in the Volunteer Resource Guide (Tab G). It provides helpful probing questions to ask the taxpayer.



Tax Software Hint: The entries for each qualifying child on the Main Information Sheet will help the software determine if the child is eligible for the child tax credit. To review information related to the software, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.

How do I calculate the child tax credit?

To calculate the credit, you must first determine which worksheet to use. Review the Child Tax Credit interview tips in the Volunteer Resource Guide (Tab G) to determine which worksheet the taxpayer must use.



Tax Software Hint: If you are using tax software, the system will automatically calculate the credit, provided you have correctly completed the:

- Dependent section of the Main Information Sheet
- Taxpayer's return through the retirement savings contribution credit line
- Part I of Form 5695, and Schedule R

If you have a question about the amount that appears as the child tax credit, the taxpayer's completed Child Tax Credit Worksheet may help you understand the determination.

What is the additional child tax credit?

This credit is for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give taxpayers a refund even if they do not owe any tax.

What is the amount of the credit?

Like the child tax credit, the additional child tax credit allows eligible taxpayers to claim up to \$1,000 for each qualifying child after subtracting the allowable amount of child tax credit. For taxpayers with earned income over \$3,000, the credit is based on the lesser of:

- 15% of the taxpayer's taxable earned income that is over \$3,000 or
- The amount of unused child tax credit (caused when tax liability is less than allowed credit)

Who can take the additional child tax credit?

Taxpayers who do not get the full \$1,000 of the child tax credit may qualify for the additional child tax credit. Review the Additional Child Tax Credit Tip in the Volunteer Resource Guide (Tab G) to see the requirements to claim the credit.

example

Remember May and Bob who have two qualifying children, a MAGI of \$86,000, and a tax liability of \$954? Because their tax liability is less than the full amount of the credit (in their case \$2,000), they may be able to take the additional child tax credit of up to \$1,046 (\$2,000 – \$954).

There is another method to compute the additional child tax credit for taxpayers with three or more qualifying children. These taxpayers may benefit if they:

- Had social security or Medicare taxes withheld from their pay
- Were self-employed and paid self-employment tax
- Paid tax on tips not reported to their employer
- Did not receive the maximum available child tax credit

The amount of the taxpayer's earned income credit is a factor in this calculation on Form 8812.

How do I calculate the additional child tax credit?

Form 8812, Additional Child Tax Credit, is used to calculate the credit, which is entered on the additional child tax credit line of the Payment section of Form 1040.



Tax Software Hint: If you are using the tax software, the system will automatically calculate the credit and place that entry on the appropriate line of the payment section.



EXERCISES (continued)

Question 4: Jose and Yolanda Alameda are Married Filing Jointly and have five dependent children under the age of 17. Jose and Yolanda both have valid SSNs. Their children have Individual Taxpayer Identification Numbers (ITINs). The children are qualifying children for purposes of the child tax credit but not the earned income credit. Jose and Yolanda's earned income is \$8,850, and their tax liability is \$0. Their social security and Medicare taxes are \$677. Are they eligible to take the additional child tax credit? Yes No

How do I avoid common errors?

When considering the child tax credit, it is critical to interview the taxpayer thoroughly to correctly identify eligible children.



Tax Software Hint: Once the birth date and dependency information is entered on the Main Information Sheet for dependents, the CTC box will check automatically, and the software will compute the amount of the credit.

Practice – Vanessa Franklin



Take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interviews with Vanessa related to Lesson 25.

Summary

The child tax credit is a nonrefundable credit that allows qualifying taxpayers to reduce their tax liability to the lesser of the amount of the credit or their adjusted tax liability.

If a taxpayer is not able to benefit from the maximum \$1,000 per qualifying child, the taxpayer may be eligible for the additional child tax credit, which is a refundable tax credit.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: A. Paul and Marie's MAGI is over the threshold of \$110,000. They are not eligible to claim a full child tax credit. They can use the Child Tax Credit Worksheet in the Form 1040 Instructions to calculate the credit.

Answer 2: Yes. Jack is a qualifying child for the child tax credit because he was under the age of 17 at the end of 2011; he meets the relationship requirement, lived with Laura for at least six months of the year; and Laura provided his complete support.

Answer 3: C. Nick may be able to take the full \$1,000 credit for each of his qualifying children because his MAGI is not affected by the threshold limit of \$75,000 for his single filing status. In addition, his tax liability of \$5,000 is more than the amount of \$1,000 per child for the credit.

Answer 4: Yes. Jose and Yolanda qualified for the initial child tax credit. However, they could not benefit from it because their tax liability (0) was less than their allowable child tax credit (\$5,000). Since their earned income is more than \$3,000, they have more than three children, and paid social security and Medicare taxes, they are eligible for the additional child tax credit.



Lesson 26: Miscellaneous Credits



Introduction

This lesson provides the information you need to be able to prepare a return with certain nonrefundable credits. The Basic Course includes retirement savings contribution credit and credit for the elderly or the disabled. The other miscellaneous credits covered in this lesson are part of the Intermediate, Advanced, Military, or International Courses.

These credits are reported in the Tax and Credits section of Form 1040.

Objectives

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

- Determine if a taxpayer qualifies for the retirement savings contributions credit and accurately complete Form 8880, Credit for Qualified Retirement Savings Contributions
- Calculate the credit for the elderly or the disabled by completing Schedule R (Form 1040 or 1040A) Credit for the Elderly or the Disabled
- **NEW** Identify the changes in the residential energy credit due to December 2010 legislation
- Calculate the nonbusiness energy property credit by completing Form 5695, Residential Energy Credits

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040
- Schedule R, Forms 1040 or 1040A
- Form 5695
- Form 5695 Instructions
- Form 8880
- Optional:** Form 1040 Instructions

Remember to use the interview techniques and tools discussed in the Screening and Interviewing lesson. Use the information from an intake and interview sheet, along with the documents provided by the taxpayer to determine eligibility for these credits.

What is a nonrefundable credit?

In an earlier lesson, you learned the difference between a nonrefundable credit and a refundable credit. A nonrefundable credit can only reduce the tax liability to zero. All the credits discussed in this lesson are nonrefundable credits.

Generally, nonrefundable credits are applied against federal tax in the order they are listed on Form 1040, page 2, in the Tax and Credits section.



Tax Software Hint: The software will calculate these credits, but the correct information must be entered. The volunteer tax preparer must make the correct determinations by using the intake and interview sheet and resource materials.

What is the retirement savings contributions credit?

The retirement savings contributions credit is a nonrefundable credit eligible taxpayers may claim if they made a qualifying contribution to a retirement plan.

If the contribution is tax deferred, the taxpayer receives the benefit of the tax deferral and a tax credit; for example, a taxpayer may be able to claim this credit and a deduction for an IRA contribution. This is considered a *double benefit* and is rarely allowed. The credit is calculated on Form 8880, Credit for Qualified Retirement Savings Contributions, and reported in the Tax and Credits section of Form 1040.

Who is eligible for the retirement savings contributions credit?

Go to the Volunteer Resource Guide (Tab G), Credits and review the flowchart in the Retirement Savings Contribution Credit – Decision Tree for the qualifications.

What is the modified AGI limit?

For 2011, taxpayers may be able to claim the retirement savings contribution credit if their modified AGI is not more than:

- \$56,500 for Married Filing Jointly
- \$42,375 for Head of Household
- \$28,250 for Single, Married Filing Separately, or Qualifying Widow(er)

What are qualified plans for the purpose of the retirement savings contributions credit?

To be eligible for the credit, the taxpayer must have contributed to a qualified plan. Plans that qualify are traditional IRAs, Roth IRAs, and:

- Salary reduction contributions (elective deferrals, including amounts designated as after-tax Roth contributions) to a:
 - 401(k) plan, including a SIMPLE 401(k) and the federal Thrift Savings Plan
 - 403(b) annuity
 - Governmental 457 plan
 - SIMPLE IRA plan
 - Salary reduction SEP
 - 501(c)(18)(D) plan
- Voluntary after-tax employee contributions to tax-qualified retirement plan or section 403(b) annuity plan. Contributions made as a condition of employment are *not* considered voluntary.



Contributions designated under Internal Revenue Code Section 414(h)(2) are treated as employer contributions, not voluntary contributions made by the employee. They do not qualify for the credit and should not be included on Form 8880, line 2. This information is stated in the Form 8880 Instructions.

How do I know if the taxpayer has made a qualifying contribution?

In most cases, qualifying plan contributions will be listed on the taxpayer's Form W-2, box 12 and preceded by one of the following codes: D, E, F, G, H, S, AA, or BB. These are the codes most frequently seen. For a complete list of box 12 codes, refer to the Form W-2 Instructions. For military personnel, there may be an amount in box 14 coded with Q or E. When reviewing the Expenses section on page 2 of the intake and interview sheet, be sure to ask if the taxpayer made a contribution to an IRA or other retirement account.



Tax Software Hint: If Form W-2 is entered into the software correctly and completely, the program will calculate the credit. Review the Volunteer Resource Guide (Tab 2), Form W-2 Instructions, for the software entries.



Some employers allow employees to contribute after-tax money to a Roth plan. These after-tax contributions are listed on Form W-2, box 12 with code AA for a Roth 401(k) or BB for a Roth 403(b).



Tax Software Hint: If the taxpayer contributed to a Roth or a traditional IRA, whether it is deductible or not, link to the IRA deduction worksheet and enter the information. Review the Volunteer Resource Guide (Tab 3), Form 1040 – Adjustments to Income, for the software entries.

What may reduce an eligible contribution for purposes of the credit?

Eligible contributions are reduced by the following distributions received during the testing period:

- Any distribution from a qualified retirement plan or eligible deferred compensation plan that is included in the taxpayer's gross income
- Any distribution from a Roth IRA that is not a qualified rollover contribution

The testing period includes:

- The tax year
- The two preceding tax years, and
- The period between the end of the tax year and the due date of the return, including extensions

Question the taxpayer to determine if they have received any distributions in the testing period.

What is the maximum contribution amount for married taxpayers?

For married taxpayers filing a joint return, both spouses may be eligible for a credit on a maximum annual contribution of \$2,000 each. If either spouse has received a distribution during the testing period, *both* spouses must reduce their eligible contribution by that amount.

example

Jose and Lucy are married and will file a joint return. Their combined adjusted gross income was \$39,000. They each contributed \$3,000 to a 401(k) plan. They did not receive any distributions during the three-year period and cannot claim any other credits. Jose and Lucy are each eligible for a credit based on the maximum eligible annual contribution amount of \$2,000 each.

example

Joe and Mary are married and filed joint returns for 2009 and 2010, and plan to do so in 2011. Joe received a distribution from a qualified plan in 2009 and a distribution from an eligible deferred compensation plan in 2010. Mary received distributions from a Roth IRA in 2010.

Both Joe and Mary made qualifying contributions to an IRA in 2011 and otherwise qualify for the retirement savings credit. They must reduce the amount of their qualifying contributions in 2011 by the total of the distributions they received in 2009 and 2010. This calculation is completed on Form 8880.

How do I determine the amount of the credit?

Form 8880 is used to figure the credit. The credit can be as low as 10% or as high as 50% of a maximum annual contribution of \$2,000 per person depending on filing status and adjusted gross income.



Tax Software Hint: If the taxpayer meets the age and income requirements and a contribution was indicated on Form W-2 or the IRA worksheet, Form 8880 will display in the forms tree, highlighted in red. You will need to address a few fields before the return is completed. Review the Volunteer Resource Guide (Tab 5), Retirement Savings Contributions Credit, for the software entries.



EXERCISES

Question 1: All of these taxpayers contributed to their employers' 401(k) plan. Who qualifies for the retirement savings credit based on adjusted gross income?

- A. Ed, who is single and has an adjusted gross income of \$35,200
- B. Sybil, who is married, files jointly, and has an adjusted gross income of \$52,500
- C. Bert, who is married, files separately, and has an adjusted gross income of \$30,600
- D. Carl, who is a qualifying widower with a dependent child, and has a modified AGI of \$29,000

Taxpayer Interview and Tax Law Application

Our volunteer is working with Ryan. She has already determined that Ryan's filing status is Single, no one can claim him as a dependent, his AGI is \$25,000, and he is 28 years old. Using the Volunteer Resource Guide (Tab G), Retirement Savings Contributions Credit – Decision Tree, follow along with our volunteer as she determines Ryan's eligibility for the credit.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Ryan, I see from your Form W-2 that you contributed \$1,500 to your employer's 401(k) plan. Did you make contributions to any other qualified plans, such as an IRA?

That's a great benefit. Were you a full-time student during 2011?

Well, it looks like you qualify for the credit. I will complete Form 8880 to see how much the credit will be.

Did you receive any distributions from your retirement plan in 2011, 2010 or 2009 or do you plan to take any distributions before the tax filing deadline?

No, loans don't count against you, so you'll get to use the full amount of your contribution in the calculation of your credit. The software shows that your credit is \$150. That will reduce your amount of total tax, so you'll end up with a bigger refund.

RYAN RESPONDS...

No, I put all my savings into the 401(k) because my employer matches it.

No, I've been out of school for several years.

Great!

Well, in 2010 I took out a loan against my 401(k) to use as a down payment on a car. I've already paid it back through payroll deductions. Does that count?

I'll take every penny!

How do I handle the Credit for the Elderly or the Disabled?

The credit for the elderly or the disabled is calculated on Schedule R and reported in the Tax and Credits section of Form 1040, line 53, and box c is checked. Schedule R is noted in the space to the right of box c.

Who qualifies for the credit for the elderly or the disabled?

Individuals who qualify for the elderly or the disabled credit are:

- Age 65 or older or
- Under age 65, retired on permanent and total disability, receiving taxable disability income, and have not reached the mandatory retirement age their company has set

TIP

A taxpayer with a permanent and total disability is unable to engage in “substantial, gainful activity,” or in other words, paid employment. Taxpayers who can do such work are not considered disabled. Working in a sheltered workshop setting, however, is not considered substantial, gainful activity.

Mandatory retirement age is the age set by a taxpayer’s employer at which the taxpayer would have been required to retire, had the taxpayer not become disabled.

Generally, disability income comes from an employer’s disability insurance, health plan, or pension plan. The payments replace wages for the time the taxpayer missed work because of the disability. The plan must provide for disability retirement for the payments to be considered disability income.

In addition to being a qualified individual, the taxpayer’s total income must be within certain limits. The income limits can be found in the Volunteer Resource Guide (Tab G), Credit for the Elderly or the Disabled, Figure B, Income Limits.

Few taxpayers qualify for this credit because the credit calculation includes the taxpayers’ nontaxable social security, veterans’ benefits, or other excludable pension, annuity, or disability benefits. Most taxpayers’ social security benefits alone exceed the limit.

example

John is unmarried and filing a single return. He is 67 years old and received \$12,000 in nontaxable social security benefits in the tax year. His AGI is \$9,000. Even though John is a qualified individual, he is not eligible to claim the credit since his nontaxable social security benefits exceed \$5,000.

How do I determine the amount of the credit?

Schedule R is used to calculate the credit, and has three parts:

- Part I, Filing Status and Age
- Part II, Statement of Permanent and Total Disability which ensures that taxpayers who are under 65 have obtained a completed physician’s statement that proves they are permanently and totally disabled
- Part III, Figure Your Credit

If the taxpayer is 65 or over, or under 65 and retired on permanent and total disability, complete Schedule R to determine the amount of the credit, if any.



Tax Software Hint: The tax software will complete most of Schedule R based on the data from the Main Information Sheet and income entries. It will determine whether the taxpayer is eligible for the credit and transfer the credit amount to the appropriate line on Form 1040. Go to the Volunteer Resource Guide (Tab 5), Nonrefundable Credits for software entries.



All social security and railroad retirement benefits must be entered on the worksheet for social security benefits line of Form 1040, even if no social security is taxable, so the tax software can correctly calculate this credit.



EXERCISES (continued)

Question 2: Taxpayers may be able to take the credit for the elderly or disabled if they are:

- Under age 65 at the end of 2011
- Retired on permanent and total disability
- Not the normal retirement age on January 1, 2011, and
- Receiving taxable disability income for 2011

True False

Taxpayer Interview and Tax Law Application

Determining Albert's Eligibility

Albert arrives at the tax center with his Form 1040 nearly complete, but he wants to know if he can claim the credit for the elderly or the disabled. Follow along in the conversation.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

ALBERT RESPONDS...

Are you either a U.S. citizen or a resident alien?

Yes, I'm a U.S. citizen.

Are you over 65?

No, I'm only 54, not even old enough for retirement. But I had to stop working last year because of my disability.

Are you retired on permanent and total disability?

Yes. In fact, I started receiving disability retirement benefits last August.

Sounds like you may qualify. What is your adjusted gross income?

\$15,430.

How much did you receive in social security?

I got \$4,430 in social security benefits.

Did you receive any other pension benefits that might not be taxable?

No, I just get my social security and disability checks from the place I retired.

And your filing status is Single, so it looks like you might be able to claim the credit. If you would like for me to do your return, I will go back through it step-by-step to make sure.

Refer to the Volunteer Resource Guide (Tab G), Credit for the Elderly or the Disabled. Figure B shows that Albert's AGI (\$15,430) is under the limit for a single filer (\$17,500), and his income from nontaxable social security or pension benefits (\$4,430) is also within the limit for a single filer (\$5,000).



What are Residential Energy Credits?

Individuals who make purchases for qualified energy-efficient improvements or an energy efficient property for their main home may be allowed nonrefundable tax credits. There are two types of residential energy credits:

- Nonbusiness energy property credit (Form 5695, Part I)
- Residential energy-efficient property credit (Form 5695, Part II, which is out of scope for the VITA/TCE program)

Taxpayers must own their home to qualify for these credits. The IRS provides guidance on what property qualifies for the energy credits, and homeowners generally can rely on manufacturers' certifications. See the Volunteer Resource Guide (Tab G), www.irs.gov, or www.energy-star.gov for more information.



Tax Software Hint: Tax software will do all the calculations and enter the total on the appropriate line of Form 1040. Remember, any time you need to see the form instructions, access the program's help feature.

What is the nonbusiness energy property credit?

The nonbusiness energy property credit is available for certain qualifying energy efficiency improvements or residential energy property costs. Review the Life Events section of the intake and interview sheet to see if there are any purchases that may qualify taxpayers for the nonbusiness energy property credit.

The qualifying items are:

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

NEW The nonbusiness energy property credit has been extended for one year, with the following limitations for 2011:

- For tax years after 2005, the total combined credit limit is \$500, and the combined credit limit for windows is \$200 (Form 5695, Part I).
- The maximum credit for residential energy property costs is \$50 for any advanced main air circulating fan; \$150 for any qualified natural gas, propane, or oil furnace, or hot water boiler; and \$300 for any item of energy-efficient building property. The energy-efficiency standards for qualified natural gas, propane, or oil furnaces, and hot water boilers have increased.

Residential Energy Credits

▶ See instructions.
 ▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2011
 Attachment
 Sequence No. **158**

Name(s) shown on return

Your social security number

Part I Nonbusiness Energy Property Credit

1a Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions) ▶

1a Yes No

Caution: If you checked the "No" box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.

b Print the complete address of the main home where you made the qualifying improvements.

Caution: You can only have one main home at a time.

Number and street Unit No.

City, State, and ZIP code

c Were any of these improvements related to the construction of this main home? ▶

1c Yes No

Caution: If you checked the "Yes" box, you can only claim the nonbusiness energy property credit for qualifying improvements that were not related to the construction of the home. Do not include expenses related to the construction of your main home, even if the improvements were made after you moved into the home.

2 Lifetime limitation. Amounts claimed in 2006, 2007, 2009, and 2010.

- a** Amount, if any, from line 12 of your 2006 Form 5695 **2a**
- b** Amount, if any, from line 15 of your 2007 Form 5695 **2b**
- c** Amount, if any, from line 11 of your 2009 Form 5695 **2c**
- d** Amount, if any, from line 11 of your 2010 Form 5695 **2d**

e Add lines 2a through 2d. If \$500 or more, **stop**; you cannot take the nonbusiness energy property credit

3 Qualified energy efficiency improvements (original use must begin with you and the component must reasonably be expected to last for at least 5 years; do not include labor costs) (see instructions)

- a** Insulation material or system specifically and primarily designed to reduce heat loss or gain of your home that meets the prescriptive criteria established by the 2009 IECC **3a**
- b** Exterior doors that meet or exceed the Energy Star program requirements **3b**
- c** Metal or asphalt roof that meets or exceeds the Energy Star program requirements and has appropriate pigmented coatings or cooling granules which are specifically and primarily designed to reduce the heat gain of your home **3c**

d Exterior windows and skylights that meet or exceed the Energy Star program requirements **3d**

e Maximum amount of cost on which the credit can be figured **3e** \$2,000

f If you claimed window expenses on your Form 5695 for 2006, 2007, 2009, or 2010, enter the amount from the Window Expense Worksheet (see instructions); otherwise enter -0- **3f**

g Subtract line 3f from line 3e. If zero or less, enter -0- **3g**

h Enter the smaller of line 3d or line 3g **3h**

4 Add lines 3a, 3b, 3c, and 3h **4**

5 Multiply line 4 by 10% (.10) **5**

6 Residential energy property costs (must be placed in service by you; include labor costs for onsite preparation, assembly, and original installation) (see instructions)

- a** Energy-efficient building property. Do not enter more than \$300 **6a**
- b** Qualified natural gas, propane, or oil furnace or hot water boiler. Do not enter more than \$150 **6b**
- c** Advanced main air circulating fan used in a natural gas, propane, or oil furnace. Do not enter more than \$50 **6c**

7 Add lines 6a through 6c **7**

8 Add lines 5 and 7 **8**

It is important to note that:

- The credit is only available for existing homes that are the taxpayer's principal residence – new construction and rentals do not qualify.
- Amounts provided by subsidized federal, state, or local energy financing do not qualify for the credit.
- This tax credit expires on December 31, 2011.

Review Form 5695 and the instructions for more information about these changes to the nonbusiness energy property credit for 2011. If the taxpayer is eligible for the credit for the elderly or the disabled, compute that credit first.



Costs for on-site preparation and installation depend on the type of qualified property.

Items on Form 5695, line 3 do not include on-site preparation and installation costs. The items on Form 5695, line 6 can include these costs. Review the Form 5695 Instructions for more information.

What is the residential energy-efficient property credit?

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



What are other energy incentives of which I should be aware?

These topics are out of scope for the VITA/TCE program. This information is provided for your awareness only. Taxpayers who may qualify for these credits should be referred to a professional tax preparer.

- Plug-In Electric Vehicle Credit: Internal Revenue Code Section 30D provides a credit for qualified plug-in electric drive motor vehicles and Internal Revenue Code Section 30 provides a credit for qualified plug-in electric vehicles.
- Conversion kits: The law also provides a tax credit for plug-in electric drive conversion kits.
- Alternative fuel vehicle refueling credit and the alternative motor vehicle credit.

What is the Mortgage Interest Credit?

This topic is out of scope for the volunteer program and is included for informational purposes only. Taxpayers who hold mortgage credit certificates (MCCs) under a qualified state or local government program may claim a nonrefundable credit for mortgage interest paid. The taxpayer must have a document titled, "Mortgage Credit Certificate (MCC)." The amount of the credit is listed on the certificate. Refer taxpayers who choose to claim this credit to a professional tax preparer.

How are the total nonrefundable credits reported?

The total of all nonrefundable credits is reported on the applicable line in the Tax and Credits section of Form 1040.



Tax Software Hint: Based on your entries for all the credits, the software calculates the total of the taxpayer's credits and enters the amount on the Total Credits line. Remember, the nonrefundable credits cannot exceed the taxpayer's federal income tax.

Practice – Vanessa Franklin



Go to Appendix A, to determine if Vanessa is able to take the Credit for Qualified Retirement Savings Contributions.

Summary

Retirement Savings Contributions Credit

Taxpayers who contributed to certain retirement plans or IRAs may be eligible for a nonrefundable qualified retirement savings contributions credit.

Be sure to ask the taxpayer if IRA contributions were made. Carefully review the taxpayer's Form(s) W-2 for pretax retirement plan contributions and accurately input the amounts into the tax software. The software calculates the retirement savings credit based on the information entered.

The amount of the credit is determined by the taxpayer's filing status, adjusted gross income, and the taxpayer's qualified retirement contributions.

Form 8880 is used to calculate the credit.

Credit for the Elderly or the Disabled

Taxpayers age 65 or older, or under age 65 who retired on permanent and total disability, may be able to claim a special nonrefundable credit if they are U.S. citizens or resident aliens. Few qualify for this credit because most taxpayers' social security benefits exceed the income limits.

The Volunteer Resource Guide (Tab G) provides a flowchart for determining basic eligibility and a quick reference table of income and social security limits. Schedule R, Credit for the Elderly or the Disabled, is used to calculate the credit.



Taxpayers' IRA contributions are often overlooked. Ask taxpayers if they made traditional or Roth IRA contributions that may qualify for the retirement savings contributions credit.

Residential Energy Credits

NEW There are changes to the nonbusiness energy property credit for tax year 2011; the amounts are less than what was allowed in previous years.

Residential energy credits are available to taxpayers for making energy-saving improvements to their home. Form 5695, Residential Energy Efficient Property Credit Part I is used to claim the nonbusiness energy property credit. Form 5695, Part II is out of scope for the volunteer program. Refer to the Volunteer Resource Guide (Tab G) for key points on Energy Credits.

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

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

- Residential energy-efficient property credit (Form 5695, Part II)
- Plug-in electric vehicle credit
- Conversion kits
- Alternative fuel vehicle refueling credit and alternative motor vehicle credit
- Mortgage interest credit
- District of Columbia, first-time homebuyer credit



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: *B. Sybil qualifies for the credit because her adjusted gross income is under \$56,500, which is the threshold limit for Married Filing Jointly.*

Answer 2: *True. A taxpayer who is under age 65 at the end of 2011, retired on permanent and total disability, on January 1, 2011 had not reached normal retirement age, and who receives taxable disability income for 2011, may be able to take the credit for elderly or disabled.*

All these items must first be met before a taxpayer who is under age 65 can be considered for the credit for the elderly or disabled.



Lesson 27: Other Taxes



Introduction

This lesson covers the Other Taxes section of the return. You will determine if taxpayers owe additional taxes, and determine their total tax.

