



4491

VITA/TCE Training Guide

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

2010 RETURNS



Take your VITA/TCE training online at www.irs.gov (keyword: Link and Learn Taxes) with online testing, immediate scoring, feedback and more. Gain experience using the Electronic Software Practice Lab!



WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

November 19, 2010

Greetings Everyone!

As we prepare for the 2011 filing season, let me express my sincere appreciation to those of you who are always there when we call. The success of the 2010 filing season and IRS Open Houses are attributable to your unwavering support. Thank you for your hard work and dedication.

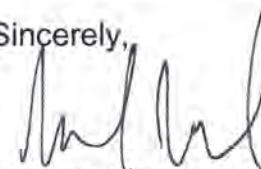
This training package contains the detailed technical guidance and procedural information you will need to provide high quality tax preparation assistance. In addition to two optional e-modules (Cancellation of Debt and Health Savings Accounts), the scope of the types of returns you will be preparing has expanded. Many of the enhancements are based on feedback from our partners, volunteers, and employees.

Your instructor will assist you in selecting the course appropriate for the taxpayers you will be assisting. If you have access to the Internet, you should consider Link & Learn Taxes to supplement your classroom training. The application is accessible from 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 your suggestions for improving your experience and encourage you to embrace the taxpayer's experience by adhering to the standards of conduct in your volunteer agreement. I will ensure my staff considers your comments in future revisions of the materials. Please e-mail your feedback to partner@IRS.gov or mail them 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 make this our best filing season ever!

Sincerely,


Michael Beebe
Acting 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 2010 that was available at the time this publication was approved for print• Publication 4491 is now 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 scope of returns prepared at VITA/TCE sites expanded to include:<ul style="list-style-type: none">- Lesson 9, Schedule C with limitations- Lesson 12, Royalty Income on Schedule K-1s- Lesson 28, Form 5329, Part I, Additional Tax on Early Distributions <p>Note: The following optional modules are available on www.irs.gov, keyword "Link & Learn Taxes," for VITA/TCE tax preparers with Advanced, Military or International certifications:</p> <ul style="list-style-type: none">- Cancellation of Debt for Credit Cards and Mortgages- Health Savings Accounts (HSAs)
Publication 4491-W, Comprehensive Problems & Exercises Workbook	<ul style="list-style-type: none">• Problem and practice exercises that cover new 2010 tax law and changes to what is in scope this year.• If possible, sites should wait to use the tax year 2010 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">• The job aid for using Form 13614-C, Intake/Interview & Quality Review Sheet is revised to include an "unsure" column.• Additional guidance for charts and exhibits revised to reflect tax year 2010 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 2010 values for deductions, exemptions, tax, and credits. To be a certified volunteer, the student must demonstrate competency in 2010 tax law. Only the 2010 version of the software will generate the correct answers for 2010 returns.
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 "Link and Learn Taxes." 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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Form 1040 – Lesson and Curriculum Crosswalk