Other Taxes	56	Self-employment tax. Attach Schedule SE	56	
	57	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
	59a	Household employment taxes from Schedule H	59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
	60	Other taxes. Enter code(s) from instructions	60	
	61	Add lines 55 through 60. This is your total tax	61	

Objectives

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

- Identify the different types of other taxes on a return
- Determine if a taxpayer is liable for other taxes that are within scope of the volunteer program
- Determine how to report these additional taxes on the tax return, and complete the applicable forms or schedules

What are other taxes?

“Other taxes” are different from the income tax from the tax tables or figured using the Tax Computation Worksheet. They include:

- Self-employment tax
- Social security and Medicare taxes on tip income
- Additional taxes on IRAs and other qualified retirement plans
- Repayment of first-time homebuyer credit

These amounts are usually calculated on their own form or schedule. The taxes are added after the nonrefundable credits are calculated; the nonrefundable credits do not reduce the other taxes.

Household employment taxes are also included in the Other Taxes section. However, this topic is beyond the scope of the volunteer program. Taxpayers who must file household employment taxes should be referred to a professional tax preparer.



Tax Software Hint: The software makes most of the calculations and displays the resulting tax on Form 1040.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Publication 334
- Publication 531
- Form 1040 Instructions
- Form 4137
- Form 5329 and Instructions
- Form 5405 and Instructions
- Form W-2
- Schedule SE



Social security and Medicare taxes on tip income is covered under the Basic course. Self-employment tax, additional tax on IRAs and other qualified retirement plans, and repayment of first-time homebuyer credit are Intermediate-level topics. If an issue related to an Intermediate-level topic arises at a volunteer site, be sure that a volunteer with required certification provides assistance.



What is self-employment tax?

Self-employment (SE) tax is social security and Medicare taxes collected primarily from individuals who work for themselves, similar to the social security and Medicare taxes withheld from the pay of most wage earners. Payments of SE tax contribute to the taxpayer's coverage under the social security system. Social security coverage provides the taxpayer with retirement, disability, survivor, and hospital insurance (Medicare) benefits.

NEW A recent tax law change provides for a temporary decrease in the employee's share of payroll tax. Social security will be withheld from an employee's wages at the rate of 4.2% (down from 6.2%), up to the social security wage limit of \$106,800. There is no change to Medicare withholding. The same reduction applies to net earnings from self-employment – the temporary rate will be 10.4% (down from 12.4%), up to the social security wage limit of \$106,800. As a result of this change, the self-employment tax rate is reduced from 15.3% to 13.3%.



Tax Software Hint: As a result of the reduction in the self-employment tax rate for tax year 2011, there is a slight difference in the calculation for the adjustment to income, which is completed by the tax software.

Who must pay self-employment tax?

SE tax must be paid if either of the following applies:

- The taxpayer had income as a church employee of \$108.28 or more.
- The taxpayer receives net earnings from self-employment income in the amount of \$400 or more (excluding church employee income).

Generally, taxpayers who are independent contractors and receive Form 1099-MISC must file Schedule C/C-EZ and Schedule SE. Since taxes are not withheld from independent contractors' pay, it is the taxpayer's responsibility to pay income and SE tax.

Schedule SE contains two ways to compute the tax: the long version and the short version. The instructions on the form guide you in deciding which version the taxpayer needs. The short version is used more often in the VITA/TCE program, but you should understand both versions.

How do I figure and report this tax?

As a volunteer, you may be qualified to assist self-employed taxpayers who need to complete Schedule C (with limits) or Schedule C-EZ, Net Profit from Business (covered in an earlier lesson). When assisting a taxpayer with self-employment income, first complete Schedule C or C-EZ. Schedule SE is used to calculate the self-employment tax. The deductible part of the self-employment tax is reflected as an adjustment to income on Form 1040, page 1. This amount is from line 6 of Schedule SE, the deduction for employer-equivalent portion of self-employment tax. The adjustment to income is similar to the benefit that employees receive because their employers pay a portion of the social security and Medicare taxes.



Tax Software Hint: The software automatically transfers the appropriate information from Schedule C or C-EZ to Schedule SE and calculates the self-employment tax and the adjustment of the deductible part of the self-employment tax.

TIP

The VITA/TCE program scope includes Schedule C, with limits. The Schedule C criteria is the same as Schedule C-EZ except it includes those taxpayers who have up to \$10,000 in expenses. In addition, taxpayers who meet the criteria can file more than one Schedule C if they have more than one business.

TIP

Self-employed taxpayers who receive tips should include the tips in gross receipts on Schedule C/C-EZ.



What about taxes on unreported tip income?

All tip income is subject to federal income tax. However, tips of less than \$20 per month that are not reported to the employer are not subject to social security and Medicare taxes.

Individuals who receive \$20 or more per month in tips from any one job must report their tip income to their employer. The employer reports these tips as part of the wages on Form W-2, box 1. The employer withholds social security and Medicare taxes and federal income tax on that income.

NEW For 2011 only, the social security tax rate an employee must pay on tips is reduced from 6.2% to 4.2%.

What about allocated tips?

An employer may “allocate” tips to an employee if the employee worked in a restaurant, cocktail lounge, or similar business and reported tips that were less than the employee’s share of 8% of food and drink sales. If the employer allocates tips to employees, the amount is reported on Form W-2, box 8, and included in income on Form 1040. Social security and Medicare taxes are not withheld on allocated tips. The employee pays the social security and Medicare taxes by completing Form 4137, Social Security and Medicare Tax on Unreported Tip Income.

If the employee can show, using Publication 1244, Employee’s Daily Record of Tips and Report to Employer, or some similar daily tip record, that the actual tips received are different from the allocated amount, then the actual amount is reported on Form 1040. The actual tips received are also reported on Form 4137 to calculate social security and Medicare taxes.

What about tips that the employee did not report to the employer?

If the employee received \$20 or more in unreported cash and charge tips in any month from any job, the employee must report that income on Form 1040 and pay the social security and Medicare taxes on that income. But, if the employee received less than \$20 in tips in any month from any job, they are not required to report them to the employer. However, these amounts *do* need to be included on Form 1040. They will not be subject to social security or Medicare taxes.



Tax Software Hint: All tips are reported on Form 4137 because the software calculates social security and Medicare taxes only on the applicable tips. The software will then add unreported tips to Form 1040, line 7.

example

Carla waits tables at a café. Her employer reports all tips that customers add to their credit card tabs, but she leaves it up to Carla to keep track of her cash tips. Carla receives more than \$20 per month in cash tips. Carla keeps a record but, because she doesn’t report her cash tips to her employer, they are not included on her Form W-2. Carla includes the unreported tips as income on Form 1040, line 7. Carla also uses Form 4137 to calculate and pay the social security and Medicare taxes on those tips.

How do I figure and report these taxes?

To figure the tax, determine if during any month the taxpayer received \$20 or more in cash and charge tips that were not reported to the employer. Enter this amount on Form 4137 to figure the social security and Medicare taxes.

Report the tax amount on the applicable line on Form 1040.



Tax Software Hint: The tax software will compute the correct tax on allocated and unreported tip income. Go to the Volunteer Resource Guide (Tab 2), How to Enter Tips, for software entries.



As part of your interview, explain to taxpayers that sometimes people do not realize they owe taxes on tips they do not report to their employer. Also explain the taxes paid on those tips actually boost the taxpayer's future social security benefits.



EXERCISES

Answers follow the lesson summary.

Question 1: Nancy had a summer job at a coffee hut. She made \$18 in tips in May, \$755 in June, \$600 in July, and \$45 in August. Until a co-worker told her, she didn't realize she had to report her tips to their employer. She then reported \$1,000 in tips to her boss.

What amount of tips will Nancy have to add to her Form 1040, line 7?

- A. \$1,418
- B. \$1,000
- C. \$418
- D. \$18

Question 2: What amount of unreported tips does Nancy have to pay social security and Medicare taxes on when she files her tax return?

- A. \$1,418
- B. \$400
- C. \$45
- D. \$18



What about taxes on IRAs and other qualified retirement plans?

Traditional IRAs and other qualified plans allow individuals to defer paying taxes on contributions and earnings until the funds are distributed.

If the rules for contributions and distributions are not followed, additional penalty taxes may be due. For example, the taxpayer must pay income tax plus an additional tax if any of the following apply:

- A distribution is taken before the individual reaches the age of 59½ and is not rolled over into another qualified plan or IRA and no other exception applies (in scope)
- Minimum distributions are not withdrawn when required (out of scope)
- Excess contributions are not removed by the due date of the return including extensions (out of scope)

TIP

If the taxpayer is under the age of 59½, earnings on excess contributions withdrawn *by the due date* of the return are early distributions and subject to the 10% additional tax. Refer to the Adjustments to Income lesson for more information.

The additional tax for each situation is outlined on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Only Part I of Form 5329 is in scope. This part provides for the exceptions to the additional tax on part or all of the early distributions from IRAs or qualified pension plans. The other parts of Form 5329 are out of scope; refer taxpayers with these issues to a professional tax preparer.

Refer to the intake and interview sheet, Part III – Income, for the question regarding pension or IRA distributions. If the answer is “yes,” ask for any Form 1099-R that reports these payments to determine if the taxpayer is subject to the additional tax or qualifies for an exception.

If Form 1099-R correctly shows code 1 in box 7 indicating an early distribution, the additional tax applies unless the taxpayer qualifies for an exception. Guidelines permit entering 10% of the taxable amount directly on Form 1040, on the applicable line for additional tax on IRAs or other qualified retirement plans. “No” is entered to the left of this line to indicate Form 5329 is not required. Tax software does this automatically based on entries on Form 1099-R.

Frequently, taxpayers who receive Form 1099-R with code 1 in box 7 *are* subject to the 10% additional tax for early distribution because the money was spent for items that are not on the list of exceptions, for example, household expenses or bills. This situation does not require completion of Form 5329.



Some exceptions apply only to IRA distributions, some apply only to distributions from a qualified retirement plan, and some exceptions apply to both IRA and retirement plan distributions. Refer to Publication 17 chapters Retirement Plans, Pensions, and Annuities or Individual Retirement Arrangements for the list of exceptions

example

John is 39 years old and received Form 1099-R with code 1 in box 7. He used the money to pay for car repairs. For the additional tax, enter 10% of the taxable amount on the applicable line of Form 1040. The word “no” appears to the left of this line to indicate that Form 5329 is not required.

How do you complete Form 5329, Part I?

If an exception to the additional tax on early distributions applies, Form 5329, Part I, must be completed.

- Form 5329, line 1, is the amount of the distribution included in income.
- Line 2 is the amount that qualifies for the exception. The applicable code is also entered. Refer to the Volunteer Resource Guide (Tab 6) for a screen shot of Form 5329, Part I, and the exceptions. For additional information, see Form 5329 Instructions.
- For line 3 the amount from line 2 is subtracted from line 1. This is the amount subject to the additional tax.
- Line 4 is the additional tax that is carried over to the Other Taxes section of the return.

example

Laura is 41 years old and received an early distribution from her 401(k) account. The volunteer determines that Laura used the money for unreimbursed qualified medical expenses, and she meets the requirements for exception code 05. In this case Form 5329, Part I, would be completed. Laura would not have to pay the additional tax on this distribution.

IRA distributions, pensions, and annuities are covered in the Retirement Income lesson. If you are not certified above the Basic level, refer taxpayers with these issues to a volunteer who is certified at the Intermediate level or higher.

What about repayment of the first-time homebuyer credit?

The first-time homebuyer credit is covered in the Payments lesson. However, certain situations may require the credit to be repaid and reported in the Other Taxes section of Form 1040.

Review the Life Events section of the intake and interview sheet to determine if the taxpayer:

- Sold a home in 2011 for which the homebuyer credit was claimed in 2009 or 2010, and the home was not used as a principal residence for the 36-month period
- Claimed the 2008 homebuyer credit and must pay back a portion of the credit each year

If the taxpayer received the first-time homebuyer credit in 2009 or 2010 and the home ceases to be their main home within the 36-month period beginning on the purchase date, the taxpayer generally must repay the credit.

If the taxpayer received the first-time homebuyer credit for a home purchased in 2008, generally they must repay the credit over a 15-year period in 15 equal installments. The repayment period began in 2010. However, if the home ceases to be the taxpayer's main home before the 15-year period is up, the taxpayer must repay all remaining annual installments.



The 2008 homebuyer credit had different rules. The credit functions like a no-interest loan and must be paid back. Taxpayers who received the credit in 2008 should be paying back their second installment with their 2011 tax return.

example

Joan received a first-time homebuyer's credit of \$7,500 in 2008 and she still lives in the home. Joan paid the first installment with her 2010 return. She will pay her second installment of \$500 with her 2011 tax return. The \$500 is entered on the Form 1040, Other Taxes section.

The home ceases to be the main home if the taxpayer sells the home; converts the entire home to business or rental property; the home is destroyed, condemned, or disposed of under threat of condemnation; or the lender forecloses on the mortgage. There are certain exceptions to the repayment rule. See the general instructions for Form 5405, First-Time Homebuyer Credit and Repayment of the Credit, for details.

The credit is repaid by including it as additional tax on the return for the year the home ceases to be the taxpayer's main home. If the taxpayer is required to repay the credit, it is calculated on Form 5405 and reported on the applicable line in the Other Taxes section of Form 1040. Certain taxpayers who are repaying an installment of the credit claimed for homes purchased in 2008 are not required to file Form 5405. See Form 5405 Instructions for more information.

How do I figure total tax?

The Other Taxes section provides a total of income tax and other taxes that may apply to the taxpayer. Adding the amounts on these lines gives the total tax. This amount reflects the tax on all income, adjustments to income, deductions, nonrefundable tax credits, and other taxes. The next step is entering tax payments and refundable credits. Then calculate the taxes owed or the amount overpaid that will result in a refund.



Tax Software Hint: The tax software will calculate the total tax automatically. Go to the Volunteer Resource Guide (Tab 6), Form 1040, Page 2 – Other Taxes and Payments, for software entries.

Practice – Vanessa Franklin



Let's take a look at how a tax preparer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review to the sample interview with Vanessa related to Lesson 27.

Summary

This lesson explained how to complete the Other Taxes section of the return. Other taxes are not calculated using the income tax tables or the Tax Computation Worksheet. They include:

- **NEW** Self-employment tax rate is reduced from 15.3% to 13.3%
- **NEW** Social security and Medicare taxes on unreported tip income – temporary rate decrease from 6.2% to 4.2%
- Additional taxes on IRAs and other qualified retirement plans
- Repayment of first-time homebuyer credit



Tax Software Hint: These amounts are calculated on separate forms or schedules. The tax software provides all of the forms and performs most of the calculations.

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

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

- Household employment taxes
- IRA minimum distributions not withdrawn when required
- Excess contributions to an IRA are not removed by the due date of the return including extensions
- Parts II through VIII of Form 5329 (only Part I is in scope)



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: C. Nancy's combined tips for May, June, July, and August were \$1,418, and she reported only \$1,000 to her employer. She needs to add \$418 to line 7 of her tax return.

Answer 2: B. Nancy does not have to pay social security and Medicare taxes on the tips she received in May, because they amounted to less than \$20 for the month.

Notes



Lesson 28: Payments



Introduction

This is one of several lessons that cover the Payments section of the return, which includes payments, additional child tax credit, the refundable education credit, and earned income credit. After finishing these lessons, you will be able to complete the Payments section of the taxpayer's return. This lesson covers income tax withholding, estimated tax payments, certain refundable credits, and other payments made by the taxpayer.

Additional child tax credit and the refundable education credit have already been covered. Earned income credit will be covered in the next lesson.

Payments		62	Federal income tax withheld from Forms W-2 and 1099	62		
		63	2011 estimated tax payments and amount applied from 2010 return	63		
If you have a qualifying child, attach Schedule EIC.		64a	Earned income credit (EIC)	64a		
		b	Nontaxable combat pay election	64b		
		65	Additional child tax credit. Attach Form 8812	65		
		66	American opportunity credit from Form 8863, line 14	66		
		67	First-time homebuyer credit from Form 5405, line 10	67		
		68	Amount paid with request for extension to file	68		
		69	Excess social security and tier 1 RRTA tax withheld	69		
		70	Credit for federal tax on fuels. Attach Form 4136	70		
		71	Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> 8839 c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885	71		
		72	Add lines 62, 63, 64a, and 65 through 71. These are your total payments	72		
Refund		73	If the amount on line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid.	73		

Objectives

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

- Identify the following types of payments and credits that are applicable for most low- and moderate-income taxpayers:
 - Federal income tax withheld from Forms W-2, Wage and Tax Statement
 - Federal income tax withheld from Forms 1099
 - Estimated tax payments and amounts applied from the prior year's return
 - Homebuyer credit (first-time homebuyer and long-time resident)
 - This credit has expired for most taxpayers; military and certain federal employees serving outside the U.S. have extra time
 - Amount paid with a request for an extension to file
 - Excess social security and tier 1 RRTA tax withheld
- Report these payments and credits correctly on the taxpayer's return

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form W-2
- Form 1040
- Optional:**
- Publication 505
- Publication 919
- Form 1040 Instructions
- Form 1040-ES
- Forms 1099
- Form 4868
- Form 5405

The information you obtain from the taxpayer's intake and interview sheet will help you determine the payments and credits that should be reported. Refer to the Volunteer Resource Guide (Tab 6), Other Taxes and Payments section, to identify and review the Payments section of the return.

How do I report federal income tax withheld?

The federal income tax system is a “pay as you go” system. That means tax is paid as income is earned or received during the year and is referred to as withholding credit.

Income tax is generally withheld from the following types of income:

- Salaries and wages
- Tips
- Taxable fringe benefits
- Sick pay
- Pensions and annuities
- 401(k) and IRA distributions
- Gambling winnings
- Unemployment compensation
- Certain federal payments such as social security benefits

If taxpayers have income tax withheld during the tax year, they will receive one of the following forms showing the amount withheld:

- Form W-2, Wage and Tax Statement
- Form W-2G, Certain Gambling Winnings
- One of several different types of Forms 1099

The total amount withheld is entered on Form 1040, Payments section, on the line for federal income tax withheld.

TIP

The total amount withheld from income is included on the return, but not all income statements must be attached. Attach all Forms W-2. Also attach Forms W-2G and Forms 1099 if tax was withheld.

example

Freda worked as a clerk and received a Form W-2 that reported federal income tax withholding of \$1,000. She also received Form 1099-INT from her bank, which reflected federal income tax withholding of \$50. The correct total withholding reported on her return would be \$1,050 ($\$1,000 + \50).



Tax Software Hint: By the time you reach the Payments section, you have already entered information from the taxpayer’s Form(s) W-2 and Form(s) 1099, including the federal income tax withheld. The tax software calculates the total and displays it on the Payments section of the return.

What about estimated taxes and amounts applied from the prior year’s return?

What are estimated tax payments?

Many taxpayers have income from self-employment, dividends, interest, capital gains, rent, and royalties. The “pay as you go” system also applies to this income. If the tax due on this income exceeds certain limits, estimated tax must be paid quarterly by the taxpayer. If estimated tax payments are not paid when they are required, a penalty could be imposed. This also applies if taxpayers do not have enough income tax withheld from their salary or wages.

TIP

Estimated tax includes the taxpayer’s income tax and self-employment tax, which is equivalent to the social security and Medicare taxes withheld from employee’s pay.

See the Refund and Amount of Tax Owed and Concluding the Interview lessons for more information on estimated taxes.

Where do I get this information?

Review the taxpayer's intake and interview sheet to determine if they had income from sources such as self-employment or investments for which taxes may not have been withheld. If so, ask, "Did you pay estimated taxes to the IRS in 2011?" If the answer is "yes," ask to see the taxpayer's record of payments, such as Form 1040-ES, Estimated Tax for Individuals.

If taxpayers need more information about estimated taxes, refer them to Form 1040-ES, which includes instructions and a worksheet for computing the amount of estimated taxes they should pay. Forms can be obtained on www.irs.gov or by calling toll-free, 1-800-829-3676.

TIP

If a taxpayer paid substantially more or less than required in estimated tax, encourage them to recalculate it. They can adjust their estimated tax payments by following the instructions and worksheet on Form 1040-ES.

What about tax payments applied from a previous year?

Taxpayers who overpay their income taxes in one year can apply all or part of their overpayment to the next year's estimated tax by indicating the amount they want to apply.

Where do I get this information?

This information should be included in the intake and interview sheet, but confirm by asking the taxpayer:

- Did last year's return show an overpayment?
- Did you apply any part of the overpayment to this tax year?

If the answer is "yes" to both questions, ask to see the 2010 tax return to document the amount of tax applied to 2011. Add this amount to the estimated tax payments and enter the total on the applicable line.



Tax Software Hint: For software entries to record 2011 estimated tax payments, go to the Volunteer Resource Guide (Tab 6), Form ACH 1040/ES, and refer to the hint in the margin.

Taxpayer Interview and Tax Law Application

Let's see how our volunteer helped a taxpayer, Ernie, with this part of the Payments section.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Let's complete the Payments section of your return. The tax software added up all the income tax withheld from your Forms W-2 we entered earlier. I know you had a little self-employment income and I see you responded "yes" to the question on estimated tax payments on the intake and interview sheet. Is that correct?

Do you have a record of your payments, perhaps on a Form 1040-ES?

Good, you paid each quarter. We'll enter those payments. While we're here, did last year's return show an overpayment?

Did you apply any of that to your 2011 taxes?

Okay, we'll enter that too. Now we show the total of the withholding from your Forms W-2, your estimated tax paid and the refund amount from last year's return applied to this year.

ERNIE RESPONDS...

Yes, I did.

Yeah, here it is.

Yes, here it is: \$150.

Yes, all of it.

Good!



What is important to know about the first-time homebuyer credit?

The first-time homebuyer credit (and long-time resident credit) has expired for most taxpayers. However, members of the military and certain other federal employees serving outside the U.S. have an extra year to buy a principal residence in the U.S. and qualify for the credit. An eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2011. If a taxpayer enters into a binding contract by that date, they have until September 30, 2011 to close on the purchase. Members of the uniformed services, members of the Foreign Service, and employees of the intelligence community are eligible for this special rule. It applies to any individual (and, if married, the individual's spouse) who serves on qualified official extended duty service outside of the United States for at least 90 days during the period beginning after Dec. 31, 2008, and ending before May 1, 2010.

TIP

A refundable credit can be more than a taxpayer's tax liability. This means taxpayers will receive the credit amount in a refund even if their tax is zero.

Which home purchases qualify for the credit?

To be considered a first-time homebuyer, taxpayers cannot have owned a home in the last three years, and, once they buy the home, they must live in it for three years to avoid having to repay the credit. Only the purchase of a main home located in the United States qualifies and only for a limited time. A main home is where the taxpayer lives most of the time. It can be a house, houseboat, house trailer, cooperative apartment, condominium, or other type of residence. Vacation homes and rental property are not eligible.

The maximum credit amount remains \$8,000 for a first-time homebuyer.

The law also provides a "long-time resident" credit of up to \$6,500 to taxpayers who do not qualify as "first-time homebuyers" (married individuals filing separately are limited to \$3,250). To qualify for the "long-time resident" credit, a buyer must have owned and used the same home as a principal or primary residence for at least five consecutive years of the eight-year period ending on the date of purchase of a new home as a primary residence.

Form 5405, First-Time Homebuyer Credit and Repayment of Credit, is used to claim the credit. Taxpayers who claim the credit will not be able to file electronically but instead will need to file a paper return. Review Form 5405 and Instructions for documentation requirements and additional information on this credit.

What more should I know about this credit?

Under certain circumstances, the full amount of the credit must be repaid. Taxpayers must repay the credit in full if the home ceases to be their main home within the 36-month period beginning on the purchase date. This includes situations where the taxpayer sells the home, converts the home to business or rental property, or the home is destroyed, condemned, or disposed of under threat of condemnation. Taxpayers must repay the credit by including it as additional tax on the return for the year the home ceases to be their main home.

The pay back (recapture) provision is waived for certain members of the military when the home ceases to be a principal residence due to an official change of duty station.

The reference to condemnation is for awareness only. The topic of condemnation is out of scope for the volunteer program. Taxpayers with this issue should be referred to a professional tax preparer.



Foreclosure of a home is considered a sale or disposition requiring repayment of the credit if it occurs within the three-year period. Refer to Publication 523, Selling Your Home, or www.irs.gov for more information.

Refer to the Other Taxes lesson and Form 5405 and Instructions for details on repaying the credit.



What about amounts paid with an extension to file?

Taxpayers can get an automatic six-month extension of time to file by submitting Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. This form extends the time to file until October 15. This is only an extension to *file*, not an extension to *pay*. If taxpayers do not pay the tax by April 15, they will owe interest and may be charged penalties.

Later, when taxpayers file their return, they report the payment made with Form 4868 on the applicable line in Form 1040, Payments section.

TIP

If the April 15 deadline falls on a Saturday, Sunday, or legal holiday, the deadline is the next business day.

example

One of Bernice's Forms W-2 was lost in the mail. She requested a copy from her former employer, but it did not arrive by April 15. She filed for an extension, calculated the amount of taxes owed based on her final pay stub from that employer, and paid the \$243 that was due. When she finally received her Form W-2, she filed her return and reported the \$243 on the applicable line in Form 1040, Payments section.

How can taxpayers file the extension?

Taxpayers may file the extension electronically or on paper. The extension must be transmitted or mailed by the due date of the return. You can help taxpayers file for an extension using the tax software.



Tax Software Hint: Go to the Volunteer Resource Guide (Tab 6) to review the step-by-step procedures for filing for an extension using the tax software.

What other types of payments are there?

The Payments section of Form 1040 also lists the following credits, which are out of scope for the volunteer program. Refer taxpayers who choose to claim any of these credits to a professional tax preparer.

- Form 4136, Credit for Federal Tax Paid on Fuels
- Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains
- Form 8801, Credit for Prior Year Minimum Tax
- Form 8839, Qualified Adoption Expenses
- Form 8885, Health Coverage Tax Credit

What is excess social security and tier 1 RRTA tax withholding?

A taxpayer may have more than one employer and a combined income over the amount for the social security wage base. This means the taxpayer may have paid more in social security tax than is required. This excess amount is entered on the applicable line in Form 1040, Payment section, and is a refundable credit.



Tax Software Hint: The software will calculate this automatically based on the amount entered for each Form W-2. Therefore, be sure the information from each Form W-2 is accurately entered.

How do I find the total payments?

Figuring the total tax payments is easy. Add the lines in the Payments section, and enter the total on Form 1040, total payments line.



Tax Software Hint: The software totals all payments automatically.

Practice - Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to Lesson 28. Return to this lesson after you have reviewed this information.

Summary

Completion of the Payments section is critical to an accurate tax return. It lists all the payments the taxpayer made during the year, and the taxpayer's refundable credits. You must be able to identify the types of payments and credits that apply to individuals who qualify for volunteer return preparation assistance.

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

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

- Taxpayers who claimed the first-time homebuyer credit and their home is destroyed, condemned, or disposed of under threat of condemnation
- Taxpayers who choose to claim any of the following credits:
 - Form 4136, Credit for Federal Tax Paid on Fuels
 - Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains
 - Form 8801, Credit for Prior Year Minimum Tax
 - Form 8839, Qualified Adoption Expenses
 - Form 8885, Health Coverage Tax Credit



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



Lesson 29: Earned Income Credit (EIC)



Introduction

This lesson covers the Earned Income Credit (EIC). There are several common errors associated with claiming this credit on the return. Publication 4012, Volunteer Resource Guide, and the intake and interview sheet are critical tools in avoiding these mistakes.

Objectives

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

- Determine if a taxpayer is eligible for the earned income credit
- Calculate the earned income credit

What do I need?

- Intake and Interview Sheet
 - Publication 4012, Volunteer Resource Guide
 - Publication 17
 - Publication 4491-W
 - Form 1040 and Instructions
- Optional:**
- Publication 596
 - Schedule EIC

What is the EIC?

The Earned Income Credit (EIC) is a refundable tax credit for most people who work but do not earn high incomes. The purpose of the EIC is to reduce their tax burden and to supplement the wages of working families whose earnings are less than the maximums for their filing status. Eligible taxpayers can receive a refund with this credit, even if they have no filing requirement, owe no tax, and had no income tax withheld.

The EIC can be a very valuable credit. For 2011, the EIC expands to allow families to claim credit for three or more children, up to a maximum of \$5,751. The EIC amounts are adjusted for inflation every year.

The EIC is reported in the Payments section of the tax return.



NEW The Advance EIC was repealed when The Education Jobs and Medicaid Assistance Act of 2010 was signed into law on August 10, 2010. Advance EIC has not been available to workers since December 31, 2010.

How does a taxpayer qualify for the EIC?

There are general sets of rules for claiming the earned income credit:

- Rules for everyone
- Rules for taxpayers with a qualifying child
- Rules for taxpayers who do not have a qualifying child

What rules apply to everyone?

The taxpayer must meet all the rules to qualify for the earned income credit. Turn to the chart titled Summary of EIC Eligibility Requirements in the Volunteer Resource Guide (Tab H). Review Part A, Rules for Everyone, and Part D, Earned Income and AGI Limitations.



Both earned income and adjusted gross income must be below the limits in order for the taxpayer to qualify for the EIC. These amounts are adjusted for inflation every year.



Individual Taxpayer Identification Numbers (ITINs) and Adoption Taxpayer Identification Numbers (ATINs) cannot be used when claiming the EIC. If a couple is filing a joint return, both spouses and all qualifying children must have valid social security numbers. However, if a valid number is obtained later and the taxpayer meets all the qualifications, an amended return may be filed claiming the EIC.

What is “earned” income for EIC purposes?

Earned income is wages, salaries, tips, and other taxable employee pay. Turn to the Earned Income Table in the Volunteer Resource Guide (Tab H) for examples of earned income.

One type of payment considered earned income is “taxable long-term disability benefits received prior to minimum retirement age.” Disabled taxpayers can sometimes receive a disability pension from their employer even though they are younger than the minimum retirement age. Minimum retirement age is generally the age at which taxpayers can first receive a pension or annuity from their employer if they are not disabled. Taxpayers usually receive Form 1099-R reporting the pension.

Turn to the Volunteer Resource Guide (Tab 2), 1099-R Pension and Annuity Income. Find the page showing Form 1099-R. A distribution code of “3” in box 7 indicates this is a disability pension. If the taxpayer is under the plan’s minimum retirement age, this income is reported on line 7 of Form 1040. If the taxpayer is at or above the company’s minimum retirement age, this would be reported as a regular pension. Sometimes the employer does not change the code in box 7 to indicate it is now regular pension income. If this is the case, the taxpayer should request a corrected Form 1099-R from the employer.



There is a limit to the amount of investment income a person can receive and still qualify for the EIC. For 2011, the amount is \$3,150. Investment income includes such items as taxable interest and dividends, tax-exempt interest, capital gain net income, and income from residential rental property.



Tax Software Hint: To review information on reporting disability income for a person under retirement age, go to the Volunteer Resource Guide (Tab 2), 1099-R Pension and Annuity Income.

What about combat pay?

Combat pay is never taxable to most soldiers. Members of the U.S. Armed Forces who served in a combat zone may elect to include their nontaxable combat pay in their earned income for the purposes of computing this credit only. Doing this may increase or decrease the taxpayer’s EIC. Figure the EIC amount with and without the pay before making the election. If the election is made, *all* of the nontaxable combat pay must be included. If both spouses filing a joint return have combat pay, they can individually choose to make the election on the tax return.



Tax Software Hint: If a taxpayer has combat pay listed in box 12 of Form W-2 marked with code Q, the software will determine if the combat pay should or should not be added to your taxpayer’s income.

For information on the nontaxable combat pay election, refer to the Volunteer Resource Guide (Tab 6), Form 1040 – Other Taxes and Payments.

What about self-employment income?

Net earnings from self-employment are considered earned income. For most taxpayers within the scope of the volunteer program, “net earnings” for EIC purposes will be the amount reported on line 12 of Form 1040, minus the deductible portion of the self-employment tax that is reported in the Adjusted Gross Income section of the tax return.

example

Jeff's self-employment income reported on Form 1040, line 12 is \$2,000. The deductible portion of his self-employment tax, which is recorded in the adjustments section of Form 1040, is \$141.

His income for EIC purposes is $\$2,000 - \$141 = \$1,859$.

Reminder: Nonwage income received for doing work (such as for side jobs or contract labor) is self-employment income, even for taxpayers who do not think of themselves as "self-employed." All self-employment income should be reported on Schedule C-EZ, Net Profit from Business, or Schedule C, Profit or Loss from Business. Taxpayers not meeting the VITA/TCE program requirements for filing Schedules C and C-EZ will need to seek the assistance of a professional tax preparer.



Volunteers must remember to include all allowable expenses when completing Schedules C and C-EZ.

What about household employee income?

Domestic employees such as housekeepers are only issued Form W-2 if their earnings are more than \$1,700. The income should be added to line 7 on Form 1040. This income should also be included when calculating the EIC.

Earned income not qualifying for the EIC

One income item that is reported on Form W-2, but does not qualify as earned income for EIC purposes, is income received for work while an inmate in a penal institution (including work performed while in a work release program or while in a halfway house). Refer to the Volunteer Resource Guide (Tab H) to find this listed in the Earned Income Table.



Tax Software Hint: If you indicate on the EIC worksheet that the income was earned while an inmate in a penal institution, "PRI" and the amount will be printed next to Form 1040 line 7. To review information related to the software, go to the Volunteer Resource Guide (Tab 6), Schedule EIC Worksheet.



EXERCISES

Use the Summary of EIC Eligibility Requirements Chart in the Volunteer Resource Guide (Tab H) to answer the following questions. Answers follow the lesson summary.

Question 1: A taxpayer is filing as Married Filing Separately. Does this taxpayer qualify for the EIC?

Yes No

Question 2: A taxpayer has interest income of \$3,200. His earned income is only \$7,000. He is single, has a valid social security number and is not the qualifying child of anyone else. Does he qualify for the EIC? Yes No

What are the rules for taxpayers with qualifying children?

The taxpayer can file Form 1040 to claim the EIC with a qualifying child. The taxpayer has a qualifying child for EIC purposes if the child meets **all** the tests outlined in the Volunteer Resource Guide (Tab H). A short version of the rules is shown in Part B, Rules If You Have a Qualifying Child. A detailed version is on the next page of the Volunteer Resource Guide.

example

Jane, 31, and Todd, 33, have an 8-year-old daughter, Amanda. All are U.S. citizens and have valid SSNs. Jane and Todd have never been married. Jane and Amanda lived together all year in an apartment. Todd lived alone. Jane earned \$15,000 working as a clerk in a clothing store. Todd is an assistant manager of a hardware store and earned \$48,000. He paid over half Jane's rent and utilities, and also gave Jane extra money for groceries.

Todd does not pay any expenses or support for any other family member. Although Todd provided over half the cost of a home for Jane and Amanda, he cannot file Head of Household and he cannot claim the child for EIC, since Amanda did not live with him more than half the year. Jane cannot file as Head of Household either. Review the Filing Status for Head of Household rules in the Volunteer Resource Guide (Tab B).

Jane is the only one who can claim Amanda as a qualifying child for EIC. Review the Earned Income Credit rules in the Volunteer Resource Guide (Tab H).



For EIC purposes, a qualifying child does *not* have to be the taxpayer's dependent (unless the child is married). In the case of divorced or separated parents, the custodial parent (with whom the child lived for more than half the year) can qualify for the EIC regardless of whether or not they claim the dependency exemption for the child. The noncustodial parent cannot qualify for EIC because the child did not live with them for more than half the year.

What are the rules for a qualifying child of more than one person?

A child who meets the conditions to be a qualifying child of more than one person can only be claimed by one taxpayer for the EIC.

example

Robyn is 25 years old. She and her 2-year-old son, Aiden, lived with Robyn's mother all year. Aiden has a valid social security number.

Using the Interview Tips (EIC with a Qualifying Child) from the Volunteer Resource Guide (Tab H), based on what we have learned so far about Robyn and her family:

Step 1 is YES

Step 2 is YES

Step 3 is YES

Step 4 is NO

Step 5 is YES

For step 6, check to see if Aiden can be anyone else's qualifying child, for EIC purposes.

Who else lived in the house that is related to Aiden? Robyn's mother also lives with them. Go through the steps to see if Aiden can be a qualifying child for Robyn's mother.

Review the Qualifying Child of More than One Person rules in the Volunteer Resource Guide (Tab H).



Tax Software Hint: List children from youngest to oldest in the software and check the EIC box. For more information, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.

What are the rules for taxpayers without qualifying children?

Taxpayers can claim the EIC without a qualifying child. Confirm that the taxpayer and spouse cannot be claimed as dependents by their parents or anyone else. Review the rules in the Volunteer Resource Guide (Tab H), under Part C, Rules If You Do Not Have a Qualifying Child.

TIP

Taxpayers turning 25 on January 1 are considered to be of age as of December 31. Taxpayers reaching the age of 65 on January 1 are still considered 64 as of December 31. Taxpayers in either of these situations whose return is rejected may need to file a paper return.

example

Tom and Martha are a married couple. Tom is 66 and Martha is 58 years old. If all other rules are met, they would qualify for the EIC.

TIP

For a couple filing a joint return, only one taxpayer has to meet the age requirement.



EXERCISES (continued)

Using the interview tips in the Volunteer Resource Guide, determine if each of these taxpayers has a qualifying child or can claim the EIC. Each child has a valid social security number.

Question 3: Maureen's 20-year-old daughter, Angie, lived with her for eight months of the year. Angie is not married and is a full-time college student. Is Angie a qualifying child for the EIC? Yes No

Question 4: Starting in February of the tax year, Sam has cared for Lisa, the 10-year-old daughter of his stepson. Does Lisa meet the EIC requirements for a qualifying child? Yes No

Question 5: Three children live with Mira, who cares for them as her own: Twila, the 3-year-old daughter of Mira's cousin; Chez, Mira's newly adopted 2-year-old son from Europe, who has lived with Mira since November of the tax year; and Dwight, Mira's 20-year-old son, who attends community college part time. Which of them are qualifying children? Twila Chez Dwight None

Question 6: A married couple is filing jointly. They are raising their 10-year-old granddaughter because their daughter is serving a long prison term. They are also caring for an unrelated 8-year-old boy who was placed with them as a foster child by the State Department for Family and Dependent Children. They have wages and an AGI of \$41,463. Assuming they meet all other tests, can they claim the EIC? Yes No

Question 7: Imagine that the married couple in the previous question was in a different situation: What if they were only caring for their granddaughter? Would they be able to claim the EIC? Yes No

Question 8: Margie's daughter, Aimee, turned 23 early in the tax year while attending college full time. Margie is filing as Head of Household. Margie has an AGI of \$29,231. Assuming that she and her daughter pass all other tests, can Margie claim the EIC? Yes No

Question 9: Rob and Laura are divorced. Laura is the custodial parent for Dawn, who lived with her all year. Laura signed Form 8332, allowing Rob to claim the dependency exemption for Dawn until she turns 18. Can Rob claim Dawn for the EIC? Yes No

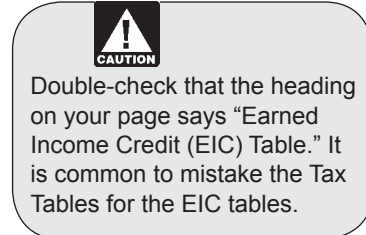
Question 10: Mark and Evelyn Bell are married and file a joint return. They have an 8-year-old child, Jennifer, who lived with them the entire year and whom they claim as a dependent. The Bells have adjusted gross income of \$31,250, from wages of \$31,211 and interest income of \$39. You have already verified their identities and social security information. Mark and Evelyn are both age 32 and no one is permanently and totally disabled. Do Mark and Evelyn qualify for the EIC? Yes No

How should I handle a taxpayer whose EIC was disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed EIC in a prior year because special rules apply. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide (Tab H), Disallowance of the Earned Income Credit.

How is the correct EIC amount calculated?

The credit is determined using worksheets and the Earned Income Credit tables. The EIC worksheets can be found in Publication 596 or Form 1040 Instructions. The software will determine the amount of EIC.



Class Exercise

A taxpayer is filing Head of Household and has one qualifying child. The earned income and AGI is \$19,000. How much EIC is the taxpayer entitled to?

Turn to the first page of the EIC tables. Find the amount in the “At least - But less than” column. Find the correct filing status column: Single, head of household and qualifying widow(er), or in a separate column, married filing jointly. There are subcolumns for the number of qualifying children. For this taxpayer, the EIC is \$2,721. If you didn’t get this answer, try again.

The EIC amount is entered on the Earned Income Credit line in the Payments section of the return.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 1), Main Information Screen “Dependents/Nondependents” entries and (Tab 6), Schedule EIC Worksheet.

Do I need to attach Schedule EIC or the Schedule EIC worksheets to the return?

If the taxpayer has at least one qualifying child, complete Schedule EIC, Earned Income Credit Qualifying Child Information, and attach it to the tax return. Taxpayers with no children make a direct entry on the EIC line.

The tax software will print Schedule EIC to be attached to the taxpayer’s copy of the return.

Practice – Vanessa Franklin



Take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interviews with Vanessa related to this lesson.

Summary

The earned income credit computation is based on filing status, number of qualifying children, earned income, and adjusted gross income. Certain individuals with no children may also qualify.

By using the intake and interview sheet, the interview tips in the Volunteer Resource Guide and correctly filling out the EIC worksheets, most of the errors that arrive from incorrectly computing the EIC can be avoided.

The EIC is entered in the Payments section of the return.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: No. Married Filing Separately does not qualify for the EIC.

Answer 2: No. His investment income exceeds the limit for 2011.

Answer 3: Yes. Daughter Angie meets all the eligibility tests to be a qualifying child.

Answer 4: Yes. Lisa is a descendent of Sam's stepson and meets the other eligibility requirements.

Answer 5: None of the children under Mira's care are qualifying children for the EIC. Twila does not meet the relationship test, Chez does not meet the residency test, and Dwight does not meet the age test.

Answer 6: Yes. Both children meet the relationship, age and residency tests, and the couple's AGI is below the maximum income for two qualifying children.

Answer 7: No. With just one qualifying child, the married couple's income would be more than the limit for 2011, so they cannot claim the EIC.

Answer 8: Yes. Margie meets the general eligibility requirements and Aimee meets the Qualifying Child rules.

Answer 9: No. While Rob can claim his daughter as a dependent, the daughter did not live with him for more than half the year, so she fails the residency test. Dawn is the qualifying child of Laura.

Answer 10: Yes, Mark and Evelyn Bell both meet the general eligibility requirements and, their daughter meets all the qualifying child tests.



Lesson 30: Refund and Amount of Tax Owed



Introduction

This lesson covers the Refund and Amount You Owe sections of the taxpayer's return. After completing this lesson, you will determine if taxpayers have overpaid (a refund is due) or have underpaid (balance is due to the government) their tax. This part of the return is a summary of the tax, credits, and payments.

Taxpayers may be entitled to a refund or owe tax. In either case, they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This is especially true because of the increase in the number of taxpayers coming in to VITA/TCE sites who owe tax for the first time and need guidance.



Feedback results indicate volunteers are less familiar with the procedures for payment options than the procedures for refund options. Be sure to identify the payment options available to taxpayers that are outlined in this lesson and in the Volunteer Resource Guide (Tab 12).

Refund	72	Add lines 02, 03, 04a, and 65 through 71. These are your total payments .		
	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid .	73	
	74a	Amount of line 73 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/>	74a	
Direct deposit? See instructions.	b	Routing number	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
	d	Account number		
	75	Amount of line 73 you want applied to your 2012 estimated tax	75	
Amount You Owe	76	Amount you owe. Subtract line 72 from line 61. For details on how to pay, see instructions	76	
	77	Estimated tax penalty (see instructions)	77	

To complete these sections of the taxpayer's return, you will need to confirm answers provided on page 3 of the intake and interview sheet, regarding direct deposit and direct debit. Also, review the Volunteer Resource Guide (Tab 6) and (Tab 12) which provide guidance on refunds and balance due returns.

TIP

If available, use Publication 4853 or Publication 4853(SP) bookmarks that summarize payment options. These are useful items to hand out to taxpayers at your volunteer site.

Objectives

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

- Identify the applicable section and lines of Form 1040 for the refund or amount owed
- Report the correct amount of refund or amount owed
- Identify the refund options available, including the purchase of savings bonds
- Describe the different payment options for the amount owed
- Identify the purpose of and determine how to complete the Third Party Designee portion of the tax return

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040
- Form 8888
- Form W-4
- Form W-4P

Optional:

- Publication 594
- Publication 4541
- Publication 4542
- Publication 4853
- Publication 4853(SP)
- Form 2210 and Instructions
- Form 9465

How do I know if the taxpayer is due a refund?

The taxpayer's total tax appears on the applicable line in Form 1040, Other Taxes section.

The taxpayer's total tax payments already made, which includes refundable credits, appears on the applicable line in Form 1040, Payments section.

If the payments made exceed the amount of tax liability, the amount of the overpayment is shown on the applicable line in the Refund section of the Form 1040. This is the amount the taxpayer has overpaid.

What are the options for an overpayment?

Taxpayers can choose to:

- Apply any portion of their overpayment to the following tax year
- Receive all or part of their refund using direct deposit
- Receive all or part of their refund as a check
- Purchase Series I Savings Bonds



RALs, RACs, and Other Financial Products: You may be asked about Refund Anticipation Loans (RALs). A RAL is money borrowed by a taxpayer from a lender based on the taxpayer's anticipated income tax refund. A variation of a RAL is a Refund Anticipation Check (RAC). Financial Institutions also offer a variety of other financial products to taxpayers based on their refunds. Providers that assist taxpayers in applying for a RAL or other financial products have additional responsibilities and may be sanctioned by the IRS if they fail to adhere to the requirements.

How do I apply part of the overpayment to the following year?

For taxpayers who want to apply a portion of the overpayment to next year's taxes, enter the amount to be applied to the following year on the applicable line. By entering an amount on this line, the taxpayer is electing to apply all or a portion of the current year's overpayment to next year's estimated tax.



Tax Software Hint: The software shows the remaining amount to be refunded to the taxpayer on the amount to be refunded line.

How do I indicate that the entire refund should be sent to the taxpayer?

For taxpayers who want the entire refund sent to them, leave the line for amount applied to estimated tax blank or enter 0.



NEW A new field in the signature section at the bottom of Form 1040 labeled Identity Protection PIN is designed to help prevent refunds from being issued to an identity thief. See Form 1040 Instructions for more information.



Tax Software Hint: The tax software shows the entire refund amount on the amount to be refunded line.

What are a taxpayer's refund options?

Taxpayers may choose to have their refund deposited directly into their account at a bank, credit union, or other financial institution. Direct deposits are usually received within two weeks of return acceptance. Taxpayers may choose to have a refund check mailed to them. Refund checks are usually mailed within 6 to 8 weeks after the return is filed. In addition, taxpayers can request that their refund be deposited directly

into a TreasuryDirect online account to buy U.S. Treasury marketable securities and savings bonds. Details can be found at www.treasurydirect.gov.

Taxpayers who do not have a TreasuryDirect online account also have the option to purchase savings bonds with their federal income tax refunds. Additional details will be covered later in the lesson.

What are the benefits of direct deposit?

Encourage taxpayers to use direct deposit; direct deposit refunds are received faster than checks (usually within 10 to 14 days) and eliminate the possibility of a check being lost or stolen. Direct deposit is more convenient for the taxpayer.

Direct deposit saves tax dollars because it costs the government less.

How do I enter the information for direct deposit?

Make sure taxpayers show you proof of their bank account and routing information. Bank deposit slips are not a reliable source for routing and account numbers for direct deposit. The Volunteer Resource Guide (Tab 12), Pointers for Direct Deposit of Refunds, includes a diagram showing where to find the Routing Transit Number (RTN) and Depositor Account Number (DAN) information on a check.



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 1), Main Information Screen on Direct Deposit. Enter the RTN and DAN on the Main Information Screen and Form 1040, page 2. For direct deposit into one account, the software makes sure the information was entered properly. If the information does not match, the program will give you a warning during diagnostics in the completion phase of the return.

Can the refund be deposited into more than one account?

Taxpayers may choose to have their refund deposited in up to three accounts. For example, a person expecting a refund of \$600 could choose to deposit \$200 into a checking account, \$300 into a savings account, and \$100 into an IRA account.



Tax Software Hint: Use Form 8888, Allocation of Refund (Including Savings Bond Purchases), to list the RTN and account number for each deposit. Form 8888 is not required if the refund is to be deposited into a single account. Go to the Volunteer Resource Guide (Tab 6), Split Refund Option page, for the software entries.

What if the taxpayer makes a mistake on the return that increases the amount of the refund?

The IRS recommends using electronic filing to avoid math errors and other common problems that can require adjustments to a return after it is filed. If an adjustment results in a larger refund than expected, the IRS adds the difference to the last account designated for direct deposit.



Direct deposit of a taxpayer's refund is to be made to an account (or accounts) only in the taxpayer's name. Advise taxpayers their refunds may only be deposited directly into their own accounts.



If the routing and account numbers are not valid, the refund will be delayed 4–6 weeks. If the direct deposit is rejected, a check will automatically be mailed to the address on the return.



Publication 4541 and Publication 4542, available for download on www.irs.gov, provide information about split refunds.



When an adjustment is made to a tax refund, the IRS sends a letter explaining any errors that resulted in the adjustment, as well as any changes made to the refund amount and the amount of each direct deposit.

What if the taxpayer makes a mistake on the return that decreases the amount of the refund?

If an adjustment results in a smaller than expected refund, the IRS uses a bottom-up rule and deducts the difference from the direct deposit amount designated for the last account shown on Form 8888. If the difference exceeds the amount designated for the last account, the IRS deducts the remainder from the amount designated to the next account, until the amount due is paid.

example

Joan's return shows a refund of \$300 and she asks the IRS to split her refund among three accounts with \$100 to each account. Due to an error, her refund is decreased by \$150. The IRS will adjust her direct deposits as follows:

	Requested Direct Deposits	Actual Direct Deposits
Account 1	\$100	\$100
Account 2	\$100	\$50
Account 3	\$100	0

The IRS will apply this same bottom-up rule to adjust direct deposits for refund offsets for *unpaid federal taxes* or if the *Earned Income Credit (EIC) portion of the taxpayer's refund* is withheld pending further review. After the EIC review, if a refund is allowed, it will be direct-deposited in the account listed first on Form 8888.

example

Bill asks that his refund of \$780 be deposited into three different accounts: \$300 into Account 1, \$300 into Account 2, and \$180 into Account 3. However, Bill owes federal taxes of \$290 on an earlier tax year, and after this is offset, only \$490 remains to be direct deposited. Account 3 will receive \$0, Account 2 will receive \$190, and Account 1 will receive \$300.

example

Melanie is due a refund of \$1,000; \$700 of the refund is an Earned Income Credit (EIC). She asks that her refund be split into three different accounts: \$500 into Account 1, \$300 into Account 2, and \$200 into Account 3. Melanie's EIC amount of \$700 was held pending a review. So, \$300 went to Account 1 and \$0 went to Accounts 2 and 3. Later, when the IRS allowed her EIC refund amount, it was deposited into Account 1.

What happens if the taxpayer owes other debts like student loans or child support?

If the refund is decreased due to an offset to pay state income tax, child support, or certain federal nontax debts, such as student loans, then the decrease will be taken first from the account that appears first on the payment file received from the IRS. The IRS payment file orders accounts from the lowest to the highest routing number. If the debt exceeds the payment designated for the account that appears first on the payment file, the Treasury Department's Financial Management Service (FMS) will reduce the payment designated for the account that appears next.

What should I watch out for?

Double-check the RTN of the financial institution before the return is transmitted if:

- You are unfamiliar with the financial institution.
- The RTN is for a credit union that is payable through another financial institution. Taxpayers should contact their credit union for the correct RTN.
- If more than one account is selected for direct deposit, be sure that the amounts on Form 8888 equal the refund amount on Form 1040.



Financial institutions generally do not allow a joint refund to be deposited into an individual account. The IRS is not responsible if a financial institution refuses a direct deposit.



EXERCISES

Answers follow the lesson summary.

Question 1: Using direct deposit is one way to reduce the chance that a refund will be lost or stolen.

True False

Question 2: When entering an account number for direct deposit, make sure to include all spaces and hyphens. True False

What do I need to know about the option to buy U.S. savings bonds with a federal tax refund?

IRS will provide taxpayers with an opportunity to purchase U.S. savings bonds with their tax refunds. Volunteers should review these guidelines to promote this asset-building opportunity as part of the filing season.