Certification Level Indicators/Legend



Basic - A



Intermediate - B



Advanced - C



Military - D



International - E



Out of Scope



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1040		Department of the Treasury – Internal Revenue Service		2010	
U.S. Individual Income Tax Return				(99) IRS Use Only – Do not write or staple in this space.	
Label				OMB No. 1545-0074	
Entire Section 3-All		For the year Jan. 1-Dec. 31, 2010, or other tax year beginning _____, 2010, ending _____, 20_____			
Use the IRS label. Otherwise, please print or type.		Your first name and initial _____ Last name _____		Your social security number _____	
H E R E		If a joint return, spouse's first name and initial _____ Last name _____		Spouse's social security number _____	
P r e s i d e n t i a l E l e c t i o n C a m p a i g n		Home address (number and street). If you have a P.O. box, see page 14. _____ Apt. no. _____		Make sure the SSN(s) above and on line 6c are correct.	
F i l i n g S t a t u s		City, town or post office, state, and ZIP code. If you have a foreign address, see page 14. _____		Checking a box below will not change your tax or refund.	
Entire Section 4-All also see lesson 7		Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 14) ► <input type="checkbox"/> You <input type="checkbox"/> Spouse			
E x e m p t i o n s 5, 6, 7-All		1 <input type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ►		4 <input type="checkbox"/> Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ► 5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 16)	
If more than four dependents, see page 17 and check here ► <input type="checkbox"/>		6a <input type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a. b <input type="checkbox"/> Spouse c Dependents: (1) First name _____ Last name _____ (2) Dependent's social security number _____ (3) Dependent's relationship to you _____ (4) <input checked="" type="checkbox"/> If qualifying child for child tax credit (see page 17) <input type="checkbox"/> d Total number of exemptions claimed _____		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 (see page 18) Dependents on 6c not entered above Add numbers on lines above ► <input type="checkbox"/>	
I n c o m e		7 Wages, salaries, tips, etc. Attach Form(s) W-2 8a Taxable interest. Attach Schedule B if required b Tax-exempt interest. Do not include on line 8a 9a Ordinary dividends. Attach Schedule B if required b Qualified dividends (see page 22) 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 23) 11 Alimony received 12 Business income or (loss). Attach Schedule C or C-EZ 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ► <input type="checkbox"/> 14 Other gains or (losses). Attach Form 4797 15a IRA distributions <input type="checkbox"/> 15a 11-B-E b Taxable amount (see page 24) 16a Pensions and annuities <input type="checkbox"/> 16a 11-B-E b Taxable amount (see page 25) 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 18 Farm income or (loss). Attach Schedule F 19 Unemployment compensation (see page 27) 20a Social security benefits <input type="checkbox"/> 20a 14-AII b Taxable amount (see page 27) 21 Other income. List type and amount (see page 29) 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ►		7 8-AII/16-D-E 8a 8-AII 9a 8-AII 10 8-B-E 11 8-B-E 12 9-B-E 13 10-C-E 14 OFS 15b 11-B-E 16b 11-B-E 17 12-C-E 18 OFS 19 13-AII 20b 14-AII 21 15-AII 22	
A d j u s t e d G r o s s I n c o m e		23 RESERVED (see page 29) 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 25 Health savings account deduction. Attach Form 8889 26 Moving expenses. Attach Form 3903 27 One-half of self-employment tax. Attach Schedule SE 28 Self-employed SEP, SIMPLE, and qualified plans 29 Self-employed health insurance deduction (see page 30) 30 Penalty on early withdrawal of savings 31a Alimony paid b Recipient's SSN ► 32 IRA deduction (see page 31) 33 Student loan interest deduction (see page 34) 34 RESERVED (see page 35) 35 Domestic production activities deduction. Attach Form 8903 36 Add lines 23 through 31a and 32 through 35 37 Subtract line 36 from line 22. This is your adjusted gross income ►		23 24 21-D 25 L&LT-C-E 26 18-D 27 17-B-E 28 OFS 29 OFS 30 17-AII 31a 17-B-E 32 17-B-E 33 17-B-E 34 35 OFS 36 37	
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 97. Cat. No. 11320B Form 1040 (2010)					

Form 1040 – Lesson and Curriculum Crosswalk

Certification Level Indicators/Legend



Out of Scope **Link & Learn Taxes**
OFS **L<**

Basic - A

Intermediate - B

Advanced - C

Military - D

International - E

Form 1040 (2010)