Taxpayers now have more choices, including the purchase of bonds for co-owners, such as children or grandchildren.

What are U.S. savings bonds?

U.S. savings bonds are savings instruments for individual savers issued by the U.S. Department of the Treasury. For purposes of this program, only Series I Savings Bonds will be offered.

Series I Savings Bonds are sold at face value (a \$50 bond costs \$50), and grow in value for up to 30 years. The bonds can be purchased in denominations of \$50, \$100, \$200, \$500, \$1,000. In any single calendar year, taxpayers can purchase up to \$5,000 of savings bonds of any denominations.

Series I Savings Bonds pay interest based on a combination of a fixed rate (which remains the same throughout the life of the savings bond) and a semiannual inflation rate, which is updated each May and November. Savings bonds accrue interest until redeemed or until they reach their final maturity in 30 years.

Savings bonds can be redeemed for principal and accrued earnings anytime after the first 12 months after they are purchased (unless the taxpayer lives in an area affected by natural disaster.) Also, if a savings bond is redeemed within the first five years, the three most recent months' interest will be forfeited. After five years, no penalty will apply.

How can purchases be made at VITA/TCE sites?

Taxpayers can choose to save part or all of their refunds by requesting savings bonds on Form 8888. The specific details on how to purchase savings bonds with a federal tax refund are included in the Form 8888 Instructions.

In addition to the three direct deposits, taxpayers can allocate their refund to request up to three different savings bond registrations and receive a check. Form 8888 is divided into separate parts to reflect this.

- Part I: Complete this part for direct deposit of a portion of a refund to one or more accounts.
- Part II: Complete this part to buy paper bonds with part of a refund. In addition to making bond purchases for themselves, taxpayers can make bond purchases and add beneficiaries or co-owners, and make bond purchases for someone other than themselves.
- Part III: Complete this part if taxpayers wish to receive part of their refund by check.
- Part IV: Total allocation of refund. Add the amounts for each part together; they must equal the total refund amount.

The Form 8888 Instructions provide directions for the specific information to include on the form for the purchase of savings bonds.

example

Mary's tax return shows she is due a refund of \$548.00. She wants to buy a \$500 savings bond. Using Form 8888, Mary can purchase the savings bond and elect to deposit the remaining \$48 into her checking account.

How does the taxpayer receive the savings bonds?

Taxpayers will receive the amount they designated by mail in the form of U.S. Series I Savings Bonds. However, if taxpayers make an error in figuring their refund, the bond request is not a multiple of \$50, or the refund is offset for any reason, this option will not apply and the entire amount of the refund will be sent to taxpayers in the form of a check.

When will requested bonds not be issued?

Bonds will not be issued if any of the following apply:

- The bond request is not a multiple of \$50.
- More than one name is entered on line 5b, 5c, 6b, or 6c.
- The refund is decreased because of a math error.
- The refund is offset for any reason.

Instead, the **entire** refund will be sent to the taxpayer in the form of a check.

If an error is made on the return and the amount of the refund is increased, the additional amount will be sent to the taxpayer in the form of a check.

Whom does the taxpayer contact if the savings bonds are not received?

The first step is to check the status of the refund by going to the "Where's My Refund" feature on www.irs.gov, or calling 1-800-829-1954. Taxpayers can generally get information about their refund 72 hours after the IRS acknowledges receipt of their e-filed return, or three to four weeks after mailing a paper return. If the IRS has processed the refund and placed the order for their savings bonds, taxpayers will need to contact the Treasury Retail Securities office at 1-800-245-2804 to inquire about the status of the savings bonds.

For additional information refer to Form 8888 or go to www.irs.gov.

How do I know if an amount is owed?

Taxpayers who owe money on their returns are often afraid and do not know what to do next. This is a good opportunity to advise the taxpayers of the various options for payment.



Tax Software Hint: The software automatically calculates the amount that is owed when the payment total is less than the amount of tax. Refer to the Volunteer Resource Guide (Tab 6), Form 1040, page 2, Other Taxes and Payments. Review the line for Amount You Owe.

Explain to taxpayers that the tax return will be filed now and that they should submit their payment of taxes due no later than April 15 (or the next business day if April 15 falls on Saturday, Sunday, or a legal holiday). Remind taxpayers that filing an extension of time to file does not extend the time for payment.

What forms of payment are acceptable?

The payment options are:

- Check or money order submitted with Form 1040-V, Payment Voucher
- Electronic funds withdrawal
- Credit card
- Electronic Federal Tax Payment System (EFTPS)



Tax Software Hint: Go to the Volunteer Resource Guide (Tab 12), Finishing the Return, to review the information on balance due returns. Be sure to read this reference and refer to it when preparing a return that has an amount owed; it provides more information on EFTPS. If using Electronic Funds Withdrawal, located at the bottom of Form 1040, page 2, indicate that the taxpayer wants to pay all or part of the taxes electronically. Refer to the Volunteer Resource Guide (Tab 6) for electronic funds withdrawal software entries.

What if the taxpayer cannot pay?

If taxpayers state that they cannot pay, first advise them to file the return and pay as much as they can with the return. This will reduce penalty and interest charges. Once they receive a notice, they can pay the remaining amount in full or choose another payment option if more time is needed.

Taxpayers who cannot pay the full amount owed, shown on Form 1040 in the Amount You Owe section, may request one of the following agreements:

- Pay in full within 60 or 120 days with no fee; interest and penalties are charged on payments after the April due date.
- Monthly installment payments (file Form 9465, Installment Agreement Request). A fee is charged for this option, in addition to interest and penalties.



To avoid a penalty, taxpayers with an amount owed must file their return by the due date even if they cannot pay the full amount with the return.



Taxpayers who pay their income tax (including estimated tax) by credit or debit card can deduct the convenience fee charged by the card processor as a miscellaneous itemized deduction (subject to the 2% AGI floor).



Taxpayers should not mail cash with their returns.



Form 1040-V includes instructions and a table of IRS addresses.



Any amount of tax owed that is not paid by the April due date is subject to penalties and interest. Taxpayers who cannot pay should choose the option that is the least costly. For example, the 60- or 120-day pay-in-full option has no user fee.



Taxpayers who can show they will have a substantial financial difficulty if they pay their tax on the due date are considered to have an *undue hardship*. Such taxpayers can request an extension of time to pay by filing Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship, by the due date of the return. Remember, undue hardship is more than inconvenience.

How do I handle Form 9465, Installment Agreement Request?

The following outlines key information related to an installment agreement.

- If the return is being filed electronically, Form 9465 can also be included with the e-filed return.
- When filing a paper return, Form 9465 should be completed and attached to the front of the return before mailing.
- If the request is granted, the taxpayers must also pay a fee of \$105, or \$52 if payments are made by electronic funds withdrawal. If the taxpayers' income is below certain limits, they may qualify for a reduced fee of \$43. Taxpayers can also request a reduced user fee of \$43 by completing Form 13844, Application for Reduced User Fee for Installment Agreement. Taxpayers can obtain Form 13844 at www.irs.gov or by calling the IRS forms number at 1-800-829-3676.
- If the IRS approves the agreement, a notice is issued that provides details of the agreement and requests the user fee at that time.
- Instead of completing Form 9465, the taxpayer can file an Online Payment Agreement (OPA) at the IRS web page. For more information, go to www.irs.gov and search for the term "OPA" or, on the "I need to" list, select "Set Up a Payment Agreement."



Tax Software Hint: If the taxpayer chooses to apply for an installment agreement using Form 9465, the form can be e-filed. Refer to the Volunteer Resource Guide (Tab 6), Form 1040, page 2, and review the line Amount You Owe and software entries for Form 9465.



EXERCISES (continued)

Question 3: For which of the following will the taxpayer be charged a convenience fee?

- Direct deposit of a refund
- Electronic funds withdrawal of a tax payment
- Using a credit card to make a tax payment
- Using a personal check to make a tax payment

Taxpayer Interview and Tax Law Application

Seymour's Form 1040 shows his total tax is \$450. His tax payments come to just \$200. Therefore, Seymour owes \$250.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

The amount of tax you owe for 2011 is \$250. You can either mail in a check or money order with the payment voucher, use electronic funds withdrawal, or call in a credit card payment. You'll have to pay an additional convenience fee for using a credit card.

No, we can designate the date that the debit will occur, any time up to April 17. I would just need to see proof of account to verify your bank account information so I can include the routing and account numbers in your electronic return.

Right. And it saves you the trouble of mailing in the voucher with your payment.

You can do that too. Here's Form 1040-V, which has been completed for you. Make your check or money order payable to "United States Treasury." If it's not already printed on the check, make sure it shows your name, address and daytime phone number. Also, print your social security number and "2011 Form 1040" on the front of your check. Then mail the payment with the voucher. I'll get the mailing address for you.

Just make sure it gets postmarked by the due date. I can e-file your tax return right now, but it's up to you to make sure you send in your payment on time.

SEYMOUR RESPONDS...

Hmm. How does electronic funds withdrawal work? Does it come out of my account right away?

And there's no charge?

Sounds good to me. But I don't have my checking account information with me. Maybe I should just mail in my payment.

That doesn't seem too hard.

Thank you for your help. I will make sure the payment is made on time.

How is the estimated tax penalty calculated?

The estimated tax penalty is calculated on Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, and reported on the applicable line in Form 1040, Amount You Owe section. While completion of Form 2210 is out of the scope of the VITA/TCE program, it is important for volunteers to have an awareness of the estimated tax penalty provisions.

What is the Estimated Tax Penalty?

In most cases, taxpayers must make estimated tax payments if they expect to owe at least \$1,000 in tax (after subtracting withholding and credits) and their withholding and credits will be less than the smaller of:

- 90% of the tax shown on the current tax return or
- 100% of the tax shown on the prior year's tax return (110% for certain higher-income taxpayers; see Form 1040-ES)

An estimated tax penalty may apply if the taxpayer does not make estimated tax payments as required.

There are special situations when a taxpayer will not have to pay a penalty. See Form 2210 Instructions or Publication 17 for more information.

example

Mark's total tax is \$1,657 for 2011. His withholding is \$417. He owes \$1,240. His 2010 tax was \$2,000. Mark will probably be charged an estimated tax penalty because the amount he owes is over \$1,000 and his withholding and credits are less than 90% of his 2011 tax or 100% of his 2010 tax.

Do I have to calculate the estimated tax penalty?

Because Form 2210 is complicated, leave the estimated tax penalty line blank on Form 1040. This will not prevent the IRS from calculating the penalty if it is due. Let the taxpayer know that a penalty may be owed, and if so, the IRS will send a notice.



Form 2210 is no longer included with the estimated tax penalty notice. Refer taxpayers who need assistance with Form 2210 to a professional tax preparer.



Tax Software Hint: Form 2210, line 9 should default to \$0, to prevent volunteer preparers from calculating the estimated tax penalty. The desktop software defaults are preset when the software is issued, but they are sometimes changed. If necessary, volunteers can reset this default back to \$0.

For the online tax program, the default is set on the Master Template. However, not all sites use the Master Template. Volunteers in sites that do not use the Master Template will need to set this default manually.



EXERCISES (continued)

Question 4: Dion's total tax liability is \$1,044. After withholding, she owes \$640. This means Dion might have to pay a penalty for underpayment of estimated tax.

True False

How can taxpayers make sure the correct amount of tax is withheld?

Form W-4, Employee's Withholding Allowance Certificate, includes the following types of information the employer uses to figure the taxpayer's correct withholding:

- Marital status (married taxpayers may request the employer to withhold at the higher single rate)
- Withholding allowances the taxpayer claims
- Any additional amount to be withheld
- Qualification of exempt status

The amount of tax the employer withholds from the taxpayer's wages depends on:

- The amount of pay the taxpayer earns
- How often the taxpayer is paid
- The taxpayer's information entered on Form W-4

When should taxpayers submit a revised Form W-4 to their employer?

The taxpayers may submit a new Form W-4 whenever they want to increase or decrease the withholding amount.

Life events such as a change in marital status, birth of a child, or purchase of a home will change exemptions, adjustments, deductions, and credits on the tax return. These taxpayers should submit a revised Form W-4 to their employer.



Refer to Form W-4 instructions to see the applicable lines a taxpayer must complete to revise Form W-4.

In some situations, getting the right amount withheld is difficult if:

- The taxpayers are married and both work
- The taxpayers have more than one job
- The tax law regarding deductions or credits changes

Publication 919, *How Do I Adjust My Tax Withholding?*, has more information on this topic. Taxpayers can go to the withholding calculator on www.irs.gov to help calculate the correct withholding.

example

Mary was claiming an allowance for her son on her Form W-4. Mary will not be able to claim her son as a dependent on next year's return. Mary will change her Form W-4 to reduce the number of allowances and submit it to her employer.

example

John works two full-time jobs. He reviews his withholding and realizes he will not have enough tax withheld. He gives his employer a revised Form W-4 to increase his withholding so he will not owe money when he files his return.

How do taxpayers request an increase or decrease in withholding for other income payments?

Taxpayers can use the following withholding forms to request a change in their withholding on other types of income.

- Form W-4P, Withholding Certificate for Pension or Annuity Payments
- Form W-4S, Request for Federal Income Tax Withholding from Sick Pay
- Form W-4V, Voluntary Withholding Request (generally used for certain government payments)

TIP

Refer to the Volunteer Resource Guide (Tab 12), *Balance Due Returns*, for guidance on helping taxpayers avoid a balance due. Advise taxpayers to use the withholding calculator on www.irs.gov to check their withholding for next year. If they need to adjust the amount withheld, suggest they submit a revised Form W-4, and if appropriate, help them complete the revised Form W-4.

What is the Third Party Designee?

For taxpayers who want to allow a friend, a family member, or another person to discuss their tax return with the IRS, the "Yes" box of the Third Party Designee area of the return can be checked. You may see this situation in the case of an individual going overseas, a personal representative (executor) filing a return for a deceased taxpayer, or elderly parents who wish to have their adult child handle their affairs. You will also need to enter the name, phone number, and any five numbers the designees choose as their Personal Identification Number (PIN).



Volunteer preparers must *never* be designated as a third party designee.



See Publication 17 for information on what the taxpayer is authorizing when designating a third party designee.

The screenshot shows a portion of a tax form. At the top, it says "You Owe 77 Estimated tax penalty (see instructions) 77". Below that, there is a section titled "Third Party Designee". The question is "Do you want to allow another person to discuss this return with the IRS (see instructions)?" with two radio buttons: "Yes. Complete below." and "No". Under "Yes", there are three fields: "Designee's name", "Phone no.", and "Personal identification number (PIN)". The "PIN" field is a five-digit grid. Below the form, there is a signature line that says "Under penalty of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief..."

How can I avoid common errors?

Double- and triple-check the routing number and account numbers for direct deposit and electronic funds withdrawal. Have the taxpayers compare the numbers entered on the return to their checks or other account information. If an error is made in the bank information, taxpayers must work with the bank to resolve any misdirected funds.

Practice – Vanessa Franklin



Let's see how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review the sample interview with Vanessa related to Lesson 30.

Return to this lesson after you have reviewed this information.

Summary

Refunds

If the payments made exceed the amount of tax, then the amount of the overpayment is entered on the overpaid line in the Refund section of Form 1040.

Taxpayers can choose to apply any portion of their overpayment to the following tax year or receive their refund as a check or direct deposit. Direct deposits can be split among as many as three different accounts by using Form 8888.

For direct deposit of the refund, enter the Routing Transit Number (RTN) and Depositor Account Number (DAN) on the Main Information Sheet and Form 1040, page 2. Use a check as proof of account. When the return is printed, this information will appear on the applicable lines in Form 1040, Refund section.

Taxpayers can use their federal tax refund to buy U.S. savings bonds for themselves or others, such as children or grandchildren. They do not need to have a bank account or an existing account with Treasury.

Review Form 8888 for more information about splitting a refund and the purchase of savings bonds. Form 8888 can be downloaded from www.irs.gov.

Amount Owed

If the payment total is less than the amount of tax owed, then tax software shows the amount owed on the applicable line in the Amount You Owe section of Form 1040 and generates a copy of Form 1040-V, which is used for mail-in tax payments.

Taxpayers are often very anxious if they owe tax on their return. Take the time to provide the various payment options to taxpayers in this situation.

Explain to taxpayers that the tax return can be electronically filed now but that they should submit their payment of taxes by the due date of the return. They can pay with a check or money order, with Form 1040-V, electronic funds withdrawal, or a credit card.

Taxpayers who are unable to pay may request an additional 60 or 120 days to pay, or complete Form 9465 for an installment agreement. This request can be made with an e-filed return, or by using the Online Payment Agreement feature on www.irs.gov.

Interest and penalty are charged on amounts not paid by the due date. There are fees associated with certain payment options.

Estimated Tax Penalty

Form 2210, line 9 should default to \$0 to prevent volunteers from calculating the estimated tax penalty. The desktop software defaults are preset when the software is issued. For the online tax program, the default is set on the master template.

If it appears taxpayers may owe an estimated tax penalty, let them know the IRS will calculate the penalty and send a bill. Completion of Form 2210 is out of scope. Refer taxpayers who need assistance with Form 2210 to a professional tax preparer.

Adjusting Tax Withholding

Advise taxpayers who did not have enough tax withheld for 2011 to submit a revised Form W-4 (to their employer) or Form W-4P (to a pension payer). Use the withholding calculator on www.irs.gov and Publication 919 to calculate the correct withholding amount.

Third Party Designee

Taxpayers can authorize a friend, a family member, or another person to discuss their return with the IRS. Volunteers should *never* designate themselves as a Third Party Designee.

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

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

- Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: True. Direct deposit is safer since there is no check to be lost or stolen.

Answer 2: False. Enter the account number from left to right, leaving out all spaces and special characters.

Answer 3: C. The credit card processor covers its costs by assessing a “convenience fee” to taxpayers using this system. Taxpayers will be advised of the amount of this fee when they call the interactive voice response system.

Answer 4: False. The tax Dion owes is less than \$1,000, so she does not have to pay a penalty.



Lesson 31: Quality Review of the Tax Return



Introduction

This lesson covers the quality review of a tax return in the return preparation process. The quality review includes confirming the accuracy of the taxpayers' return before obtaining their signatures. If you take the steps identified in this lesson, the taxpayers should have a better understanding of their tax return.

Objectives

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

- Identify the three methods of quality review
- Perform a quality review using the intake and interview sheet, Section C
- Perform the final steps for completing a return



Quality Reviewers must be certified at the Intermediate level or above.

How is a quality review of a return completed?

All tax returns prepared at volunteer tax preparation sites must be quality reviewed. The quality review process includes reviewing the tax return and a completed Form 13614-C, Intake/Interview & Quality Review Sheet, along with all source documents. The taxpayer should be present for and participate in the quality review.

To perform a quality review of a tax return, use the intake and interview sheet, Section C, and the tools in the Volunteer Resource Guide. Depending on the site, one of three quality review methods must be used by an individual certified at the Intermediate level or above:

- A certified designated reviewer (designated quality review) – **the preferred method**
- Certified preparers review each other's work (peer review)
- Certified preparers review their own work (self-review, only allowed if a second qualified person cannot be present)

The intake and interview sheet, Section C, has a list of items that must be verified when quality reviewing tax forms. Reviewing these items prevents common errors from occurring.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W

Optional:

- Form 8332
- Form 8453
- Form 8879



Volunteers should always review their work, even if it is to be reviewed by another party.

How do I conduct a quality review of a return?

A quality review must be conducted with the taxpayer after completing the return and before the taxpayer signs Form 8879, IRS e-file Signature Authorization. Make sure you fully understand the taxpayer's tax situation. If all the questions on the intake and interview sheet are not complete, the quality reviewer should either complete the form with the assistance of the taxpayer or return it to the preparer to be completed with the taxpayer.



Corrections must be marked on the intake sheet by the preparer or quality reviewer.

The taxpayer's answers on the intake and interview sheet should be validated during the quality review process. Review the completed tax return and all supporting documents with the taxpayer to ensure that all items on the intake sheet were correctly marked by the taxpayer and correctly transferred to the return.

If the intake sheet and all supporting documents do not match what is reported on the return, either make the appropriate changes or follow up with additional questions to the taxpayer and return preparer.

Confirm each item in Section C of the intake and interview sheet. Verify that the tax return reflects the correct tax law application to the information and source documents the taxpayer provided.

It may help to compare the sections of the intake and interview sheet to the sections of the tax return.

- Part I, Your Personal Information
 - Verify name, address and SSN match Form 1040 (the intake and interview sheet does not show SSN)
 - Use photo ID to verify taxpayer's identity
 - Use social security cards or ITIN letter to verify name and SSN/ITIN on the return
 - Verify date of birth and phone numbers
- Part II, Marital Status and Household Information, should reflect the correct tax law determination for Form 1040, Filing Status and Exemptions sections
 - Use Publication 4012 (Tab B), Filing Status to determine the correct filing status
 - Use Publication 4012 (Tab C), Dependency Exemptions to verify if taxpayers can be claimed by someone else to determine personal exemption
 - Use Publication 4012 (Tab C), Dependency Exemptions to determine if persons listed in Question 2 meet the test to qualify as dependents and are entered correctly on the return
- Part III, Income, should match the type of income reported on Form 1040, Income section
 - Verify that all income from Forms W-2 and 1099, as well as cash received for services, is correct on the return
 - Verify all of the required source documents are included
- Part IV, Expenses, should match tax law determination for Form 1040, Adjusted Gross Income, Tax and Credits, and Payments sections
 - Verify that any adjustments to income are reported correctly and are supported by the taxpayer's documentation
 - Verify that all information is correct and documentation supports standard or itemized deductions
 - Verify that all applicable credits are reported correctly
 - Verify that any withholding amounts shown on Form(s) W-2 and 1099, and other source documents are reported correctly
- Part V, Life Events, should match tax law determination for Form 1040, Income, Adjusted Gross Income, Tax and Credits, and Payments sections
 - Verify all required forms and documentation are used and reported correctly on the return
- Additional Information and Questions entries must match Form 1040, Refund section
 - Verify checking or savings account and routing information are correct and match the supporting documents
 - Review any additional comments the taxpayer notated

- Section B, For Certified Volunteer Preparer Completion, should reflect tax law determinations for Form 1040, Filing Status and Exemptions sections
 - Verify answers to all the questions
 - Use Publication 4012 (Tab B) to determine filing status
 - Use Publication 4012 (Tab C) to determine personal exemptions and dependency exemptions
- Section C, For Certified Quality Reviewer Completion, should validate all sections of Form 1040
 - Verify all tax law issues identified in items 1 through 10 have been addressed
 - Verify correct SIDN is on the return
 - Check all boxes once the quality review is complete

Use Publication 4012 (Tab 12), Finishing the Return: Check Your Work – The Quality Review and the Line-by-Line Job Aid for Volunteers to conduct the review.



Check returns for accuracy – review social security numbers, double-check math, and verify amounts transferred from schedules and tax tables.

When should the taxpayer sign the return?

After the quality review is completed, before asking taxpayers to sign their return (either by signing Form 1040 or Form 8879, IRS e-file Signature Authorization, or entering a self-select PIN), advise taxpayers that they are ultimately responsible for the information on their return. Furthermore, explain that to sign the return is to guarantee that they have examined the return and its accompanying forms and schedules for accuracy.



Always include the taxpayer in the quality review process.

NEW There is a new field next to spouse's occupation at the bottom of Form 1040 labeled, Identity Protection PIN. This is designed to help prevent refunds from being issued to an identity thief. If the taxpayer has been a victim of identity theft, verify the special PIN (6 digit IPPIN) is correct using CP01A Notice or See Form 1040 Instructions for more information.



For deceased taxpayers, review documentation authorizing the executor of the estate to file the final return. See Publication 559 for details.

The Volunteer Resource Guide has complete instructions on signature procedures for different types of situations. Please review the Volunteer Resource Guide (Tab 12), Finishing the Return.

Publication 17, Your Federal Income Tax for Individuals, also contains information on signature processes. Be sure to review information on when someone can sign for the taxpayer. Rules for a return signed by a power of attorney are very specific.

Do I have to enter a site number?

The IRS captures a wide range of important statistical information from tax returns, including which returns were prepared at VITA/TCE tax preparation sites. **It is critical that the correct site identification number (SIDN) is included on all returns prepared by VITA/TCE sites.**

At sites using tax preparation software, this information is usually programmed to print automatically on each return. The SIDN is reported in the Paid Preparer Use Only section at the bottom of Form 1040, page 2. You must ensure the correct SIDN appears on the return. If the correct SIDN is not there, immediately inform the Site Coordinator. **Do not complete any other information in the Paid Preparer Use Only section.**

Print/Type preparer's name		Preparer's signature		Date	Check <input type="checkbox"/> if self-employed	PTIN S15011111
Firm's name ▶				Firm's EIN ▶		
Firm's address ▶				Phone no.		

Form 1040 (2011)

Your Site Coordinator provides the SIDN along with other necessary guidelines for completing the return. Once you have obtained the taxpayer's signature or PIN and verified the SIDN, you are ready to assemble the return. Refer to the Concluding the Interview lesson for these steps.



EXERCISES

Answers follow the lesson summary.

Question 1: A joint return requires the signature or PIN of:

- A. At least one spouse
- B. Both spouses
- C. The spouse with the higher income

Question 2: What is the form number of the IRS quality review sheet used by all volunteers for quality review?

What are the final steps in the quality review process?

Once the tax return has gone through the quality review process, assemble the return and ensure that all necessary documentation is complete.

If the taxpayer has chosen not to use a Self-Select PIN, obtain the taxpayer's signature on Form 8879. If the return is a joint return, make sure both signatures are included on the form, otherwise the return will not be electronically transmitted. Review the Volunteer Resource Guide (Tab 12), *Finishing the Return: Check Your Work—The Quality Review* for the final steps in the process.



For members of the Armed Forces who are signing joint returns, refer to Publication 3. Electronic transmission is not always possible.



EXERCISES (continued)

Question 3: What are the three methods of quality review?

Practice – Vanessa Franklin



Let's take a look at how a volunteer helped our taxpayer, Vanessa Franklin. Go to Appendix A and review Vanessa's intake and interview sheet. Return to this lesson after you have reviewed the intake and interview sheet.

Summary

All quality reviewers must use the intake and interview sheet, Section C, to conduct a quality review and be certified at the Intermediate level or above.

The intake and interview sheet must be complete and have all taxpayer information validated during the quality review process. It is important to discuss and review the intake and interview sheet, the tax return, and all supporting documents with the taxpayer.

All returns must be quality reviewed **prior to** the taxpayer signing Form 8879. Form 8879 is signed when the Practitioner PIN signature option is used. Use of the Self-Select PIN does not require Form 8879.

It is critical that the correct site identification number (SIDN) is included on all returns prepared by VITA/TCE sites. The SIDN is reported in the Paid Preparer Use Only section of Form 1040. If the SIDN is missing or not correct, immediately contact your Site Coordinator.



EXERCISE ANSWERS

Answer 1: *B. Both spouses must sign a joint return, even if only one spouse had income.*

Answer 2: *The intake and interview sheet, Section C.*

Answer 3: *Designated quality reviewer (the preferred method), peer review, and self-review, only allowed if a second qualified person cannot be present.*



Lesson 32: Concluding the Interview



Introduction

In this lesson, you will receive insights and information for concluding your interview with the taxpayer.

Using the interview techniques and tools discussed in the Screening and Interviewing lesson, such as active listening and building rapport, share the following with the taxpayers:

- Which records/documents they should keep and why
- What documentation is maintained at the site – why, how long, etc.
- What they need to know and do if they overpaid their taxes (e.g., refund cycle dates, increasing the number of exemptions on Form W-4 to avoid overpayments)
- What they need to know and do if they owe additional taxes (e.g., payment due date, estimated tax payments, and reducing the number of exemptions on Form W-4 to increase withholding)

These are important tasks to accomplish after the tax return is completed, quality reviewed, and ready to be filed. The way that you conclude the interview can impact taxpayers' attitudes toward the taxpaying experience and their satisfaction with the volunteer tax return assistance program. It can also make next year's tax preparation easier for taxpayers and the volunteer who assists them.

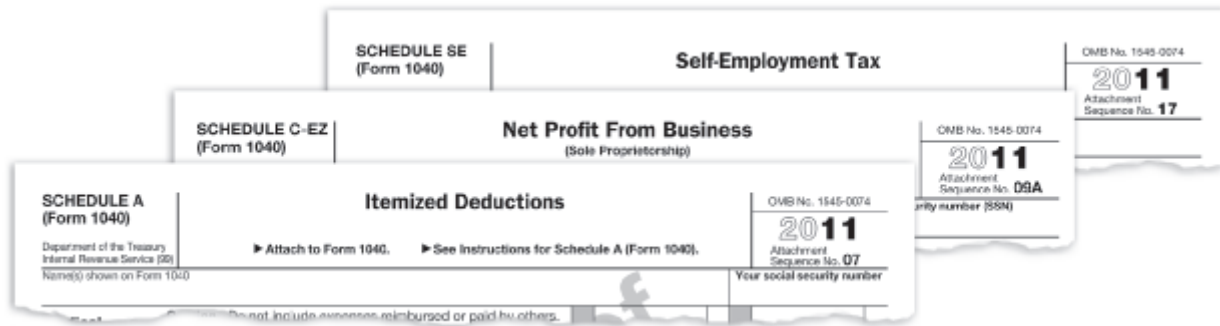
Objectives

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

- Assemble the taxpayer's copy of the tax return
- Identify the records the site maintains
- Explain to taxpayers which records they should maintain
- Use the e-file Refund Cycle Chart to identify when refunds may be paid to the taxpayer
- Explain to taxpayers what they should do when they owe money
- Explain to taxpayers how to adjust withholding
- Explain to taxpayers how and when they can make estimated payments
- End the interview

What do I need?

- Publication 4012, Volunteer Resource Guide
 - Publication 17
 - Publication 4491-W
 - Publication 730
 - Form 1040-V
- Optional:**
- Publication 505
 - Publication 919
 - Form 1040-ES
 - Form 8332
 - Form 8879
 - Form 9465
 - Form W-4
 - Form W-4P
 - Form W-4V



How do I prepare the e-filing packet?

Volunteer tax assistance sites use tax software to create and e-file tax returns. Even so, taxpayers must retain paper copies of their returns. Follow the steps in Publication 4012 (Tab 12), Finishing the Return to prepare the packet. In general:

1. Use tax software to print the entire return, including all forms, schedules, and attachments
2. Make sure the taxpayer names and social security numbers are legible on every sheet
3. Assemble the packet:
 - Start with Form 1040 on top
 - Place each form, schedule, and attachment in the proper sequence, based on the sequence number shown in the upper right corner of the form
4. Show the taxpayers the printed copy of the tax return, verifying once more the name, SSN, ITIN, address, filing status, dependents, income, expenses, deductions, credits, payments, and finally, tax refund or balance due.

Who keeps the records?

What forms should taxpayers keep?

Taxpayers must keep records to prove their income and expenses. If they own a home or investments, their records should contain information needed to calculate the basis of the property.

Advise taxpayers to keep a copy of the following documents for at least three years:

- Form 1040 with all forms, schedules, and attachments.
- All other tax-related documents, including Forms W-2 and Forms 1099.
- If applicable:
 - Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (or similar statement)
 - Power of Attorney document
- For e-file returns, taxpayers must also keep a copy of the signed Form 8879, IRS e-file Signature Authorization. This form is not needed if the self-select personal identification number (PIN) method is used.

If Publication 730, Important Tax Records Envelope, or an alternative is available, place the return and supporting documents into that envelope.

TIP

Advise taxpayers to bring the envelope to the site next year.

What tax return data will the site keep?

The site will keep the following data confidential and in a secure location until December 31 of the current year, except as noted:

- A master backup disk containing all electronically transmitted returns unless the site is using an internet-based software
- Signed copies of IRC 7216, Consent to Disclose and Consent to Use Notices, are recommended to be retained for three years



The site is no longer required by IRS to retain signed copies of Form 8879.

What should I tell the taxpayer about refunds or balances due?

For taxpayers who are due a refund:

- Review the 2012 IRS e-file Refund Cycle Chart in Publication 4012 (back cover) and provide the expected date of the refund. (The cycle chart will provide you with dates for direct deposit and paper checks.)
- Make sure the taxpayer realizes that this is not a guaranteed date, since delays can occur.
- Advise the taxpayer of the split refund and saving bond options.

For taxpayers who owe money to the IRS (also known as having a balance due):

- Electronic Funds Withdrawal can be set up to have payments electronically withdrawn from the taxpayer's checking or savings account on a future date, up to the April filing due date. This may be set up using tax software and e-filed with the return; see Publication 4012 (Tab 6).
- Advise taxpayers to send Form 1040-V, Payment Voucher, to the appropriate address if they wish to mail a payment. Form 1040-V will be generated by the e-file software when the tax return results in a balance due.
- Advise taxpayers that payment must be made by the April filing due date to avoid penalties and interest. If taxpayers are unable to pay in full, see Publication 4012 (Tab 12) for the various payment options available.
- If taxpayers can pay a portion of the amount owed by the April filing due date, they will not be charged interest and penalties on that portion.



Advise the taxpayer that the IRS charges a fee for setting up an installment agreement.

How can the taxpayer avoid a balance due next year?

There are several ways to pay taxes during the year to avoid having a balance due when the return is filed. Depending on the taxpayer's situation, here are some suggestions:

- Taxpayers whose income is mostly from wages or pensions can adjust their withholding.
- Taxpayers whose income is mostly from self-employment or investments can make or increase their estimated tax payments.
- A combination of increased withholding and estimated tax payments may work best for some taxpayers.

How can taxpayers adjust their withholding?

Taxpayers receiving wage income can adjust their withholding by providing their employer with a new Form W-4, Employee's Withholding Allowance Certificate. By decreasing the number of allowances claimed on Form W-4, the amount withheld from each paycheck will increase.

To help taxpayers adjust their withholding using Form W-4, use the withholding calculator at www.irs.gov – keyword: withholding calculator. More information can be found in the Form W-4 Instructions, Publication 17, Your Federal Income Tax for Individuals, Tax Withholding and Estimated Taxes, or in Publication 919, How Do I Adjust My Tax Withholding?

Taxpayers can also use Form W-4 to request an additional dollar amount be withheld. Form W-4 can also be used to decrease the amount of tax withheld. This may be useful for taxpayers who received large refunds due to excessive withholding.

Withholding from pension income is voluntary, not automatic, as it is for wages. As a result, many retirees do not have tax withheld from their retirement payments and are unpleasantly surprised by a balance due at the end of the year. Taxpayers can request withholding from pension and annuity payments by submitting Form W-4P, Withholding Certificate for Pension and Annuity Payments, to the payer.

Withholding can be requested from certain government payments, such as social security and unemployment compensation, by submitting Form W-4V, Voluntary Withholding Request, to the paying agency.

When should the taxpayer make estimated tax payments?

Estimated tax is the amount a taxpayer expects to owe for the tax year after deducting any tax credits or federal withholding. Taxpayers with significant income that is not subject to withholding (such as interest, dividends, capital gains, or self-employment income) will often find they need to make estimated tax payments.

The decision tree in Publication 17, Your Federal Income Tax for Individuals, Tax Withholding and Estimated Taxes can help determine if the taxpayer should make estimated tax payments. See Lesson 28, Payments, for more information.

example

Maria is retired, and her only income is from a pension and some investments. She had no withholding and is not eligible for any tax credits. When you complete her return this year, she has a balance due of \$1,300. Maria should begin making estimated payments, since her balance due next year will be more than \$1,000, and she has no withholding. If Maria does not want to make estimated payments, she could submit Form W-4P to request withholding from her pension instead.

How is estimated tax figured?

Use Form 1040-ES, Estimated Tax for Individuals to compute the amount of estimated tax that should be paid over the year. This form includes worksheets to help the taxpayers estimate their income and tax liability for the year. The current year's tax return can be used as a starting point, but any anticipated changes should also be taken into account. Taxpayers may also have to adjust their payments during the tax year if a change in income or the tax law will affect their tax liability.

Estimated tax payments are due four times a year. If any due date falls on a Saturday, Sunday, or legal holiday, the payment is due the next business day. Each due date covers a specific time period:

For the period:	Due Date:
January 1 through March 31	April 15
April 1 through May 31	June 15
June 1 through August 31	September 15
September 1 through December 31	January 15 next year

Most taxpayers will pay their estimated tax in four equal installments. However, a taxpayer can choose to make payments for each period based on the actual amount of income received during that period. If taxpayers do not pay enough each payment period, they may be charged a penalty even if they are due to receive a refund when the tax return is filed. Generally, the simplest and safest procedure is to make sure that each payment is at least one-fourth of the prior year's total tax, less tax withheld during the period. For more information about estimated tax payments, refer to Publication 17, Tax Withholding and Estimated Taxes, or Publication 505, Tax Withholding and Estimated Tax.

How is estimated tax paid?

Estimated tax payments can be sent electronically to the IRS by direct debit payment from the taxpayers' checking or savings account, by credit card, or by check or money order with Form 1040-ES, Estimated Tax for Individuals. Each voucher is numbered and inscribed with its due date. Remind taxpayers to be sure to use the correct voucher for each payment. Advise taxpayers to write social security numbers and "2012 Form 1040-ES" on the check or money order payable to the "United States Treasury."

For more information, see the Form 1040-ES Instructions.

How do I close the contact?

Before seeing taxpayers off, show as much concern and interest as you did at the start of your time together:

- Ask taxpayers, "Do you have any questions before you leave?"
- Advise taxpayers how to get answers to questions that may come up later.
- Encourage taxpayers to consider volunteering if they seem interested in learning more about tax preparation. Provide them with contact information or take their contact information, depending on your site's procedures.
- Ensure that you have the contact information needed to reach taxpayers in case there are any problems with e-filing the return.
- Thank taxpayers for using the service.

Does the taxpayer have to do anything else?

Give taxpayers a brief explanation of how the e-file process works:

- The Site Coordinator or designee transmits all the e-file returns.
- The Site Coordinator or designee receives an acknowledgment for each successful e-file, or a reject notice if there was a problem with the electronic file. The most common problem is a name or social security number that does not match IRS records.
- If the e-file is rejected, the Site Coordinator or designee needs to contact the taxpayer to resolve the problem.
- If the return is not being e-filed, taxpayers must mail the signed copy of the tax return, along with copy B of all Forms W-2 and any Forms 1099-R with withholding. Taxpayers who are filing a state return may need another copy of the return and Forms W-2. Make sure taxpayers know the correct address for mailing the return(s). Advise taxpayers that the return must be postmarked by the April filing due date.

Summary

Concluding the interview properly ensures that taxpayers have a complete record of the return, understands what will happen next, and knows how to get answers to questions that come up later. If you handle the interview well, it can help taxpayers develop a more positive attitude toward the tax experience, which can foster greater accuracy in returns and timeliness in filing.

You should know how to assemble the tax packet and how to end the interview. The taxpayers should leave with instructions on:

- Which records the site is maintaining
- Which tax records they should maintain
- When (approximately) to expect the refund
- How to avoid having a balance due in the future



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



Lesson 33: Military Finishing and Filing the Return



Introduction

This lesson will help you address special filing concerns of United States service members. To do this you need to determine where and when to file a federal tax return, who qualifies for a deadline extension, and who qualifies for special tax benefits.

Objectives

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

- Identify the special tax filing concerns of members of the Armed Forces
- Describe the extensions to file that are available for members of the Armed Forces
- Determine the effect on taxes of being in a combat zone
- Identify the tax forgiveness provisions related to military or terrorist actions

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 3
- Publication 17
- Publication 525
- Publication 4491-W
- Form 1040
- Form 4868
- Form 8822

Optional:

- Form 1040 Instructions

Where and when should members of the Armed Forces file their returns?

Where should the taxpayer file the return?

Members of the Armed Forces should send their federal returns to the service center for where they currently live. Refer to the Form 1040 Instructions for the appropriate address.

The address may be different depending on if the taxpayer encloses a payment or if the military member is stationed overseas with an APO or FPO address.

TIP

Many military facilities have a Volunteer Income Tax Assistance center that will e-file tax returns.

example

Sergeant Kane, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the service center for Maine.

When should the taxpayer file the return?

Most individual tax returns cover a calendar year, January through December.

Calendar-year taxpayers who live in the United States or Puerto Rico should file their individual tax returns by the April due date of the following year.

Taxpayers who have a balance due can pay by check, money order, electronic funds withdrawal, or credit card.

TIP

If April 15 falls on a weekend or holiday, then the due date is the next business day. For tax year 2011, the due date is April 17, 2012 because of the Emancipation Day holiday.

What action should be taken when a member of the Armed Forces moves?

Taxpayers who changed their mailing address during the year should notify the IRS of the change on Form 8822, *Change of Address*.

Taxpayers who move after filing a tax return should fill out and mail Form 8822 to the IRS service center for the state where their returns were previously filed. The service centers' addresses are listed on page 2 of the form.

TIP

If the postal service does not deliver to the taxpayer's street address and the taxpayer has a post office box, enter the post office box number on the line for the present home address.

Form **8822**
(Rev. January 2012)
Department of the Treasury
Internal Revenue Service

Change of Address
(For Individual, Gift, Estate, or Generation-Skipping Transfer Tax Returns)
Please type or print.
See instructions on back. Do not attach this form to your return.

OMB No. 1545-1163

Part I Complete This Part To Change Your Home Mailing Address

Check all boxes this change affects:

1 Individual income tax returns (Forms 1040, 1040A, 1040EZ, 1040NR, etc.)
If your last return was a joint return and you are now establishing a residence separate from the spouse with whom you filed that return, check here (see instructions)

2 Gift, estate, or generation-skipping transfer tax returns (Forms 706, 709, etc.)



EXERCISE

Answers are after the lesson summary.

Question 1: Tony, who is due a refund, filed his tax return from his home address in Florida on March 12. On March 30 he was transferred to Puerto Rico. Where should Tony submit his Form 8822, Change of Address?

- A. To the IRS service center for Florida
- B. To the IRS service center for Puerto Rico
- C. Either of the above

What do members of the Armed Forces need to know about getting a refund or having an amount of tax owed on their returns?

Members of the Armed Forces who you assist may be entitled to a refund or owe tax. In either case they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This information was covered in Lesson 30, Refund and Amount of Tax Owed. Refer to this lesson to review these options.

What are the extension requirements for taxpayers within the U. S.?

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the U.S. and those who live outside the U.S.

The IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted. The only exception is when the combat zone extension applies.

TIP

See Publication 3, Armed Forces Tax Guide which is a helpful resource for those assisting members of the Armed Forces.

How does a taxpayer get an automatic extension?

Taxpayers living in the United States can receive an automatic six-month extension of time to file their federal tax returns.

To get the automatic extension, taxpayers must file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, by the due date for their tax return (usually April 15). Calendar-year taxpayers who take the extension will have until October 15 to file their tax return.

Taxpayers *cannot* use the automatic six-month extension if they:

- Choose to have the IRS figure their tax or
- Are under a court order to file their returns by the regular due date

TIP

There are three ways to request an automatic extension of time to file a U.S. individual income tax return:

- e-file Form 4868
- Pay all or part of the estimated income tax due using a credit or debit card
- File a paper Form 4868

See Form 4868 for details.

Will the taxpayer owe interest and/or penalties?

Although taxpayers are not required to pay the amount they estimate as due, Form 4868 does not extend the time to pay their taxes. *If taxpayers do not pay the amount due by the regular due date, they will owe interest.*

In addition, taxpayers may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90% of the actual tax owed.

If Form 4868 is filed late, the IRS will inform the taxpayer that the request was denied.

TIP

For more details on penalties, refer to filing information in Publication 17.



EXERCISES (continued)

Question 2: True or False? Interest is charged on the balance remaining after the due date of the return. True False

Question 3: Which of the following calendar-year taxpayers can receive an automatic six-month extension?

- A. Avery, who filed Form 4868 in February and chose to have the IRS figure his taxes
- B. Benton, who filed Form 4868 on April 15 and did not include any tax payments
- C. Calvin, who filed Form 4868 on April 20 and included a tax payment that was over 90% of what he owed
- D. None of the above

How does the taxpayer file the return after obtaining a filing extension?

When the tax return is actually filed, any payment that was submitted with Form 4868 should be entered on the applicable line for amounts paid with extension on Form 1040. This line is located on Form 1040, Payments section, page 2.



Tax Software Hint: For instructions on filing an extension using the tax software, go to the Volunteer Resource Guide (Tab 6), Filing for an Extension Using TaxWise.

What are the extension requirements for taxpayers outside the U.S. and Puerto Rico?

Extension requirements for taxpayers who live outside the United States and Puerto Rico differ from those who live inside the U.S.

Who qualifies for an Automatic Two-Month Extension?

U.S. citizens and resident aliens are allowed an automatic two-month extension to file their return if they are:

- Living outside the U.S. and Puerto Rico on the due date of the return, and their main place of business or assigned post of duty is outside the U.S. and Puerto Rico
- Members of the Armed Forces on duty outside of the U.S. and Puerto Rico on the due date of the tax return

Although calendar-year taxpayers in this situation don't have to file or pay until June 15, they will owe interest charged from the April due date to the date the tax is paid. Form 4868 is not required to obtain this automatic two-month extension to file.

What must taxpayers attach to their return?

Taxpayers using the automatic two-month extension must attach a statement to their return stating that they meet the requirements.

TIP

Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic two-month extension.

What is the extension rule for married taxpayers?

For married taxpayers who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

For married taxpayers who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

How can a taxpayer request an additional extension?

Taxpayers who live outside the U.S. and Puerto Rico and whose main place of business or assigned tour of duty is outside the U.S. and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 15 and checking the box on line 8.

The due date will then be extended to **October 15**.



EXERCISES (continued)

Question 4: Which of the following calendar-year taxpayers has until June 15 to file a tax return? (Select all that apply.)

- A. Weston, who files a joint return with his wife, Sheila. She was stationed in the Philippines from January through May, and they paid their taxes by credit card on April 2.
- B. Lilly, who lives in Mexico from January through April working for a company, returning to her main business in Texas on May 1.
- C. Dwayne, who was stationed in South Korea from July 1, 2011, through January 31, 2012.
- D. None of the above.



EXERCISES (continued)

Question 5: Pvt. Franklin, a U.S. citizen, is a calendar-year taxpayer. What would the due date be for him to file a return if his assigned tour is in Puerto Rico?

- A. April 17
- B. June 15
- D. June 16

How should the IRS be notified about combat zone service?

The IRS works with the Department of Defense to identify taxpayers who are serving in a combat zone, so the IRS may suspend compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may also notify the IRS directly of their status through a special e-mail address: combatzone@irs.gov. They should provide name, stateside address, date of birth, and date of deployment to the combat zone. They should not include any social security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative.

The IRS cannot provide tax account information by e-mail. The IRS will send responses to any questions about the taxpayer's account by regular mail to the address on record for the person, within two business days. The IRS may provide general answers to questions regarding the status of individual combat zone updates via e-mail.

What are the tax options for combat zone participants?

For members of the Armed Forces serving in a combat zone or qualified hazardous duty area, the deadline for filing tax returns, paying taxes, filing claims for refunds, and taking other actions with the IRS is automatically extended.

The deadline for taking action with the IRS is extended 180 days after the later of:

- The last day in a combat zone/qualified hazardous duty area
- The last day of any continuous hospitalization for injury from service in a combat zone or qualified hazardous duty area

In addition to the 180-day extension, the deadline is also extended by the number of days that were left to take the action with the IRS when the taxpayer entered a combat zone (or began performing qualifying service outside the combat zone). If a taxpayer entered the combat zone or qualified hazardous duty area before the period of time to take action began, the deadline is extended by the entire period of the time to take action.

Generally, spouses of individuals who served in a combat zone are entitled to the same deadline extension. There are two exceptions:

- Any tax year beginning more than two years after the date the area ceases to be a combat zone
- Any period the qualifying individual is hospitalized in the U.S. for injuries incurred in a combat zone

In these instances, the extension does not apply to a spouse.

example

Captain Kristina Jones entered a combat zone on December 1, 2009. She remained there through March 31, 2011, when she departed for the U.S. She was not injured and did not return to the combat zone. Her deadlines for filing 2009, 2010, and 2011 returns are:

- 2009 tax return deadline is January 10, 2012. This deadline is extended by 285 days (180 plus 105) after the Captain's last day in the combat zone. The 105 additional days are the number of days in the 3½ month filing period that were left when she entered the combat zone (January 1–April 15, 2010).
- 2010 tax return deadline is January 10, 2012; the deadline is extended by 285 days (180 plus 105).
- 2011 tax return deadline is not extended because the 180-day extension period after March 31, 2011, ends on September 27, 2011 (which is before the start of the next filing period, January 1–April 15, 2012).

Publication 3 will provide additional information for combat zone extension of deadlines.



EXERCISES (continued)

Question 6: If a member of the Armed Forces served in a combat zone from December 30, 2009 through May 31, 2011, and was not injured, the deadline for filing a 2009 tax return would be extended by how many days?



Request Publication 3 if you prepare returns at a military site. There are many special provisions that apply to service personnel and this publication is a valuable reference.

What are other tax options for combat zone participants?

Other situations that count as time served in a combat zone or qualified hazardous duty area are:

- Missing status such as missing in action or prisoner of war time counts as time served
- Support personnel including Red Cross, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces
- Hospitalization outside the U.S. and up to five years of hospitalization in the U.S. as a result of an injury while serving in a combat zone or a contingency operation

When can taxes be deferred?

Reservists called to active duty and enlistees in the Armed Forces might qualify for a deferral of taxes owed if they can show that their ability to pay taxes was affected by their military service. The Servicemembers Civil Relief Act provides this benefit. The act covers active duty members of the military services and commissioned officers of the uniformed services.

What are rules for deferment?

The deferral is not automatic; a taxpayer must apply for it. A taxpayer must have received a notice of tax due, or have an installment agreement with the IRS, before applying for the deferral. When applying, the taxpayer must:

- Be performing military service, and
- Show how the member's ability to pay the income tax has been materially affected by military service

The IRS will review each request and advise the taxpayer in writing of its decision. The service member will then be allowed up to 180 days after termination or release from military service to pay the tax. If the tax is paid in full by the end of the deferral period, no interest or penalty will be charged for that period.

Can other parties assist with a tax return?

If a taxpayer wants a third party designee to discuss a tax return with the IRS, the "Yes" box in the Third Party Designee area of the return must be checked. Also, the taxpayer must provide the designee's name, phone number, and any five numbers the designee chooses as a personal identification number.

Volunteers may not be named as a "Third Party Designee."

The image shows a portion of a tax form with the following fields and options:

You Owe 77	Estimated tax penalty (see instructions)	77
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)?	<input checked="" type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No
	Designee's name ▶	Phone no. ▶
		Personal identification number (PIN) ▶
Sign	Under penalty of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief,	

Form 2848, Power of Attorney and Declaration of Representative, may also be used to grant authority to an individual to represent the taxpayer before the IRS and to receive tax information. If the return is e-filed, a copy of Form 2848 must be attached to Form 8453, U.S. Individual Income Tax Transmittal Form for an IRS e-file Return, and mailed to the IRS.

Use caution when allowing a representative to sign for someone. See Signatures in the Filing Information chapter in Publication 17 for more information.

If it is not possible to obtain a signature for a joint return from a spouse serving in a combat zone, a signed authorization to act on the taxpayer's behalf can be accepted. The IRS also accepts a written statement explaining that the spouse is serving in a combat zone. The statement must be signed by the spouse who is not serving in a combat zone and attached to the return.

What are the tax forgiveness provisions for decedents?

Special tax-forgiveness provisions apply to individuals who die:

- While serving in a combat zone or from wounds, disease, or other injury incurred while serving in a combat zone or
- From wounds or injuries incurred in a terrorist or military action while working for the U.S. government

TIP

Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness.

The forgiveness applies to:

- The tax year death occurred and
- Any earlier tax year in the period beginning with the year before the year in which the wounds or injury occurred

Any forgiven tax liability that has already been paid, will be refunded.

In addition, any unpaid taxes for years ending before the member began service in a combat zone will be forgiven, and any of those taxes that are paid after the date of death will be refunded.

The tax forgiveness provision also applies to those taxpayers serving outside the combat zone if the service:

- Was in direct support of military operations in the zone and
- Qualified the member for special military pay for duty subject to hostile fire, imminent danger, and/or terrorist actions



EXERCISES (continued)

Question 7: Mr. Morris, a civilian employee of the United States, died in 2011 as a result of injuries he suffered during a terrorist attack in 2009. What years are Mr. Morris' income liabilities forgiven?