Page 2

Tax and Credits	38 Amount from line 37 (adjusted gross income) 39a Check <input type="checkbox"/> You were born before January 2, 1946, <input type="checkbox"/> Blind. Total boxes checked ► 39a if: <input type="checkbox"/> Spouse was born before January 2, 1946, <input type="checkbox"/> Blind. ► 39b b If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ► 39b 40 Itemized deductions (from Schedule A) or your standard deduction (see page 35) 41 Subtract line 40 from line 38 42 Exemptions. Multiply \$3,650 by the number on line 6d. 43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- 44 Tax (see page 37). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 45 Alternative minimum tax (see page 40). Attach Form 6251 46 Add lines 44 and 45 47 Foreign tax credit. Attach Form 1116 if required 48 Credit for child and dependent care expenses. Attach Form 2441 49 Education credits from Form 8863, line 23 50 Retirement savings contributions credit. Attach Form 8880 51 Child tax credit (see page 42) 52 Residential energy credits. Attach Form 5695 53 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/> 54 Add lines 47 through 53. These are your total credits 55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- 	38 19-AII 19-B-E 40 19-AII, 20, 21, 22-B-E 41 42 5-AII 43 44 45 OFS 46
Other Taxes	56 Self-employment tax. Attach Schedule SE 57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 28-AII b <input type="checkbox"/> OFS 58 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required 59 a <input type="checkbox"/> 28-AII -2, box 9 b <input type="checkbox"/> OFS H, line 27 c <input type="checkbox"/> 28-B-E line 16 60 Add lines 55 through 59. This is your total tax	54 55 56 28-B-E 57 58 28-B-E 59 60
Payments	61 Federal income tax withheld from Forms W-2 and 1099 62 2010 estimated tax payments and amount applied from 2009 return 63 Making work pay credit. Attach Schedule M 64a Earned income credit (EIC) b Nontaxable combat pay election 64b 30-AII 65 Additional child tax credit. Attach Form 8812 66 American opportunity credit from Form 8863, line 14 67 First-time homebuyer credit from Form 5405, line 10 68 Amount paid with request for extension to file (see page 72) 69 Excess social security and tier 1 RRTA tax withheld (see page 72) 70 Credit for federal tax on fuels. Attach Form 4136 71 Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> 8839 c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885 72 Add lines 61, 62, 63, 64a, and 65 through 71. These are your total payments	61 29-AII 62 29-AII 63 29-AII 64a 30-AII 65 26-AII 66 24-B-E 67 29-B-E 68 29-AII 69 29-AII 70 71 72
Refund <small>Direct deposit? See page 73 and fill in 74b, 74c, and 74d, or Form 8888.</small>	73 If line 72 is more than line 60, subtract line 60 from line 72. This is the amount you overpaid 74a Amount of line 73 you want refunded to you. If Form 8888 is attached, check here ► <input type="checkbox"/> 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 2011 estimated tax ► 75 31-AII	73 31-AII 74a 31-AII 75 76 31-AII
Amount You Owe	76 Amount you owe. Subtract line 72 from line 60. For details on how to pay, see page 74 77 Estimated tax penalty (see page 74)	77
Third Party Designee Do you want to allow another person to discuss this return with the IRS (see page 75)? <input type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No Designee's name ► 31-AII Phone no. ► Personal identification number (PIN) ► <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
Sign Here <small>Joint return? See page 15. Keep a copy for your records.</small> Your signature ► 31-AII Date Your occupation Daytime phone number Spouse's signature. If a joint return, both must sign. ► Date Spouse's occupation		
Paid Preparer Use Only Print/Type preparer's name 31-33-AII Preparer's signature Date Check <input type="checkbox"/> if self-employed PTIN Firm's name ► Firm's EIN ► Firm's address ► Phone no.		

Form 1040 (2010)



Important Tax Law Changes for 2010



Due Date of Return

The due date for the US Individual Income Tax Return for Tax Year 2010 is April 18, 2011. The due date is April 18, instead of April 15, because of the Emancipation Day holiday in the District of Columbia.

Wage Threshold for Household Employees

The social security and Medicare wage threshold for household employees is \$1,700 for 2010. This means that if a household employee was paid cash wages of less than \$1,700 in 2010, the taxpayer does not have to report and pay social security and Medicare taxes on that employee's 2010 wages.

Loan Repayment Assistance Programs (LRAP)—Health Care Professionals

The Affordable Care Act of 2010 included a change in the law that expands the exception to the general rule of the inclusion of canceled debt in income for amounts received by health professionals under loan repayment and forgiveness programs. Prior to the new law, only amounts received under the National Health Service Corps Loan Repayment Program or certain state loan repayment programs eligible for funding under the Public Health Service Act qualified as an exception.

The Affordable Care Act expands the exception to include any state loan repayment or loan forgiveness programs intended to increase the availability of health care services in underserved areas or health professional shortage areas and makes this exception retroactive to the 2009 tax year.

Health care professionals participating in these programs who reported income from repaid or forgiven loan amounts on their 2009 returns, possibly after receiving a Form W-2, Wage and Tax Statement, or Form 1099, may be due refunds. Those who believe they qualify for this relief may want to consult their state loan program offices to determine whether the program is covered by the new law. Form 1040X, Amended U.S. Individual Income Tax Return, may need to be filed if the payments are eligible loan repayment or forgiveness amounts.

Investment Income of Certain Children

The amount of taxable investment income a child can have without it being subject to tax at the parent's rate remains at \$1,900 for 2010.

Income Limits Increased for Reduction of Education Savings Bond Interest Exclusion

For 2010, the amount of the interest exclusion is phased out for Married Filing Jointly taxpayers or Qualifying Widow(er) taxpayers whose modified AGI is between \$105,100 and \$135,100. If the modified AGI is \$135,100 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 \$70,100 and \$85,100. If the modified AGI is \$85,100 or more, no deduction is allowed.



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

Standard Deduction Amount Increased for Head of Household

The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) has increased for those filing as Head of Household. The standard deduction amounts for all the other filing statuses remain the same for 2010:

- \$11,400 – Married Filing Jointly or Qualifying Widow(er)
- \$8,400 – Head of Household
- \$5,700 – Single or Married Filing Separately

State or Local Sales or Excise Taxes Paid in 2010 for a New Motor Vehicle Purchased in 2009

Some taxpayers who purchased a qualified motor vehicle **after** February 16, 2009, and **before** January 1, 2010, did not have to pay their new motor vehicle taxes until 2010. In these instances, they may be eligible to deduct the amount paid on their 2010 income tax return.

Exemption Amount

The amount each taxpayer can deduct for each exemption remains at \$3,650 for 2010.

Personal Exemption and Itemized Deduction Phaseouts

For 2010, taxpayers with an AGI above a certain amount will not lose part of their deductions for personal exemptions and itemized deductions. Under the current law these phaseouts will resume in 2011.

Economic Recovery Payment (ERP)—Some Individuals May Have Received the ERP of \$250 in 2010

Some individuals may have received a \$250 economic recovery payment in 2010 if they did not receive an economic recovery payment in 2009 but were recipients of social security benefits, supplemental security income, railroad retirement benefits, veterans disability compensation, or pension benefits in November 2008, December 2008, or January 2009.

Any making work pay credit must be reduced for those individuals in 2010.

Earned Income Credit (EIC)

Amount of Credit Increased

For 2010, the maximum credit is:

- \$3,050 with one qualifying child
- \$5,036 with two qualifying children
- \$5,666 with three or more qualifying children
- \$457 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:

- \$35,535 (\$40,545 if Married Filing Jointly) with one qualifying child
- \$40,363 (\$45,373 if Married Filing Jointly) with two qualifying children
- \$43,352 (\$48,362 if Married Filing Jointly) with three or more qualifying children
- \$13,460 (\$18,470 if Married Filing Jointly) with no qualifying child

Investment Income

Taxpayers whose investment income is more than \$3,100 cannot claim the EIC.

Advance Payment of the Credit

Qualifying taxpayers could have received advance EIC payments up to \$1,830 from their employer with their pay in 2010.