- A. 2009 through 2010
- B. 2009 through 2011
- C. 2008 through 2011

What are the rules for filing a return for decedents?

The personal representative must file the final income tax return for the year of death and any returns not filed for preceding years. A surviving spouse may have to file the returns for the decedent.

To make a claim, the decedent's representative must file:

- A tax return for each year a tax return has not yet been filed
- Form 1040X for each year an income tax return has already been filed

If an individual died after the tax year, but before the return for that year was filed, the return for the tax year is not the final return; it is a regular return. The return for the year the taxpayer died will be the final tax return.

example

Bob died in February 2011. His 2010 tax return—due on April 18, 2011—is not the final tax return. The final tax return would be the 2011 Form 1040, filed in 2012.

The final tax return is due at the same time the decedent's return would have been due had the death not occurred.



Tax Software Hint: For software entries related to filing a decedent's return, go to the Volunteer Resource Guide (Tab 1), Main Information Sheet (first 2 pages).

For information on signing a joint return if one spouse has died or cannot sign the return, see Publication 17 Index, keyword: Signatures.

Summary

This lesson will help you determine special filing concerns for members of the U.S. Armed Forces.

- Members of the Armed Forces should send their federal returns to the service center for where they currently live.
- Most taxpayers who live in the U.S. or Puerto Rico should file their individual tax returns by April 15, unless that date falls on a weekend or holiday.
- Taxpayers who changed their mailing address should notify the IRS of the change on Form 8822, Change of Address.
- Taxpayers have options for receiving their refund or for paying a balance due. Be sure to review Lesson 30, Refund or Amount of Tax Owed.
- The extension rules vary depending on whether the taxpayer lives in the U.S. or outside the U.S.
- The taxpayer, spouse, authorized agent, or representative can notify the IRS about combat zone service by sending an email to combatzone@irs.gov. Social security numbers should not be included in the email.
- For members of the Armed Forces serving in a combat zone or Qualified Hazardous Duty Area, deadlines for taking action with the IRS are automatically extended until 180 days (plus any time remaining to take action) from the time the member leaves the combat zone/qualified hazardous duty area.
- The income tax liability of a member of the Armed Forces is forgiven if a member dies as a result of service in a combat zone or from a terrorist or military action outside the U.S.
- The terrorist or military action forgiveness also applies to an individual who is a U.S. employee at death and dies from wounds or injuries incurred in a terrorist or military action regardless of where the action occurred.



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: A. Because he already filed his return from his previous address, Tony should submit Form 8822 to the service center for his previous address.

Answer 2: True. If the tax is paid after the regular due date, interest is charged from the regular due date to the date the tax is paid.

Answer 3: B. To get the extension, taxpayers must file Form 4868 by the return's due date. They do not have to pay their tax when submitting Form 4868, but they will owe interest on any tax not paid by the due date.

Answer 4: A. For Weston and Sheila, who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension. In scenario B, Lilly does not qualify for the two-month automatic extension since her main place of business is Texas. In scenario C, Dwayne does not qualify for the automatic two-month extension because he was back in the U.S. on the due date.

Answer 5: A. April 17.

Answer 6: The deadline for filing the 2009 tax return is 180 days plus the number of days remaining for the Armed Forces member to take action after entering the combat zone. The deadline for 2009 is extended 285 days (180 plus 105) after leaving the combat zone, to March 12, 2012. The 105 additional days are the number of days in the 3½ month filing period that were left when the taxpayer entered the combat zone on December 30 (January–April 15, 2010).

Answer 7: C. 2008, 2009, 2010, 2011.



Lesson 34: Amended and Prior Year Returns



Introduction

This lesson will help you determine how to amend a 2011 federal income tax return that was originally prepared at the same VITA/TCE site. In addition, this lesson provides guidance on preparing prior year returns for the previous three years.

If a taxpayer requests your help in filing an amended return, first confirm the original return is within the scope of the VITA/TCE program regarding amendments. Ask the taxpayer what errors they wish to correct, and examine the return carefully to determine if the original return is, in fact, in error. To amend a return, use the latest revision of Form 1040X, Amended U.S. Individual Income Tax Return.

Objectives

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

- Identify when it is appropriate to prepare an amended return, Form 1040X
- Determine the time limits for filing Form 1040X
- Identify how to assemble and submit Form 1040X
- Provide guidance when preparing prior year returns
- Identify when it is appropriate to a file prior year return

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040X
- Form 1040X Instructions

Optional:

- Form 1040 Instructions
- Form 8379

When is an amended return required?

Taxpayers should file amended returns using Form 1040X to correct any errors or omissions on a return they have already filed.

An amended return is not always required when the original return has an error. For example, the IRS will usually correct a math error on a return, or they will write the taxpayer and request a missing schedule or form. In these cases, do not amend the return. If taxpayers receive a notice from the IRS, refer them to the contact person and telephone number on the notice.

File an amended return if taxpayers:

- Received another Form W-2, a corrected Form W-2, or another income statement that was not reported on the original return
- Received an additional Form 1099 (such as unemployment compensation) or a corrected Form 1099 that was not reported on the original return
- Claimed their own personal exemption on the return when someone else was entitled to claim it
- Claimed deductions or credits they should not have claimed
- Did not claim deductions or credits they could have claimed, or
- Should have used a different filing status



If the federal return has to be amended, often the state return must also be amended.

example

Two weeks after Bernard's current-year tax return was filed, he received another Form W-2 in the mail. The volunteer tax preparer reviews Bernard's file to be sure the Form W-2 wasn't included on the original return. The volunteer then helps Bernard prepare Form 1040X to include the additional Form W-2 on the current-year return.



After the due date of the original return, a taxpayer can change from Married Filing Separately to Married Filing Jointly, but cannot change from Married Filing Jointly to Married Filing Separately. However, an executor may be able to make this change for a deceased spouse. Refer to Publication 17 for more information.

Is an amended return needed for injured spouse situations?

When a joint return is filed and only one spouse owes a past due amount such as child support, an education loan, or prior year's taxes, the other spouse who is not obligated for the debt can be considered an "injured spouse." The couple should have filed Form 8379, Injured Spouse Allocation, with their original return. If they did not file Form 8379, and one of them qualifies as an injured spouse, file Form 8379 by itself. Do not attach the form to Form 1040X.

However, if the couple is filing Form 1040X for an additional refund not associated with the original injured spouse claim, and they do not want the injured spouse's portion of the overpayment to be applied to the offset against the spouse, then complete and attach another Form 8379 to Form 1040X. See Publication 17, Form 8379, and Form 1040X Instructions for further information.

How do I start?

To file an amended return, you need a copy of the original return and the information that needs to be changed.

- Begin by researching and verifying the change requested by the taxpayer. Review the intake and interview sheet with the taxpayer **and** use the Volunteer Resource Guide and Publication 17 to make sure that what the taxpayer wants to change is correct.
- Ask probing questions, using the interview techniques and tools discussed in the Screening and Interviewing lesson, to get all the facts before preparing Form 1040X. Ask taxpayers if they have received any correspondence from the IRS making changes to the original return, or if they want to amend the return for another reason. For example, the parents of a college student correctly claimed their child as a dependent. However, their child also filed a return and incorrectly claimed the personal exemption. The child's return was processed first. In this situation, the IRS would adjust the parents' return by removing the exemption for the child. You will need this information to correctly amend the parents' and child's returns.

What is Form 1040X?

Form 1040X is not year-specific. You must specify the year for which the amended return is being prepared.

Form 1040X (Rev. December 2010)	Department of the Treasury—Internal Revenue Service		OMB No. 1545-0074
	Amended U.S. Individual Income Tax Return		
▶ See separate instructions.			
This return is for calendar year <input type="checkbox"/> 2010 <input type="checkbox"/> 2009 <input type="checkbox"/> 2008 <input type="checkbox"/> 2007			
Other year. Enter one: calendar year _____ or fiscal year (month and year ended): _____			
Your first name and middle initial		Your last name	Your social security number
If a joint return, your spouse's first name and middle initial		Your spouse's last name	Your spouse's social security number
Your current home address (number and street). If you have a P.O. box, see page 5 of instructions.		Apt. no.	Your phone number
Your city, town or post office, state, and ZIP code. If you have a foreign address, see page 5 of instructions.			

Those served by the VITA/TCE program are calendar-year taxpayers – they report income received and claim allowable deductions paid from January 1 through December 31. If the original return is on file, the tax software will enter the year for you.

Look at the format of Form 1040X; there are three columns:

- Column A is used to show the **original** or **IRS adjusted figures** from the original return or previous amendment
- Column C is used to show the entries that would have been made on the original return if it had been done correctly
- The differences between the figures in columns A and C are shown in column B (Net change)



Amended returns can be prepared using tax software. However, they cannot be filed electronically. They must be mailed to the IRS.

Part I, Exemptions (on page 2), is filled out only if the taxpayer is increasing or decreasing the:

- Number of exemptions (personal and dependents) claimed on line 6d of the return being amended, or
- Exemption amount for housing individuals displaced by a Midwestern Disaster in 2008 or 2009

Part II, Presidential Election Campaign Fund, is used to make a \$3 donation to the fund for you (or your spouse) if you did not do so on your original return.

Part III, Explanation of Changes, is used to explain specific changes being made on the return and the reasons for each change.

Explanations should be easily understood and clearly point out that the taxpayer qualifies for the change. For example, “taxpayer received another W-2 after they filed original return,” or “taxpayer qualifies to claim child care expenses of \$600 for their 10-year-old dependent child, Form 2441 attached,” or “taxpayer meets the qualifications to file as Head of Household instead of Married Filing Separately.”

What are the time limits on amended returns?

There is a statute of limitations on refunds being claimed on amended returns. In general, if a refund is expected on an amended return, taxpayers must file the return within three years of the due date of the original return, or within two years after the date they paid the tax, whichever is later. Returns filed before the due date (without regard to extensions) are considered filed on the due date.

example

Robert's 2008 tax return was due April 15, 2009. He filed it on March 20, 2009. He amends the 2008 return, expecting the correction to result in a refund. If he gets it postmarked on or before April 17, 2012, (the due date for returns this year) it will be within the three-year limit, and the return will be accepted. But if the amended 2008 return is postmarked after April 17, 2012, it will fall outside the three-year period and he will not receive the refund.

Time periods for claiming a refund are suspended for a period when a taxpayer is “financially disabled.” It is, however, very rare that a taxpayer qualifies for that status. You can read the definition of financial disability in Publication 17, Filing Information chapter.

There are a few exceptions to the three-year limit. For example, a taxpayer has a longer period of time to claim a loss on a bad debt or worthless security, or for a foreign tax credit or deduction. The exceptions are explained in more detail in Publication 17 and the Form 1040X Instructions. If you think the taxpayer may qualify for an exception to the three-year time limit, refer them to a professional tax preparer.

What if taxpayers are due a refund on their amended return?

If the amended return indicates the taxpayer is due a refund, be sure to advise that:

- The taxpayer must wait until the original return is processed.
- The taxpayer can cash the original refund check, if any, while waiting for any additional refund.
- Interest will be paid for a refund on an amended return from the due date or filing date of the original return, whichever is later, to the date the amended return is filed. (This interest will be taxable in the year it is received.)
- Generally, it takes 8-12 weeks to process an amended tax return.

What if the taxpayer owes money on the amended return?

If the amended current year return indicates the taxpayer owes money, file Form 1040X and instruct the taxpayer to pay the amount by the April due date to avoid interest and penalties.

Taxpayers who cannot pay the balance in full by the April due date should file the return on time anyway. Encourage taxpayers to pay as much as they can on time, because the IRS will calculate and bill for interest on the amount of tax owed. Refer to Form 1040X Instructions for more information on payment options.

**TIP**

Refer taxpayers to the Form 1040X Instructions for information they must include on their check or money order.



EXERCISES

Answers are after the lesson summary.

Question 1: John e-filed his 2009 Form 1040 on March 29, 2010. The next year, while preparing his 2010 return, John discovered an error in his 2009 return that resulted in a higher refund. John mailed an amended 2009 return on April 19, 2011. Is this too late to qualify for the refund?

Yes No

Question 2: Brenda discovers an error on her timely-filed 2007 tax return. Correction of this error would result in a refund. She mails an amended return on May 6, 2011. Is this too late for Brenda to claim a refund? Yes No

How do I complete the amended return using tax software?

The scope of preparing amended returns in the VITA/TCE program is limited. Generally, you will prepare amended returns in situations where the original return was prepared at that same volunteer site, using tax software. Remember to follow the interview process and use the research tools to prepare an accurate return.



Tax Software Hint: For software entries, go to Volunteer Resource Guide (Tab 12), Amended Returns, to review the step-by-step procedures for preparing Form 1040X.



The Refund or Amount You Owe section on Form 1040X must be filled out carefully. The original refund is entered on line 17, "Overpayment, if any, as shown on original return." However, if the IRS adjusted the refund, enter that amount instead of the original amount.

How do I assemble and submit Form 1040X?

What should be attached?

Remember, Form 1040X can be prepared using tax software but it cannot be e-filed. Once the amended return is complete, follow these steps to assemble the return for mailing and for the taxpayers' records:

1. Print two copies of the federal amended return from the tax software, and if there is a state return, two copies of that form: one for the taxpayers' records and one to mail.
2. Have the taxpayer (and spouse if Married Filing Jointly) sign and date Form 1040X and the state return.
3. Attach all additional or corrected Form(s) W-2 or Form(s) 1099 that the taxpayers received after filing their original return. Be sure you have included any additional federal income tax withheld in the Payments section of Form 1040X.
4. Attach any forms or schedules needed to explain the changes. Make sure the reason for amending the return is explained on Form 1040X, Part III.



Attach all affected forms and schedules when amending a return, otherwise IRS will send the amended return back to the taxpayer unprocessed.

Explain that normal processing time for an amended return is generally 8-12 weeks. Also tell the taxpayers that, if they owe money and are not paying the balance due by the original due date of the return, the IRS will send a bill that will include any interest or penalty amounts.

Who can prepare prior year returns?

VITA/TCE volunteers with at least two years experience may prepare tax returns for the current year and the previous three years. Volunteers preparing prior year returns must be certified at the Intermediate level or higher. Taxpayers seeking assistance outside the scope of the volunteers' certification should be referred to a professional tax preparer.



VITA/TCE sites are not required to prepare prior year returns.



If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, search www.irs.gov to find the closest IRS Taxpayer Assistance Center that will prepare prior year returns.

What technical resources are required?

If your site chooses to prepare prior year returns, the Site Coordinator should be aware of the requirements. The SPEC relationship managers and www.irs.gov (keyword search: prior year returns) are critical resources for administrative and technical resources.

At a minimum, the following tools are required:

- Prior year tax preparation software.
- Reference material, including Publications 17 and 4012 (available in the tax software) and volunteer quality alerts/volunteer tax alerts (available on www.irs.gov)
- Prior year Intake/Interview and Quality Review Sheets, Form 13614-C, Form 13614, and Form 8158 (available on www.irs.gov). An Intake/Interview and Quality Review Sheet must be completed for every prior year return.

TIP

The Partner and Volunteer Resource Page on www.irs.gov (keyword search: Partner and Volunteer Resource Center) includes hot topics for partners and volunteers.

Prior year tax form instructions and publications are also available on www.irs.gov for reference. If your site does not have the necessary tools to prepare prior year returns, seek guidance from your Site Coordinator.

TIP

The Interactive Tax Assistant (ITA) is an online tool that provides consistent answers to a limited number of current and prior year tax law questions using a probe and response process. ITA is available on www.irs.gov.

How do I file a prior year return?

Only prior year 2010 tax returns can be e-filed. Other prior year returns cannot be electronically filed. Refer taxpayers to the Form 1040 Instructions for the appropriate address to mail their tax return. Also see the information about balance due returns in the Volunteer Resource Guide (Tab 12).

TIP

Taxpayers can also visit the local IRS Taxpayer Assistance Center to hand-deliver their prior year return or payment.

Summary

In the VITA/TCE program, you can help taxpayers prepare an amended tax return for the *current year* using tax software if they filed the original return at the same volunteer site. Use the interview process and research tools to prepare an accurate amended return.

Amended returns should be filed if any of the following were reported incorrectly:

- Filing status
- Total income
- Deductions or credits

Additional notes:

- Amended returns and prior year returns (other than 2010) cannot be e-filed.
- A refund on an amended return cannot be direct deposited; a check is mailed to the taxpayer.
- If you are amending the federal return, you usually have to amend the state return.
- Volunteers certified at the Advanced level or higher and with at least two years of experience may prepare prior year returns.
- If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, search www.irs.gov to find the closest IRS Taxpayer Assistance Center that will prepare prior year returns.

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

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

- Taxpayers who may qualify for an exception to the three-year time limit for filing an amended return



TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem, practice exercise(s), or supplements for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: No, it is not too late. John mailed the amended return within the three-year period allowed for refunds.

Answer 2: Yes, it is too late. The postmark must be three years from the due date of the return (extended to the next business day). The IRS will disallow Brenda's amended return requesting a refund because it was filed more than three years after the due date of the original return.



Appendix A: Taxpayer Vanessa Franklin Intake and Interview Scenario

This scenario is designed to provide you with additional practice to further develop your interview skills, tax law knowledge, and ability to reference resource materials. Vanessa Franklin is our taxpayer who has come to your site. Using the processes taught in lessons throughout this training, you will need to review Vanessa's documents, interview her to clarify issues, and ensure that her intake and interview sheet is thoroughly and accurately completed.

Let's get started! Vanessa provides you her Form 13614-C, Intake/Interview & Quality Review Sheet. Using Vanessa's Form 13614-C, Publication 4012, Form 13614-C Job Aid, your tax law knowledge, and your screening and interview skills, you are ready to begin.

Lesson 2: Screening and Interviewing

Did Vanessa answer all questions on Form 13614-C in Parts I-V?

Start by reviewing Form 13614-C to make sure Vanessa answered all the questions in Section A. Vanessa's completed Form 13614-C is illustrated on page A-31. If a question was missed, ask Vanessa the missed question. If a question was marked "unsure," explain the topic to Vanessa. Determine if the answer is yes or no. Check the appropriate answer on Form 13614-C.

Lesson 3: Filing Basics

Must Vanessa file a return?

To determine if a taxpayer has a filing requirement, you need their age, possible filing status(es), and gross income.

Vanessa's Age and Marital Status

Start by reviewing Parts I and II of her Form 13614-C.

- Proof of identity (such as a valid drivers license or other government issued photo ID).

Part I. Your Personal Information

1. Your First Name Vanessa	M. I. L.	Last Name Franklin	Are you a U.S. Citizen? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
2. Spouse's First Name Harvey	M. I. M.	Last Name Franklin	Is spouse a U.S. Citizen? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
3. Mailing Address 3344 Cleveland Drive	Apt# 4	City Denver	State CO Zip Code 80202
4. Contact Information Phone: 303-555-5555 Cell Phone: n/a E-mail: n/a			
5. Your Date of Birth 11/12/1972	6. Your Job Title Retail Sales	Are you: 7. Legally Blind <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No 8. Totally and Permanently Disabled <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
9. Spouse's Date of Birth 07/14/1969	10. Spouse's Job Title Cook	Is Spouse: 11. Legally Blind <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No 12. Totally and Permanently Disabled <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
13. Can anyone claim you or your spouse on their tax return? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Unsure			

Part II. Marital Status and Household Information

1. As of December 31, 2011, were you?
 Single
 Married: Did you live with your spouse during any part of the last six months of 2011? Yes No
 Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____
 Widowed: Year of spouse's death: _____

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who lived outside of your home that you supported during 2011. If additional space is needed please check here and list on page 3.

Name (first, last) Do not enter your name or spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. daughter, son, mother, sister, none)	Number of months lived in your home in 2011	US Citizen or resident of the US, Canada or Mexico in 2011 (yes/no)	Marital Status as of 12/31/11 (S/M)	Full-time student in 2011 (yes/no)	Received less than \$3700 income in 2011 (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/11	daughter	12	yes	s	no	yes
Zachary Franklin	09/07/00	son	12	yes	s	yes	yes
Zoe Franklin	12/12/06	daughter	12	yes	s	no	yes
Annabelle Johnson	11/15/36	mother	12	yes	s	no	yes

Vanessa's possible filing statuses

On her Form 13614-C, Vanessa indicated that she is married but has not lived with her spouse during any part of the last six months. Using your interview skills and Publication 4012, you will need to verify that Vanessa has identified her correct marital status.

Vanessa's Family and Dependent Information

To also assist in determining Vanessa's possible filing statuses, you need to take a look at her family and dependent information. She has indicated four potential dependents in Part II of her Form 13614-C.

You decide to ask some questions to confirm and clarify her information.

Sample interview clarifying marital status and dependents

SAMPLE INTERVIEW

VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>I've reviewed your Form 13614-C. I want to make sure that you need to file a return based on your filing status, age, and income. So let me verify a few things. You were born on November 12, 1972, correct?</i>	Yes.
<i>Okay, that makes you 39. I see that you checked "Married" but answered "No" to living with your spouse during the past six months.</i>	Yes, Harvey moved out in February 2011.
<i>But you were still married on December 31st of last year, correct?</i>	Yes, that's right.
<i>Do you and your husband plan to file jointly?</i>	I think I want to file Married Filing Separately, but I'm not sure.
<i>And you have three children you may be claiming as dependents, and possibly your mother as a fourth dependent?</i>	Yes, that's right.
<i>Based on this initial information, there are three filing statuses you may qualify for: Married Filing Separately, Head of Household, or Married Filing Jointly, although you expressed that you don't want to use the Married Filing Jointly status.</i>	I'd rather not if I don't have to.

What are Vanessa's most likely filing statuses?

Vanessa may qualify for Married Filing Separately, Head of Household, or Married Filing Jointly.

Vanessa's Gross Income


The next step is to make sure her gross income for the tax year is more than the gross income limit. Review Publication 4012 (Tab A), Who Must File?

Remember, at this point, we're determining if Vanessa has a filing requirement so we will do a general review of her income documentation.

Vanessa's Form W-2

Briefly review Vanessa's Form W-2 and Part III of her Form 13614-C to determine her income for the tax year. Vanessa's W-2 indicates she has wages of \$31,000.

On her Form 13614-C, Vanessa also indicated that she had self-employment income. You confirm this and any other income sources. Refer to the Income section of Publication 4012 (Tab D) for other income sources you should consider.

a Employee's social security number 111-11-5555		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN) 39-9999999		1 Wages, tips, other compensation \$31,000.12	2 Federal income tax withheld \$1,239.99		
c Employer's name, address, and ZIP code Bob's Department Store PO Box 456 Denver, CO 80204		3 Social security wages \$32,000.12	4 Social security tax withheld \$1,344.00		
		5 Medicare wages and tips \$32,000.12	6 Medicare tax withheld \$464.00		
		7 Social security tips	8 Allocated tips		
d Control number		9	10 Dependent care benefits		
e Employee's first name and initial Last name Suff.		11 Nonqualified plans		12a See instructions for box 12 D \$1,000.00	
Vanessa L. Franklin 3344 Cleveland Drive Denver, CO 80202		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input checked="" type="checkbox"/> <input type="checkbox"/>	12b		
		14 Other	12c		

Section A. Please complete – check Yes, No or Unsure to all questions below. Please ask if you need help.

Part III. Income – In 2011, did you (or your spouse) receive:

Yes No Unsure

1. Wages or Salary? (Form W-2) *Wages \$31,000*
2. Tip Income?
3. Scholarships? (Forms W-2, 1098-T)
4. Interest/Dividends from: checking/savings accounts, bonds, CDs, brokerage? (Forms 1099-INT, 1099-DIV)
5. Refund of state/local income taxes? (Form 1099-G)
6. Alimony Income?
7. Self-Employment payments (such as cash received for services, small business)? (Form 1099-MISC)
8. Income (or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Forms 1099-S, 1099-B)
9. Disability Income (such as payments from insurance or workers compensation)? (Forms 1099-R, W-2)
10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R)
11. Unemployment Compensation? (Form 1099-G)
12. Social Security or Railroad Retirement Benefits? (Forms SSA-1099, RRB-1099)
13. Income (or loss) from Rental Property?
14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

Sample interview probing for other income

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Your Form W-2 shows \$31,000 as your wages for the tax year. Tell me about your self-employment income.</i>	I sell cosmetics on the side. I schedule makeup workshops in people's homes in the evenings and on weekends.
<i>How much did you earn doing that?</i>	Not much at all, after I paid my expenses, it was about \$2,400.
<i>Okay. That is close enough for what we are doing now, but we will need the exact amount later. I see that you checked "Unsure" for Alimony Income.</i>	Yes. Once in a while, my husband sends me money for the kids, but I wasn't sure if I was required to report it. Is it taxable?
<i>No. The money your husband sends you for your children is considered child support, not alimony, and is not taxable. So I'm going to change your "Unsure" answer to "No" for Alimony Income.</i>	Great, thank you.
<i>Okay, any other sources of income, for example, bonuses at your job, or any interest reported on a Form 1099?</i>	No, just the wages and business income.
<i>Okay, so your gross income is about \$33,400 based on your W-2 and income from your business.</i>	

Be sure to make notes and corrections on Vanessa's Form 13614-C to capture what she has told you; for example, change the "Unsure" response on the question about Alimony Income to "No" since you have determined that it is child support.

Chart A – For Most People Who File

Review Publication 4012 (Tab A), Chart A – For Most People Who Must File. Find Vanessa's likely filing status(es), age, and income on the chart.

We have now determined Vanessa's age, her possible filing statuses, and have reviewed her preliminary income information. Because she is under 65 years old and her gross income on her Form W-2 exceeds the income limits listed for each of her possible filing statuses, we know that Vanessa has a filing requirement.

Verify Vanessa's Identity

You now need to verify Vanessa's identity. She presents you with her driver's license and the social security cards for all the individuals listed on her Form 13614-C.



Sample interview to verify identity

SAMPLE INTERVIEW

VOLUNTEER SAYS...

By the way, thanks for taking the time to complete Form 13614-C. It looks like we can assist you with your return. I need proof of your identity and your social security card, as well as social security cards for your children and your mother.

Thanks, I'll just confirm your entries. First, is all the information on your driver's license current and correct? We want to make sure you receive all your tax benefits and that your return is processed smoothly.

Okay. Then, let's continue reviewing Form 13614-C.

VANESSA RESPONDS...

No problem! Here's my driver's license. I wrote everyone's name on the intake sheet, just as they appear on the cards.