Additional Child Tax Credit

For 2010, the minimum amount of earned income needed to claim the additional child tax credit is \$3,000.



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

Social Security and Medicare Taxes

The maximum amount of wages subject to the social security tax for 2010 is \$106,800. There is no limit on the amount of wages subject to the Medicare tax.

Refund Options—Savings Bonds

For tax year 2010, in addition to the three direct deposits, taxpayers can now use their refund to request up to three U.S. Series I Savings Bonds registrations and receive a paper check for the balance of the refund. Taxpayers can make bond purchases for themselves, add beneficiaries or co-owners, and make bond purchases for someone other than themselves. Use Form 8888, Allocation of Refund (Including Bond Purchases), to requests these refund options. For the latest information on purchasing savings bonds with your tax refund, visit www.irs.gov.



If you want your refund deposited to only one account, do not complete Form 8888. Instead, complete the account information in the Refund section of the tax return for a direct deposit.

Medicare Part D Coverage Gap “donut hole” Rebate

The Affordable Care Act of 2010 provides a one-time \$250 rebate in 2010 to assist Medicare Part D recipients who have reached their Medicare drug plan's coverage gap. This payment is not taxable. This payment is not made by the IRS. More information can be found at www.medicare.gov.



Standard Mileage Rate

• Business-Related Mileage

For 2010, the standard mileage rate for the cost of operating a car, van, or pickup/panel truck for business use is 50 cents per mile.

• Medical and Move-Related Mileage

For 2010, the standard mileage rate for the cost of operating a vehicle for medical reasons or as part of a deductible move is 16.5 cents per mile.

• Charitable-Related Mileage

For 2010, 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 2010, 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 \$89,000 but less than \$109,000 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 \$167,000 but less than \$177,000. If the modified AGI is \$177,000 or more, no deduction for contributions to a traditional IRA is allowed.

Deductible Long-Term Care Premium Limits Increased

For 2010, the maximum amount of qualified long-term care premiums includable 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*.

- \$330: age 40 or under
- \$620: age 41 to 50
- \$1,230: age 51 to 60
- \$3,290: age 61 to 70
- \$4,110: age 71 and over



The limit on premiums is for each person.

Charitable Contributions for Haiti Relief

Taxpayers were allowed to deduct certain cash contributions made for the relief of Haiti earthquake victims on their 2009 tax return. The contributions must have been made after January 11, 2010, and before March 1, 2010. If taxpayers took a deduction for these contributions on their 2009 tax return, they can not claim the same deduction in 2010.

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 2010 is \$106,800. All net earnings of at least \$400 are subject to the Medicare part of the tax.

First-Time Homebuyer Credit

Legislation enacted in July 2010 extended the closing deadline from June 30, 2010, to September 30, 2010. Eligible homebuyers who purchased a qualifying home by April 30, 2010, and settle by September 30, 2010, may be eligible for a credit of up to \$8,000. Documentation requirements apply.



Taxpayers who claimed the first-time homebuyer credit for a home bought in 2008, generally must begin repaying it in 2010. The amount must be repaid over a 15-year period. For example, eligible taxpayers who bought a home and claimed the maximum available credit of \$7,500 on their 2008 federal income tax return must begin repaying the credit by including one-fifteenth of this amount, or \$500, as an additional tax on their 2010 return.



Estate Tax and Basis Calculation/Holding Period for Inherited Property

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 repealed the estate tax for decedents dying after December 31, 2009, and before January 1, 2011. Generally, for the estates of **decedents dying after December 31, 2009, and before January 1, 2011**, the basis of assets acquired from the decedent is the lesser of the decedent's adjusted basis (carryover basis) or the fair market value of the property on the date of the decedent's death. In other words, the basis of property acquired from a decedent dying in 2010 is treated as a gift. There are some exceptions to the general rule, where the executor may make some allocations to increase the basis of some property.

In addition, the automatic, more than one year or long term for the holding period does not apply to property inherited in 2010.

Determining the basis of property inherited from a decedent in 2010 is complex and outside the scope of the VITA/TCE Program. If a taxpayer sold property that was inherited in 2010, refer the taxpayer to a professional tax preparer.



Foreign Earned Income and Housing Exclusions

For 2010, the maximum Foreign Earned Income Exclusion increased to \$91,500. The base housing amount increased to \$40.11 per day or \$14,640 for the entire calendar year.



Decrease in Personal Casualty and Theft Loss Limit

Each personal casualty or theft loss is limited to the excess of the loss over \$100 (instead of \$500). This is in addition to the 10% of AGI limit that generally applies to the net loss. These types of losses are outside the scope of the VITA/TCE Program.

Alternative Minimum Tax (AMT) Exemption Amount Decreased

The AMT exemption amount is decreased to \$33,750 (\$45,000 if Married Filing Jointly or a Qualifying Widow[er]; \$22,500 if Married Filing Separately).

Certain Credits Not Allowed Against the AMT

The credit for child and dependent care expenses, credit for the elderly or the disabled, lifetime learning credit, nonbusiness energy property credit, mortgage interest credit, and the District of Columbia first-time homebuyer credit are not allowed against the AMT and a new tax liability limit applies. For most people, this limit is their regular tax minus any tentative minimum tax.

Refundable Adoption Tax Credit

As part of the Affordable Care Act of 2010, the adoption tax credit was extended, increased, and made fully refundable in the year claimed. For 2010, the adoption tax credit may be claimed for qualified expenses up to \$13,170 for both nonspecial and special needs adoptions. The amount of the credit begins to phase out for taxpayers whose modified AGI is more than \$182,520. This credit is outside the scope of the VITA/TCE Program.

Expiring Tax Benefits

The following benefits are expired and are not available for 2010:

- Waiver of Minimum Required Distribution (MRD) rules for IRAs and defined contribution plans. However, the waiver for 2009 MRDs applies through April 1, 2010
- The exclusion of up to \$2,400 in unemployment compensation from income
- Tax-free distributions from certain individual retirement plans for charitable purposes
- Deduction for educator expenses in figuring AGI
- Tuition and fees deduction in figuring AGI
- Extra \$3,000 IRA deduction for employees of bankrupt companies
- Increased standard deduction for real estate taxes or net disaster loss
- Itemized deduction or increased standard deduction for state or local sales or excise taxes on the purchase of a new motor vehicle
- Itemized deduction for state and local general sales taxes
- District of Columbia first-time homebuyer credit homes purchased after 2009
- Government retiree credit
- Decreased estimated tax payments for certain small businesses
- Certain tax benefits for Midwestern disaster areas including the following:
 - Additional exemption amount if you provided housing for a person displaced by the Midwestern storms, tornadoes, or flooding.
 - Increased Hope and lifetime learning credits
 - Special rules for distributions from eligible retirement plans
 - Exclusion from income for certain discharges of nonbusiness debts



At the time this publication went to print, Congress was considering legislation that would increase the AMT exemption amounts and extend some of the expired tax benefits. To find out if legislation was enacted, and for details, 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.

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



Seek feedback from your sponsor about the accuracy rate of the returns completed at your site.

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.

What You'll 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 the return is free from error.

The Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) return preparation process consists of four critical components that will be taught in your training class as follows:

- Screening and interviewing taxpayers, using Form 13614-C, Intake/ Interview & Quality Review Sheet, or an IRS-approved alternative form
- Understanding and applying tax law
- Using references, resources, and tools including return preparation software
- Conducting quality reviews

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

- The testing and certification process gauges how you apply the tax law knowledge you gained during training, your effective use of the technical resources, and the interview process to deliver a complete and accurate return. A minimum score of 80% is required for each course of study. The test is open book.
- The 100% quality review process required for all returns prepared at VITA/TCE sites.
- The random review of returns prepared at selected return preparation sites during the IRS SPEC Quality Statistical Sample (QSS) and Criteria reviews.