Yes, I haven't moved since getting that license.

Sounds good.

You have now completed these filing basics:

- Determining if there is a filing requirement
- Verifying the identity of the taxpayer and confirming her social security number



Return to lesson 3.



The name(s) and number(s) on the taxpayer's return must match the information on the social security card(s). If they do not, the return processing will be delayed.

Lesson 4: Filing Status

Which filing status should Vanessa use?

Taxpayer Vanessa Franklin is at your site and you are conducting an interview to verify the accuracy of her completed Form 13614-C. After reviewing Parts I and II, you have determined that Vanessa's correct marital status is "Married" and that she and her husband have not lived together during the last six months of 2011. She has four potential dependents, her three children and her mother. Based on this information, her possible filing statuses are:

- Married Filing Jointly
- Married Filing Separately
- Head of Household

Vanessa does not want to use the Married Filing Jointly status, but if she chooses to file Married Filing Separately, it may result in a higher tax.

To determine if Vanessa qualifies for Head of Household, which may result in a lower tax than Married Filing Separately, you decide to ask some questions based on Publication 4012 (Tab B), Filing Status Interview Tips. You must also complete page 4 of Form 13614-C, Section B. These questions will assist you with determining if Vanessa qualifies to claim Head of Household as her filing status.

Sample Interview Clarifying Filing Status

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>I'm going to ask you a few questions that will help us determine the best filing status for you. First, we determined earlier that you were married at the end of the tax year but did not live with your spouse during the last 6 months. Is this correct?</i>	That's right. We're still married, but we are separated.
<i>Have you obtained a legal separation?</i>	No, I haven't been to a lawyer yet.
<i>And you don't plan to file a joint return with him.</i>	Right. I was thinking of filing separately.
<i>There are other options. For now, let's just assume that you won't file Married Filing Jointly, and I'll ask you a few more questions. I see that you have three children. I see that they lived in your home for the entire tax year, is that correct?</i>	Yes, they lived with me.
<i>Did you pay more than half the cost of keeping up your home last year?</i>	Well, I paid for everything if that's what you mean. I told you that once in a while Harvey sent some money to help with the kids, but it really wasn't all that much.
<i>Okay... Now, I need to clarify the number of months you and your husband actually lived apart. Your intake sheet indicates that he has not lived with you during the last six months of the year, is this correct?</i>	Yes, he moved out in February and we've been apart ever since.
<i>Your children may qualify you for the Head of Household status. In order to qualify, they must be your dependents. It looks like they are, but we will be getting to that in a minute. If you qualify for the Head of Household status, it may result in a lower tax for you than Married Filing Separately.</i>	That sounds good to me!

Vanessa's Filing Status Is Head of Household

Vanessa qualifies as Head of Household because she is legally married, but lived apart from her husband during the last six months of the tax year. She is “considered unmarried for head of household purposes” and at least one of her children must be her dependent to use this filing status.



Return to Lesson 4.

Lesson 5: Personal Exemptions

What personal exemptions can Vanessa claim?

Let's determine if Vanessa can claim any personal exemptions. Remember, even though she is married, she lives apart from her husband and will file as Head of Household and is therefore considered "unmarried." Personal exemptions are allowed for taxpayers and for their spouse only if they meet certain requirements.

First, review Form 13614-C, Part I, Your Personal Information to see if Vanessa can be claimed as a dependent on someone else's tax return.

07/14/1999 COOK 12. Total, including primary caregiver: Yes No Unsure

Part II. Marital Status and Household Information

1. As of December 31, 2011, were you?

Single

Married: Did you live with your spouse during any part of the last six months of 2011? Yes No

Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____

Widowed: Year of spouse's death: _____

Refer to Publication 4012 (Tab C), Interview Tips for Personal Exemptions.

Sample Interview Clarifying Personal Exemptions

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>I see on your intake and interview sheet that no one else can claim you on his or her tax return. Is that correct?</i>	Yes, that's right.
<i>We also determined that you were still legally married on December 31 but will not be filing a joint return. Is that correct?</i>	Yes, it is.
<i>Did your husband work and have income last year?</i>	Yes, he was employed as a cook for most of the year.
<i>Well, since you're not filing a joint return, and because he had income, you cannot claim an exemption for your husband—only for yourself.</i>	



Return to Lesson 5.

Lesson 6: Dependency Exemptions

Which dependency exemptions can Vanessa claim?

Let's determine which dependency exemptions Vanessa can claim. Dependents can be the taxpayer's children or relatives. Begin by reviewing Form 13614-C, Part II, Marital Status and Household Information, item 2. She lists four potential dependents.

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who lived outside of your home that you supported during 2011. If additional space is needed please check here and list on page 3.

Name (first, last) Do not enter your name or spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. daughter, son, mother, sister, none)	Number of months lived in your home in 2011	US Citizen or resident of the US, Canada or Mexico in 2011 (yes/no)	Marital Status as of 12/31/11 (S/M)	Full- time student in 2011 (yes/no)	Received less than \$3700 income in 2011 (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/11	daughter	12	yes	s	no	yes
Zachary Franklin	09/07/00	son	12	yes	s	yes	yes
Zoe Franklin	12/12/06	daughter	12	yes	s	no	yes
Annabelle Johnson	11/15/36	mother	12	yes	s	no	yes

You see that her children are under 12 years of age and her mother is 75 years old. All four lived with Vanessa for 12 months during the tax year and are U.S. citizens. (A baby born any time during the year is considered to have lived with the taxpayer for the entire tax year.)

Are Vanessa's children her dependents?

To determine if her children Bella, Zoe, and Zachary qualify as dependents, use Publication 4012 (Tab C), Interview Tips for Dependency Exemption for Qualifying Child.

Based on Vanessa's answers to the interview tips, you conclude that all three children qualify as her dependents. However, because she and her husband are separated, you need to gather more information.

TIP

When using the interview tips, you may find it helpful to substitute the child's name for the word "person." Ask interview questions individually for each child; as you gain experience with these questions, you will learn to obtain this information for each child at the same time.

Sample Interview Clarifying Dependency Exemptions

The special rules of divorced, separated, or never married parents may apply in this situation.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

It looks like you should be able to claim your children as dependents. Is there a court document or an agreement that you have signed to allow their father to claim them?

VANESSA RESPONDS...

You've got to be kidding. He better not try to claim them.

To help determine if Vanessa's husband (the noncustodial parent) can claim the children as dependents on his tax return, use Publication 4012 (Tab C), Interview Tips for Children of Divorced, Separated Parents, or Parents Who Live Apart.

After completing the interview using the interview tips in Publication 4012, you determine that Vanessa can claim the dependency exemption for all three children on her tax return.

Is Vanessa’s mother her dependent?

Now, determine if Vanessa’s mother is her qualifying relative for a dependency exemption by using the Interview Tips for Dependency Exemption for Qualifying Relative in Publication 4012 (Tab C). This time, substitute Annabelle’s name for “the person.”

Using the interview tips, you learn that, although Vanessa’s mother receives nontaxable social security, her taxable income (from a small pension) is less than the exemption amount (\$3,700 for 2011). Therefore, Vanessa’s mother meets the gross income test.

Next, you need to help Vanessa make a list of each valid expense she paid for her mother during the tax year, and compare the total amount with her mother’s total income for the year. Publication 4012 (Tab C) and the Personal Exemptions and Dependents chapter of Publication 17 provide a worksheet for determining support.

Sample Interview Clarifying Dependency Exemptions for “Qualifying Relative”

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Let’s see if we can add up the monthly expenses that count as support for your mother and figure out if you covered more than half of them, okay?</i>	Yes, I’ve got a list of the expenses here.
<i>All right, for each item we’ll write down the amount you contributed in one column, and the amount your mother contributed in the other column. Let’s start with the fair share rental value of her living in your home...</i>	Okay, my pencil’s ready.

During the interview, you and Vanessa come up with the numbers listed below.

Annabelle’s Monthly Expenses	Provided by Vanessa	Provided by Annabelle
Share of food	\$420	\$0
Clothing	\$0	\$200
Share of rent, utilities	\$680	\$0
Medical, dental	\$0	\$1,200
Education expenses	\$0	\$0
Recreation and transportation	\$800	\$700
Furniture, appliances, automobile	\$0	\$0
Share of support	\$1,900	\$2,100

The numbers show that Vanessa did not cover more than half of her mother’s (Annabelle’s) monthly expenses. Annabelle did *not* pass all five qualifying relative tests, so Vanessa cannot claim an exemption for her mother. Remember to document that Vanessa did not provide more than 50% of her mother’s support on Form 13614-C, Section B: For Certified Volunteer Preparer Completion.

Volunteer Preparer Determinations

Now, you can complete the dependent questions in Section B. Check off the applicable yes/no responses and make annotations as needed.

Based on your interview, Vanessa can claim dependency exemptions for her three children but not for her mother. Vanessa's children are the qualifying children of both Vanessa and her mother, Annabelle. Vanessa is entitled to claim the children, because she is their custodial parent. Annabelle could only claim them if Vanessa chose not to claim them and if Annabelle's AGI was higher than both parents.

Vanessa's husband cannot claim the children on his return because the children don't meet the residency requirement, and he does not meet the tests to claim them as dependents under either the qualifying child or qualifying relative rules. He also does not have a signed Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, divorce decree, or written agreement in effect that would allow him to claim the children.

A copy of the completed Section B of Form 13614-C is at the end of Appendix A. If you have any incorrect entries, use the job aid to determine your mistakes or ask your instructor for assistance.



Return to lesson 6.

Section B. For Certified Volunteer Preparer Completion

Remember: You are the link between the taxpayer's information and a correct tax return. Verify the taxpayer's information on pages 1, 2 & 3 is complete. All questions must be discussed with the taxpayer and all "Unsure" responses should be changed to "Yes" or "No".

Must be completed by Certified Volunteer only if persons are listed in Part II Question 2

Check if persons are listed in Part II Question 2

- Yes No 1. Can anyone else claim any of the persons listed in Part II, Question 2, as a dependent on their return? **If yes, which ones:**
- _____
- _____
- Yes No 2. Were any of the persons listed in Part II, Question 2, totally and permanently disabled? **If yes, which ones:**
- _____
- _____
- Yes No 3. Did any of the persons listed in Part II, Question 2 provide more than 50% of their own support? **If yes, which ones:**
- Annabelle**
- _____
- Yes No 4. Did the taxpayer provide more than half the support for each of the persons in Part II, Question 2? **If yes, which ones:**
- N/A
- _____
- _____
- Yes No 5. Did the taxpayer pay over half the cost of maintaining a home for any of the persons in Part II, Question 2? **If yes, which ones:**
- All individuals listed**
- _____

Lesson 8: Income – Wages, Interest, Etc.; Form 1040, Lines 7-11

What are Vanessa’s sources of income?

Let’s determine Vanessa’s sources of income by reviewing Form 13614-C Part III, Income. Before beginning the interview, review the Income section in Publication 4012 (Tab D) for examples of income sources not listed in Part III that may be mentioned during the interview.

Vanessa answered “Yes” to income from wages and salary, self-employment, and she checked “Unsure” for Alimony Income. In an earlier part of the interview, you learned that what she thought might be alimony was actually child support and is not included as taxable income. To correct Form 13614-C, cross out the unsure box and check “No” to Alimony Income, noting that Vanessa received child support.

Section A. Please complete – check Yes, No or Unsure to all questions below. Please ask if you need help.			
Part III. Income – In 2011, did you (or your spouse) receive:			
Yes	No	Unsure	
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	1. Wages or Salary? (Form W-2) <i>Wages \$31,000</i>
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	2. Tip Income?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	3. Scholarships? (Forms W-2, 1098-T)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Interest/Dividends from: checking/savings accounts, bonds, CDs, brokerage? (Forms 1099-INT, 1099-DIV)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	5. Refund of state/local income taxes? (Form 1099-G)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	6. Alimony Income? <i>Child support income, not alimony</i>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	7. Self-Employment payments (such as cash received for services, small business)? (Form 1099-MISC)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	8. Income (or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Forms 1099-S, 1099-B)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	9. Disability Income (such as payments from insurance or workers compensation)? (Forms 1099-R, W-2)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	11. Unemployment Compensation? (Form 1099-G)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	12. Social Security or Railroad Retirement Benefits? (Forms SSA-1099, RRB-1099)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	13. Income (or loss) from Rental Property?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

Sample Interview Clarifying Income

You ask some probing questions to learn more about her income.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Now that we have determined your filing status and who you can claim as a dependent on your return, let’s talk about your income. Earlier, you told me that you did work last year and were also self-employed. Is that correct?</i>	Yes, I’ve been working for the same store for years and I have my own cosmetics business.
<i>I see, based on your Form W-2, that’s Bob’s Department Store. Did you work for anyone else last year?</i>	No, just myself.
<i>Great! I wish I could work for myself! So, this is your only Form W-2?</i>	Yes.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

VANESSA RESPONDS...

We've identified your total wages as \$31,000.

What about my cosmetics business?

We will account for those earnings later. I see you answered no to receiving tip and scholarship income.

That's right.

Did you have any interest income, such as interest from a checking account, savings account, or certificate of deposit?

No, I went with a couple of free checking accounts that don't pay interest, one for personal use and one for my cosmetics business.

Interest income is reported on Form 1099-INT. Did you receive any of those forms?

No, I'm sure you have everything..

Did you cash in any U.S. savings bonds?

No

Did you receive a state tax refund in 2011?

No.

The volunteer and Vanessa continued reviewing the entries on Vanessa's Form 13614-C, as well as Publication 4012 (Tab D), Tables A and B. Vanessa's responses during the interview did not change any of her answers.

So far you have learned that Vanessa was employed as a sales associate in a retail department store for the entire tax year. You verified all the answers on Form 13614-C, Part III. She stated that she owns a cosmetics business, but you will ask her questions about that when you explore her self-employment income.



Return to Lesson 8.

Lesson 9: Income – Business; Form 1040, Line 12

Can Vanessa file Schedule C-EZ?

On Form 13614-C, Part III, Income, Vanessa answered “Yes” to self-employment income. You learned that this came from her cosmetics business.

Refer to Publication 4012 (Tab 2) to see a facsimile of Schedules C and C-EZ. You should familiarize yourself with the requirements for filing Schedule C-EZ prior to conducting this part of the interview. The requirements can be found in Schedule C-EZ, Part I.

You need to ask additional questions about her business income and expenses to determine if she can report it on Schedule C-EZ.

TIP

Preparation of tax returns with Schedule C are in scope for VITA/TCE under certain limited conditions and with expenses of \$10,000 or less.

Sample interview on the use of Schedule C-EZ

SAMPLE INTERVIEW

VOLUNTEER SAYS...

VANESSA RESPONDS...

Let's talk about your income from your personal cosmetics business.

OK, I have all my stuff right here.

You may be able to file Schedule C-EZ. First, during 2011, what was the total of your business expenses?

\$590. I made a summary of all my income and expenses from my business bank account. This account is purely for my business.

Okay. You use the cash method of accounting. Did you carry any inventory during the year?

No, the only things I have are the samples for parties and individual consultations. When I get an order, I send it through the supplier and the products go directly to the customer or I deliver them personally.

Did you have a loss on the business in 2011?

No. I sold \$2,990 worth of cosmetics last year and my expenses were \$590.

Did you have any employees?

No, I did it all myself.

And you aren't taking any kind of depreciation or amortization on equipment or property owned by the business?

No, I don't have anything like that!

Do you intend to deduct expenses for using your home as your office?

No, not at all.

Have you always been the only person involved in this business?

Yes.

Good. Then we can prepare Schedule C-EZ for you!

Great!

You learned key facts that determined that Vanessa can file Schedule C-EZ. She had self-employment income of \$2,990 and expenses of \$590 from her business. She has met all the requirements for the use of a Schedule C-EZ, which is within the scope of the VITA/TCE program.

Next, you ask probing questions to gather information about business expenses you will enter on Schedule C-EZ.

Sample Interview (continued)

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

VANESSA RESPONDS...

Do you have any Forms 1099-MISC for income from your cosmetics business?

No, all my clients just write me personal checks or pay in cash. But I keep this business account separate from my personal account – it's a lot easier that way!

Good! Does this year-end summary for your business account list all the deposits and expenses for your business?

Yes, it does.

That makes it easy. By the way, do you use your vehicle to conduct your business?

Yes, for parties and deliveries; that sort of thing.

Did you keep track of the mileage that went only for your business?

No.

Well, that is a deductible expense. If you do drive anywhere for the business, try keeping a pad of paper in the car and always record your odometer reading, and document the business purpose of the trip.

I sure will!

Before you continue the interview, be sure to indicate Vanessa's responses to these questions on page 2 of Form 13614-C. In the margins of Part III, item 7, enter "Total income \$2,990, expenses \$590."

Section A. Please complete – check Yes, No or Unsure to all questions below. Please ask if you need help.

Part III. Income – In 2011, did you (or your spouse) receive:

Yes No Unsure

- 1. Wages or Salary? (Form W-2) *Wages \$31,000*
- 2. Tip Income?
- 3. Scholarships? (Forms W-2, 1098-T)
- 4. Interest/Dividends from: checking/savings accounts, bonds, CDs, brokerage? (Forms 1099-INT, 1099-DIV)
- 5. Refund of state/local income taxes? (Form 1099-G)
- 6. Alimony Income? *Child support income, not alimony*
- 7. Self-Employment payments (such as cash received for services, small business)? (Form 1099-MISC)
- 8. Income (or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Forms 1099-S, 1099-B) *Total income \$2,990, expenses \$590*
- 9. Disability Income (such as payments from insurance or workers compensation)? (Forms 1099-R, W-2)
- 10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R)
- 11. Unemployment Compensation? (Form 1099-G)
- 12. Social Security or Railroad Retirement Benefits? (Forms SSA-1099, RRB-1099)
- 13. Income (or loss) from Rental Property?
- 14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

What “other income” must Vanessa report?

Recall that Vanessa only checked “Yes” to wages and self-employment in the Income section of her Form 13614-C. We previously determined that her “Unsure” response for alimony was actually child support. You will still need to verify that she did not receive any other income that must be reported, even though she answered “No” for all other income items. A list of other possible sources of income can be found in Publication 4012 (Tab D), Income section.

You ask additional probing questions to ensure all other responses to income are correct.

Sample Interview Clarifying Other Income

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<p><i>Okay, Vanessa. Even though you only checked “Yes” to Wages and Self-Employment income on your intake and interview sheet, I want to make sure that you did not receive any other form of income during 2011. Here is a list of things that are considered income. Did you receive any of these in 2011? [Volunteer shows Vanessa Table A, Examples of Income, in Publication 4012 (Tab D).]</i></p>	<p>I don't think so. No, I'm sure I didn't.</p>
<p><i>Okay, that finishes up the Income section. Next, we'll discuss any adjustments to your income.</i></p>	

Be sure to record any additional information you gained from the taxpayer's responses, on Form 13614-C, page 4.



Return to Lesson 9.

Lesson 17: Adjustments to Income

Can Vanessa claim any adjustments to her income?

“Adjustments to income” are amounts that Vanessa can subtract from her total income. Before interviewing Vanessa about possible adjustments to her income, you may want to review Publication 17, Adjustments to Income section, and Publication 4012 (Tab E), Adjustments section.

Also, review Vanessa’s Form 13614-C, particularly Part IV, Expenses.

In Part III, Vanessa indicates that she had self-employment income. She can deduct a portion of her self-employment tax as an adjustment to her income. (This adjustment is calculated on Form 1040 Schedule SE and will be covered in Lesson 27, Other Taxes.)

Because Form 13614-C does not list all the possible opportunities for adjustments to her income, you may find it helpful to ask Vanessa about each entry in the Adjusted Gross Income section of Form 1040. At a minimum, you must validate all the responses she gave on her Form 13614-C.

During the interview, Vanessa indicates that she neither paid nor received alimony. You ask her probing questions about possible IRA contributions.

Sample Interview about IRA Contributions

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>I see from box 12 of your W-2 that you put \$1,000 into your 401(k) account. I also see on Form 13614-C that you made a contribution to your traditional IRA account. Is that correct?</i>	Yes, I put \$600 into my IRA.
<i>Okay. When did you make the contribution?</i>	I did it last May, I think. Yes, here’s the statement. I always try to put money into my IRA when I have a little extra cash.
<i>Great. It looks like your income is within the limits, so you can deduct the entire IRA contribution.</i>	Thanks!
<i>Did you ever make IRA contributions that you didn’t deduct?</i>	No, I just have this one account, and I’ve always taken the deduction.
<i>Okay. You have until the due date of the return to make deductible contributions up to a total of \$5,000 and deduct them for this tax year. Are you planning to contribute any more to your IRA account?</i>	I’ll save part of my refund again, but I want to put that toward next year’s deduction.
<i>Sounds like you’ve thought about it and have a plan.</i>	Yes, I have.

Based on your interview and the information Vanessa provided on her Form 13614-C, you have now determined that she will be able to take both an IRA and self-employment tax deduction. The \$1,000 401(k) contribution on her Form W-2 will not result in an adjustment to her income and will be discussed later in Lesson 26, Miscellaneous Credits.



Return to Lesson 17.

Lesson 19: Standard Deduction

Can and should Vanessa take the standard deduction?

As you recall, Vanessa qualifies to file as Head of Household and was employed as a sales associate in a retail department store for the entire tax year. She was also self-employed with her own cosmetics business.

Let's determine if it would be more beneficial for Vanessa to itemize or to take the standard deduction. The deductions section of Publication 4012 (Tab F) contains helpful charts and interview tips for completing this section of the tax return.

Sample Interview Exploring Standard Deduction

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Based on your filing status as Head of Household, your standard deduction is \$8,500.</i>	Should I itemize this year?
<i>Your intake sheet indicates that you did not have any home mortgage payments such as interest or taxes.</i>	That's correct. We currently live in an apartment. I may purchase a home next year.
<i>You also indicated you had medical expenses and charitable contributions last year. Tell me about your medical expenses.</i>	Well, I did have some medical and dental expenses. I have receipts, and the total is about \$585. I also spent about \$1,500 when I delivered Bella.
<i>Did you make any charitable contributions?</i>	I made donations totaling \$200. I have the receipts in this envelope.
<i>So at this point, the total amount of your medical expenses and charitable contributions is \$2,285. It appears that you should probably take the standard deduction. However, just to make sure, let's see if there is anything else you may be able to itemize.</i>	Sounds good to me.

Should Vanessa itemize her deductions?

If a taxpayer's medical expenses, real estate and personal property taxes, home mortgage interest, and charitable contributions exceed the standard deduction amount, probe further using the itemized deductions worksheet in Tab 4 and the interview tips in Tab F of Publication 4012.

At this point in the interview, it does not appear that Vanessa's \$2,285 medical expenses and charitable contributions will exceed her standard deduction amount; it seems more advantageous for Vanessa to take the standard deduction.



Return to Lesson 19.

Lesson 20: Itemized Deductions

Let's determine if Vanessa should itemize her deductions. Vanessa incurred expenses that may increase her deductions. She currently qualifies for the standard deduction of \$8,500 for the tax year.

Vanessa stated that she paid medical and/or dental expenses and donations, so you decided to probe further using Publication 4012 (Tab F), Itemized Deductions Interview Tips.

Sample Interview Clarifying Medical Deductions

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<p><i>Let's see if there are any other medical expenses you may be able to claim. How much did you pay in health-care premiums?</i></p>	<p>Well, I didn't have any health insurance last year, so I had to pay for all our checkups and my kids' allergy medication prescriptions and dental fillings. Here are the receipts I told you I had. If I get health insurance this year, will my payments be deductible on my next tax return?</p>
<p><i>Yes, health insurance premiums are deductible as long as they aren't pre-tax. Let's take a look at your medical and dental expenses. You were right; the total of your receipts comes to \$585. Now, let's see if we can deduct some transportation costs. Can you determine how far you drove for your medical and dental care, and did you have to pay for parking or tolls?</i></p>	<p>All my dental and medical appointments were in the same center. I went every two months. Each round trip was 20 miles, and I have receipts for the six trips I took during the year for a total of 120 miles. I didn't have any tolls or parking fees. Don't forget that I also paid about \$1,500 when I had my daughter Bella.</p>
<p><i>Well, there were two rates in effect for qualified medical travel in 2011. The rate was 19 cents per mile for January 1 through June 30 and 23.5 cents for July 1 through December 31. So, that's \$11.40 for the first half of the year and \$14.10 for the last half for a total of \$25.50.</i></p>	<p>What about the \$1,500 I spent when I had Bella?</p>
<p><i>We'll include that amount as well! That brings your total to \$2,111. However, to claim medical expenses, you will need to have paid more than 7.5% of your adjusted gross income. Since your medical expenses are less than that amount, you cannot get this deduction. Let's see what else you may be able to claim.</i></p>	

Vanessa's Tax Deductions

During the tax year, Vanessa had some state income tax withheld as shown on her Form W-2.

15 State		16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
CO	Employer's state ID number 39-0000000	\$31,000.12	\$257.00			

Form W-2 Wage and Tax Statement **2011** Department of the Treasury—Internal Revenue Service
Copy B—To Be Filed With Employee's FEDERAL Tax Return.
 This information is being furnished to the Internal Revenue Service.

Sample Interview Clarifying State and Local Income Tax Deductions

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>You can claim the state and local income tax. Your Form W-2 shows you had some state income tax withheld, so we'll include that amount as a deduction also.</i>	Excellent!
<i>Did you pay any personal property tax?</i>	No

Sample Interview Clarifying Interest Deductions

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Did you pay any interest?</i>	Just the interest on my credit card. Is that deductible?
<i>I'm sorry, but it isn't.</i>	

Vanessa's Gifts to Charity Deductions

During the tax year, Vanessa gave a total of \$200 in contributions to her church. She gives you a copy of the letter she received from her church. She can claim this deduction.

Based on your findings during the interview, you make the following notes on Vanessa's Form 13614-C, Part IV. By item 5, you write \$2,111 and by item 8, you write \$200.

(Form 13614-C)

<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Unreimbursed employee business expenses (such as teacher supplies, uniforms or mileage)?
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	5. Medical expenses (including health insurance premiums)? \$2,111
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Home mortgage interest? (Form 1098)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Real estate taxes for your home or personal property taxes for your vehicle? (Form 1098)
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	8. Charitable contributions? \$200
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	9. Child/dependent care expenses, such as day-care?

Vanessa's Miscellaneous Expense Deductions

You refer to Publication 17, Publication 4012 (Tab F), and Schedule A to determine if there are any miscellaneous expense deductions that Vanessa can claim. She tells you that she paid her bank \$35 for her safe deposit box. The box was used to store her investment documents, which makes this a deductible expense. Since the \$35 she paid is less than 2% of her AGI, she does not get the deduction for miscellaneous expenses.

Itemized Deductions Summary

Based on your interview with Vanessa and your reference materials, you now know that Vanessa paid medical and dental expenses, state income taxes, and a fee for her safe deposit box. She also contributed money to her church. The total of all her itemized deductions is only \$457, which is less than her standard deduction amount of \$8,500. Vanessa will take the standard deduction.



Return to Lesson 20.

Lesson 22: Credit for Child and Dependent Care

Does Vanessa qualify for the child and dependent care credit?

Vanessa answered yes to paying child/dependent care expenses on her Form 13614-C. Bella, Zoe, and Zachary are Vanessa's three dependent children. Let's determine if Vanessa is eligible for the child and dependent care credit by using the Credit for Child and Dependent Care Expenses Decision Tree in Publication 4012 (Tab G).

Sample Interview Clarifying Child and Dependent Care Credit

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Did you pay for child care during the tax year?</i>	Zach attends a free after-school program. My mom watches Bella all day, and she watches Zoe most of the time; Zoe goes to preschool one day a week.
<i>You may be able to take the credit for child and dependent care expenses. Let me go over a couple of things with you. I already know that your three children qualify as dependents.</i>	Okay.
<i>And I know that you have earned income because you work in a department store. Did you pay for child care so that you could go to this job?</i>	Yes.
<i>And Zoe's day-care provider is not a relative, correct?</i>	The preschool is not. I don't have to pay my mom.
<i>We already know that you are filing as Head of Household, and meet the conditions of "unmarried" for tax purposes. Did you bring the name, address, and tax identification number of the provider with you?</i>	Yes, I did.
<i>What were your child-care expenses for the year?</i>	Well, I pay the preschool \$125 a month, so that would be \$1,500 for the year.
<i>Does your company provide any dependent care benefits?</i>	No.
<i>Well, your expenses definitely qualify. Now all we have to do is figure out the amount of your child and dependent care credit.</i>	Great! Thanks for your help!

Based on your findings during the interview, you make the following note on Vanessa's Form 13614-C. In Part IV, Item 9, you write \$1,500.

(Form 13614-C)

<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Unreimbursed employee business expenses (such as teacher supplies, uniforms or mileage)?
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	5. Medical expenses (including health insurance premiums)? \$2,111
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Home mortgage interest? (Form 1098)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Real estate taxes for your home or personal property taxes for your vehicle? (Form 1098)
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	8. Charitable contributions? \$200
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	9. Child/dependent care expenses, such as day-care? \$1,500



Return to Lesson 22.

Lesson 23: Education Credits

Does Vanessa qualify for any of the education credits?

Vanessa may be able to reduce the amount of tax due if she has education expenses that qualify for the American opportunity or lifetime learning education credits. Review the information in Publication 4012 (Tab G) regarding these credits.

Sample Interview Clarifying Education Credits

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>I see that you checked "Yes" on your intake and interview sheet that you paid educational expenses last year. Since your children are so young, is it safe to assume that they were for you?</i>	Yes, they were. I took one course last fall.
<i>So why did you take the course?</i>	The Employee Assistance Program recommended the course to my boss to improve my job skills.
<i>It sounds like you may be eligible to claim the lifetime learning credit. Do you have a receipt for the tuition payment?</i>	Yes, here are the receipts from City College.
<i>I see \$450 for tuition and \$80 for books. That totals \$530. I just need to ask you a few more questions. Did you receive any funds from an educational assistance program (EAP) from your employer?</i>	Yes, the EAP provided \$100.
<i>Did you make any tax-free withdrawals from a Coverdell educational savings account or another qualified tuition program, or from U.S. savings bonds?</i>	No.
<i>Not counting gifts, bequests, or inheritances, did you receive any other nontaxable payments specifically for educational expenses?</i>	Well, my mom gave me \$100 to help with tuition but nothing else.
<i>The \$100 was a gift, so we don't count it. So, after we subtract the \$100 employer benefit, your total allowable expenses are \$430.</i>	That should help a little.

Based on the interview, Vanessa meets the requirements for the lifetime learning credit. Make a note of your findings on Form 13614-C, page 4.



Return to Lesson 23.

Lesson 25: Child Tax Credit

Is Vanessa eligible for the full child tax credit?

Vanessa's responses on Form 13614-C Part II, Marital Status and Household Information, indicate that her children may qualify for the child tax credit. If she qualifies, the credit reduces her tax liability by up to \$1,000 for each qualifying child.

Using the Child Tax Credit and Additional Child Tax Credit Interview Tips in the Credits section of Publication 4012 (Tab G), you conclude that all three children:

- Are under the age of 17
- Are children of Vanessa
- Are U.S. citizens
- Lived in her home for more than 6 months

Sample interview clarifying the child tax credit

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>You probably qualify for the child tax credit, but let me ask you a few questions just to be sure.</i>	Okay.
<i>Based on you intake and interview sheet, Zachary, Zoe, and Bella are all under age 17, correct?</i>	Yes.
<i>And we know that they are all U.S. citizens.</i>	That's correct.
<i>They also lived with you for the entire year?</i>	Yes.
<i>And we've already established that they did not provide any of their own support.</i>	No, of course not. They're just little kids!
<i>Well, since you are claiming all three of your children as dependents and they meet the status of a qualifying child for the child tax credit, you qualify for this credit.</i>	

Remember, we determined earlier that Vanessa qualifies for the child and dependent care credit and the education credit. If her remaining tax is less than the \$3,000 credit allowed for three qualifying children, she will not be able to take the full child tax credit. However, she may be eligible for the additional child tax credit. Refer to the Additional Child Tax Credit Tip in Publication 4012 (Tab G), Credits section.



Return to Lesson 25.

Lesson 26: Miscellaneous Credits

Does Vanessa qualify for the credit for qualified retirement savings contributions?

Vanessa may be able to reduce her tax liability if she is able to take this credit. On Form 13614-C, Part IV, Expenses, Vanessa answered “Yes” to the question about contributions to a retirement account. She also checked the IRA and 401(k) boxes for this question. Based on her Form W-2, we know Vanessa contributed \$1,000 into her 401(k) plan at work. In a previous interview, she stated that she also put \$600 into her IRA. Be sure to record this information on Form 13614-C, as shown here.

Part IV. Expenses – In 2011 Did you (or your spouse) pay:		
Yes	No	Unsure
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>

1. Alimony: If yes, do you have the recipient's SSN? Yes No

2. Contributions to a retirement account? IRA Roth IRA 401K Other

3. Educational expenses paid for yourself, spouse or dependents, such as tuitions, books, fees, etc.? (Form 1098-T)

4. Unreimbursed employee business expenses (such as teacher supplies, uniforms or mileage)?

5. ... (including health insurance premiums)?

\$600 IRA, \$1,000 on Form W-2

Vanessa’s retirement savings may qualify her for the credit for retirement savings contributions. Review Publication 4012 (Tab G), Retirement Savings Contributions Credit – Decision Tree. You decide to ask Vanessa additional probing questions to determine if she is eligible.

Sample Interview Clarifying the Retirement Savings Contribution

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Since you put money into an IRA and your retirement account at work, let's see if you're eligible for the saver's credit. Your AGI isn't too high. And we know you were born before January 2, 1993.</i>	Yes, that's right.
<i>We know that you can't be claimed as a dependent by someone else. And, even though you did take a class, you were not considered a full-time student.</i>	That's correct.
<i>During 2009, 2010, or 2011, did you take any money out of your IRA account or your 401(k) plan at work, or do you plan to take any distributions before the tax filing deadline?</i>	No. I try to forget all about them. Once you start taking it out, it's too hard to put it back.
<i>You're so right about that. Well, based on your information, you may also be eligible for the saver's credit.</i>	More good news.



Return to Lesson 26.

Lesson 27: Other Taxes

Does Vanessa have any additional taxes?

As you recall, Vanessa has her own cosmetics business and answered “Yes” to self-employment income earlier in the interview process.

Sample Interview Clarifying Additional Taxes

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>We determined earlier that you have your own cosmetics business and have self-employment income. Did you know that self-employment income is subject to social security and Medicare taxes?</i>	No, but that is good to know.
<i>I see that you checked “No” for tip income on your intake and interview sheet, but I still need to verify this information. Do you receive tips at your regular job or as part of your self-employment?</i>	No, not at all.
<i>Okay. Well, let’s move on then!</i>	



Return to Lesson 27.

Lesson 28: Payments

Does Vanessa qualify for any additional credits?

At this point during the interview, you will need to discuss and verify all the items on Vanessa's Form 13614-C that may affect a potential credit or payment she is entitled to receive.

Refer to Publication 4012 (Tab 6), Other Taxes and Payments section, to identify and review the Payments section of the return.

Vanessa checked "No" on Form 13614-C, Part V, item 9, regarding estimated tax payments. Let's see if there are other payments Vanessa made during the year and if she will qualify for any additional credits that will reduce her tax liability. Her Form W-2 reveals her tax withholding.

Sample Interview Clarifying Payments

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Vanessa, based on your intake and interview sheet, you stated that you did not purchase a home in 2011.</i>	Yes, that's correct.
<i>I know you had a little self-employment income, and you did indicate on your intake and interview sheet that you did not make any estimated tax payments, but I still need to verify if this is correct.</i>	Right, again.
<i>Looking at your self-employment income and your last year's return, you probably weren't required to pay any.</i>	That's a relief!
<i>You also have your withholding from your W-2, which will be included in the payments section.</i>	Okay.
<i>We're not finished yet. Bella, Zoe, and Zachary may qualify you for the earned income credit. The EIC may increase your refund or decrease your tax liability.</i>	That's great!



Return to Lesson 28.

Lesson 29: Earned Income Credit (EIC)

Does Vanessa qualify for the EIC?

To determine if Vanessa qualifies for the EIC, you would ask questions based on the EIC General Eligibility Interview Tips found in Publication 4012 (Tab H). You may find it helpful to review these tips before starting the interview.

Sample Interview Clarifying EIC

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Are you familiar with the EIC?</i>	Yes, I got it last year.
<i>I need to ask you two questions. Has your request for the credit ever been denied, or the amount reduced by the IRS?</i>	Let me think. "No" to both questions.
<i>Good! Since you are filing as Head of Household and your income is less than \$43,998, you could qualify for the earned income credit again this year. Let's see. I already checked and you and the kids all have valid social security cards.</i>	That's right.
<i>And you are a U.S. citizen, so you weren't a nonresident alien during the tax year?</i>	No, that's for sure!
<i>Did you have any income from outside the United States?</i>	No, my only income was from my job and my cosmetics sales.
<i>Very good. Now, because the Income section of your intake and interview sheet shows that you didn't have any interest, dividend, or capital gains income, we don't have to worry about your investment income being too high.</i>	Unfortunately not.
<i>And we know that you are not someone else's qualifying child.</i>	Yes.

Based on the interview, we know that Vanessa meets the general eligibility requirements. Next, you need to determine if any of her children are a "qualifying child" for EIC.

Do Vanessa's children qualify her for the EIC?

To determine if Vanessa's children Bella, Zoe, and Zachary are qualifying children for the EIC, you should question her based on the Interview Tips for EIC with a Qualifying Child in Publication 4012 (Tab H).

Sample Interview Clarifying EIC with Qualifying Child Credit

SAMPLE INTERVIEW

VOLUNTEER SAYS...

VANESSA RESPONDS...

Lets see, we already know the kids have valid social security numbers, they are your children and they are under the age of 19.

Yes, that's correct.

And your intake and interview sheet shows that they're single.

Yeah, they're not even dating yet.

They lived with you in the U.S. for the entire year, so they meet the half-year requirement. To claim children for the EIC, they have to meet age and relationship tests, and live with you in the U.S. for more than half the year. We also know that your Mom does not qualify to claim the kids for the EIC because she only had social security and a small pension; no earned income.

That sounds right. I've always been the one to take the kids.

Volunteer Preparer Determination

Based on the interview, Vanessa meets the EIC requirements with qualifying children.



Return to Lesson 29.

Lesson 30: Refund and Amount of Tax Owed

What are Vanessa's options if she receives a refund or has a balance due?

If Vanessa's total payments are more than her total tax, she will receive a refund; if her total payments are less than her total tax, she will owe an amount.

For more information on direct deposit, the split refund option, purchasing savings bonds, and balance due guidance, refer to Pointers for Direct Deposit of Refunds and Balance Due Returns in Publication 4012 (Tab 12).

Before continuing with the interview, review page 3 of Form 13614-C, If you are due a refund or have a balance due.

Sample Interview on Refund Options

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Okay, Vanessa, we are almost finished with the interview. Let's talk about what your options are if you receive a refund.</i>	Okay.
<i>I see on your intake and interview sheet that you would like direct deposit if you receive a refund. You also checked that you would like information about purchasing U.S. savings bonds. Is that correct?</i>	Yes, definitely. I heard something about being able to purchase savings bonds with your refund and thought it might be a good thing. I'd also like part of my refund to go directly into my IRA account. Can I do all of that?
<i>You sure can. The IRS will deposit your refund directly into your account, or as many as three different accounts if you want. You can also request that your refund, or part of it, be used to purchase up to \$5,000 in U.S. Series I Savings Bonds.</i>	That's great. I do try to put money into my IRA every year. This makes it even easier to save because I don't really see it. What about the bonds? My son Zachary has been learning about saving in school. Could I purchase one for him? Then, I could have the rest of my refund deposited into my checking account, right?
<i>Yes, you can purchase bonds for someone other than yourself and add a co-owner or a beneficiary. And, as long as you have the routing number and account numbers for each separate account, we can put some of your refund into your IRA and the rest into your checking account.</i>	I have everything you need right here.
<i>Great.</i>	Thanks so much for explaining everything to me.

If, instead of a refund, Vanessa owed money and could not pay it by the due date of the return, she could pay by credit card, or she could request a payment plan with the IRS. There may be applicable fees, penalties, and interest to consider. Publication 4012 (Tab 12), Balance Due Returns, outlines the options.



Return to Lesson 30.

Section A. You should complete Pages 1-3

Thank you for allowing us to prepare your tax return. You are responsible for the information on your return so please provide complete and accurate information to the certified tax preparer. If you have any questions please ask your preparer.

You will need your:

- Tax information such as Forms W-2, 1099, 1098.
- Social security cards or ITIN letters for you and all persons on your tax return.
- Proof of Identity (such as a valid drivers license or other government issued picture ID).

Part I. Your Personal Information

1. Your First Name Vanessa	M. I. L.	Last Name Franklin	Are you a U.S. Citizen? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
2. Spouse's First Name Harvey	M. I. M.	Last Name Franklin	Is spouse a U.S. Citizen? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
3. Mailing Address 3344 Cleveland Drive	Apt# 4	City Denver	State CO	Zip Code 80202
4. Contact Information Phone: 303-555-5555 Cell Phone: n/a E-mail: n/a				
5. Your Date of Birth 11/12/1972	6. Your Job Title Retail Sales	Are you:	7. Legally Blind	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
			8. Totally and Permanently Disabled	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
9. Spouse's Date of Birth 07/14/1969	10. Spouse's Job Title Cook	Is Spouse:	11. Legally Blind	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
			12. Totally and Permanently Disabled	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
13. Can anyone claim you or your spouse on their tax return? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Unsure				

Part II. Marital Status and Household Information

1. As of December 31, 2011, were you?
 Single
 Married: Did you live with your spouse during any part of the last six months of 2011? Yes No
 Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____
 Widowed: Year of spouse's death: _____

2. List names below of everyone who lived in your home in 2011 (other than you or spouse). Also list anyone who lived outside of your home that you supported during 2011. If additional space is needed please check here and list on page 3.

Name (first, last) Do not enter your name or spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. daughter, son, mother, sister, none)	Number of months lived in your home in 2011	US Citizen or resident of the US, Canada or Mexico in 2011 (yes/no)	Marital Status as of 12/31/11 (S/M)	Full-time student in 2011 (yes/no)	Received less than \$3700 income in 2011 (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/11	daughter	12	yes	s	no	yes
Zachary Franklin	09/07/00	son	12	yes	s	yes	yes
Zoe Franklin	12/12/06	daughter	12	yes	s	no	yes
Annabelle Johnson	11/15/36	mother	12	yes	s	no	yes

- Volunteers assisting with preparing your return are trained to provide high quality service and uphold the highest ethical standards.
- To report unethical behavior to IRS, email us at wi.voltax@irs.gov or call toll free 1-877-330-1205.

To check the status of your REFUND visit "Where's My Refund?" on www.irs.gov or call 1-800-829-1954 for assistance.

Section A. Please complete – check Yes, No or Unsure to all questions below. Please ask if you need help.

Part III. Income – In 2011, did you (or your spouse) receive:

Yes	No	Unsure	
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	1. Wages or Salary? (Form W-2) <i>Wages \$31,000</i>
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	2. Tip Income?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	3. Scholarships? (Forms W-2, 1098-T)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Interest/Dividends from: checking/savings accounts, bonds, CDs, brokerage? (Forms 1099-INT, 1099-DIV)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	5. Refund of state/local income taxes? (Form 1099-G)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	6. Alimony Income? <i>Child support income, not alimony</i>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	7. Self-Employment payments (such as cash received for services, small business)? (Form 1099-MISC)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	8. Income (or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Forms 1099-S, 1099-B) <i>Total income \$2,990, expenses \$590</i>
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	9. Disability Income (such as payments from insurance or workers compensation)? (Forms 1099-R, W-2)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	10. Distributions from Pensions, Annuities, and/or IRA? (Form 1099-R)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	11. Unemployment Compensation? (Form 1099-G)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	12. Social Security or Railroad Retirement Benefits? (Forms SSA-1099, RRB-1099)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	13. Income (or loss) from Rental Property?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

Part IV. Expenses – In 2011 Did you (or your spouse) pay:

Yes	No	Unsure	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	1. Alimony: If yes, do you have the recipient's SSN? <input type="checkbox"/> Yes <input type="checkbox"/> No <i>\$600 IRA, \$1,000 on Form W-2</i>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	2. Contributions to a retirement account? <input type="checkbox"/> IRA <input type="checkbox"/> Roth IRA <input type="checkbox"/> 401K <input type="checkbox"/> Other
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	3. Educational expenses paid for yourself, spouse or dependents, such as tuitions, books, fees, etc.? (Form 1098-T)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Unreimbursed employee business expenses (such as teacher supplies, uniforms or mileage)?
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	5. Medical expenses (including health insurance premiums)? <i>\$2,111</i>
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Home mortgage interest? (Form 1098)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Real estate taxes for your home or personal property taxes for your vehicle? (Form 1098)
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	8. Charitable contributions? <i>\$200</i>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	9. Child/dependent care expenses, such as day-care? <i>\$1,500</i>

Part V. Life Events – In 2011 Did you (or your spouse):

Yes	No	Unsure	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	1. Have a Health Savings Account? (Forms 5498-SA, 1099-SA)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	2. Have debt from a mortgage or credit card canceled/forgiven by a commercial lender? (Form 1099-C)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	3. Buy, sell or have a foreclosure of your home? (Form 1099-A)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Have Earned Income Credit (EIC) disallowed in a prior year? If yes, for which tax year? _____
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	5. Purchase and install energy efficient home items (such as windows, furnace, insulation, etc.)?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Live in an area that was affected by a natural disaster? If yes, where? _____
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Receive the First Time Homebuyers Credit in 2008?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	8. Pay any student loan interest? (Form 1098-E)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	9. Make estimated tax payments or apply last year's refund to your 2011 tax? If so how much? _____
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	10. Attend school as a full time student? (Form 1098-T)
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	11. Adopt a child?
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	12. File a 2010 federal tax return containing a "capital loss carryover" on Form 1040 Schedule D?

Presidential Election Campaign Fund: (If you check a box, your tax or refund will not change.)

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund You Spouse

Catalog Number 52121E

Form **13614-C** (Rev. XX-XXXX)

Additional Information and Questions related to the preparation of your return

Many free tax preparation sites operate by receiving grant money. The data from the following questions may be used by this site to apply for these grants. Your answers will be used only for statistical purposes.

Other than English what language is spoken in the home? _____

Are you or a member of your household considered disabled? Yes No

If you are due a refund or have a balance due:

- Ask your preparer about Direct Deposit. It is the fastest, easiest way to receive your tax refund. An e-filed return means a fast refund. Taxpayers who combine e-file and Direct Deposit can get their refunds in as few as 10 days.
- Ask your preparer about purchasing Series I U.S. Savings Bonds with part or all of your tax refund. Savings bonds are a safe and secure way to invest in the future. Purchase I Bonds for yourself or others in multiples of \$50 and earn interest for up to 30 years.

If you are due a refund, would you like a direct deposit? Yes No

If you are due a refund, would you like information on how to purchase U.S. Savings Bonds? Yes No

If you are due a refund, would you like information on how to split your refund between accounts? Yes No

If you have a balance due, would you like to make a payment directly from your bank account? Yes No

Additional comments:

STOP HERE!

Thank you for completing this form.

Please give this form to the certified volunteer preparer for use in preparing your return.

Your Civil Rights are Protected: It is the Internal Revenue Service's mission to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. Under no circumstances will the Internal Revenue Service tolerate discrimination by its employees, grantees, contractors, and/or subcontractors. NO ONE shall be excluded from participating in, be denied the benefits of, or be subject to discrimination because of race, color, sex, national origin, disability, reprisal, or age in programs or activities funded by the Department of Treasury – Internal Revenue Service. Any person who believes that he/she has been discriminated against on the basis of race, color, sex, national origin, disability, reprisal or age in programs or activities receiving financial assistance (e.g. Low-Income Tax Clinics, Tax Counseling for the Elderly) from the Department of Treasury IRS, may submit a written complaint to: National Headquarters/Office of Equity, Diversity & Inclusion; Internal Revenue Service; Attn: Director, Civil Rights Division (External Civil Rights Team); 1111 Constitution Ave., NW Room 2422; Washington, DC 20224.

Paperwork Reduction Act Notice

The Paperwork Reduction Act requires that the IRS display an OMB control number on all public information requests. The OMB Control Number for this study is 1545-1964. Also, if you have any comments regarding the time estimates associated with this study or suggestion on making this process simpler, please write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, Washington, DC 20224.

Catalog Number 52121E

Form **13614-C** (Rev. xx-xxxx)

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Section B. For Certified Volunteer Preparer Completion

Remember: You are the link between the taxpayer's information and a correct tax return. Verify the taxpayer's information on pages 1, 2 & 3 is complete. All questions must be discussed with the taxpayer and all "Unsure" responses should be changed to "Yes" or "No".

Must be completed by Certified Volunteer only if persons are listed in Part II Question 2

Check if persons are listed in Part II Question 2

- Yes No 1. Can anyone else claim any of the persons listed in Part II, Question 2, as a dependent on their return? **If yes, which ones:**

- Yes No 2. Were any of the persons listed in Part II, Question 2, totally and permanently disabled? **If yes, which ones:**

- Yes No 3. Did any of the persons listed in Part II, Question 2 provide more than 50% of their own support? **If yes, which ones:**
Annabelle

- Yes No
 N/A 4. Did the taxpayer provide more than half the support for each of the persons in Part II, Question 2? **If yes, which ones:**

- Yes No 5. Did the taxpayer pay over half the cost of maintaining a home for any of the persons in Part II, Question 2? **If yes, which ones:**
All individuals listed

Reminders

Use Publication 4012, Volunteer Resource Guide and Publication 17, Your Federal Income Tax in making tax law determinations.

Additional Tax Preparer Notes:

Part II: Cannot claim mother; mother provided more than half of her own support. Husband did not live with her during last 6 months; she qualifies for H of H.
Part III: Unsure checked for alimony. Determined received child support.
Part IV: Contributions to an IRA and 401K; qualifies for Retirement Saver's Credit. Also qualifies for Lifetime Learning Credit, Child and Dependent Care Credit and CTC. Standard Deduction is more advantageous.

Section C. For Certified Quality Reviewer Completion

Confirm each item after reviewing the tax return and verifying that it reflects correct tax law application to the information provided by the taxpayer.

- 1. Sections A & B of this form are complete.
 - 2. Taxpayer's identity, address and phone numbers were verified.
 - 3. Names, SSN or ITINs, and dates of birth of taxpayer, spouse and dependents match the supporting documents.
 - 4. Filing Status is correctly determined.
 - 5. Personal and Dependency Exemptions are entered correctly on the return.
 - 6. All information shown on source documents and noted in Section A, Part III is included on the tax return.
 - 7. Any Adjustments to Income are correctly reported.
 - 8. Standard, Additional or Itemized Deductions are correct.
 - 9. All credits are correctly reported.
 - 10. Withholding shown on Forms W-2, 1099 and Estimated Tax Payments are correctly reported.
- All tax law issues above have been addressed and necessary changes have been made.
- If direct deposit or debit was elected, checking/saving account and routing information match the supporting documents.
- Correct SIDN and EFIN are shown on the return.



Return to Lesson 31.

**A**

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Link & Learn Taxes



Link & Learn Taxes is web-based training designed *specifically* for VITA/TCE volunteers. Each volunteer's ability to prepare complete and accurate returns is vital to the credibility and integrity of the program. Link & Learn Taxes, as part of the complete volunteer training kit, provides the path to achieving this high level of quality service to taxpayers.

Link & Learn Taxes and the printed technical training guide, Publication 4480, work together to help volunteers learn and practice.

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- Access to seven VITA/TCE courses
- Easy identification of the VITA/TCE courses with the course icons
 - As you progress through a lesson, the Basic, Intermediate, Advanced, Military, and International icons will display, depending on your level of certification.
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- The Practice Lab
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 - Lets volunteers complete workbook problems from Publication 4491-W
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FAST, Free Assisted Self-Service Tax Preparation, is a facilitated self-assistance model of tax preparation that allows computer-savvy taxpayers to input their own return at a VITA/TCE site. Certified volunteers act as coaches, assisting taxpayers with questions and helping them with computer issues that may arise. Partners market the program to taxpayers as Free File/VITA/TCE.

For more information contact your Relationship Manager (RM) to see if you should start a FAST site in your community. You may also request Publication 4907 (*Free File for VITA Partners*) for further details.

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