What do I need?

- Publication 4491
- Publication 4491-W
- Volunteer Resource Guide
- Publication 17
- Form 6744
- Form 13614-C Intake/ Interview & Quality Review Sheet, or
- Approved Intake/Interview & Quality Review Sheet
- 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)



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.

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 (i.e., Basic, Intermediate, Advanced, Military, or International), 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 "Providing America's taxpayers top-quality service by helping them understand their tax responsibilities and by applying the tax law with integrity and fairness."

Let's get started!



To prepare accurate and error free returns, you must understand the importance of the information that taxpayers provide during the screening and interview process and from their supporting documentation.

How is the course structured?



Caution: 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, your tax preparation software, an instruction booklet (e.g., Form 1040 Instructions), or other publication.

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 nonmilitary taxpayers living outside the United States who are assisted by volunteers working at U.S. Embassies and Consulates or other areas.

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 intake questions from Form 13614-C, Intake/Interview & Quality Review Sheet, or IRS-approved alternative form to screen the taxpayer for eligibility 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 during your interview with the taxpayer to help you prepare a 100% accurate tax return.

- An approved quality review sheet (Form 13614-C, Intake/Interview & Quality Review Sheet; Form 8158, Quality Review Sheet; or IRS-approved, partner-developed check sheet) to verify the quality of all completed returns. Adhering to a quality review process helps ensure high-quality returns at all VITA/TCE program 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.



IRS e-file is a quick and easy alternative to traditional paper returns. Most VITA/TCE volunteer sites are now set up for electronic filing using tax software.

What do I need to get started?

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

- Publication 4491-W, Workbook—Comprehensive Problems & Practice Exercises
- Publication 4012, Volunteer Resource Guide
- Form 6744, Test/Retest

The purpose, changes, and other 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 and interview process using Form 13614-C, Intake/Interview and Quality Review Sheet, can be found in Appendix A, located in the back of this publication. Interview scenarios are provided for our taxpayer, Vanessa Franklin, to help you learn and visualize the complete intake and interview 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 identify specific problems in Publication 4491-W that will allow you to practice the lesson material. Although it might not be possible to work each exercise suggested 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.

What happens after I complete this course?

You will be tested on your understanding of tax law and the guidelines and tools needed to prepare an accurate return. After you have been certified, 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 at least the Basic certification test. After your Basic certification, you can test for Intermediate certification. Once you have achieved both of these certifications, you may test for any or all of the other certifications (i.e., Advanced, Military, and International). A minimum score of 80% is required for each certification test. You may take online tests that are available in the IRS' Link and Learn Taxes e-learning course on www.irs.gov. Online testing is fast and efficient; you will know immediately if you have 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 (Form 6744) may also be available. Talk with your instructor or Site Coordinator for more information on these options.

This year, two optional specialty courses (Cancellation of Debt and Health Savings Accounts) will be available on Link & Learn Taxes only, for volunteers with an Advanced, Military, or International certification.

Check with your Site Coordinator to determine whether 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, among others.

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. If provided, you should bring your Wallet Card to the tax preparation site for identification purposes.



Remember to refer taxpayers with tax situations outside your scope of training and certification to your Site Coordinator and/or a professional tax preparer.

What types of returns can I prepare?

It is important that you assist only with returns, supporting schedules, and forms for which you have been trained and certified. You should only prepare returns that fall within the scope of the VITA/TCE program. 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 Volunteer Resource Guide (Tab 14).

How does the IRS identify volunteer-prepared returns?

Each paper or electronically filed return should be identified with the appropriate site identification number (SIDN) to ensure that all volunteer-prepared returns are readily identifiable by the Internal Revenue Service. Your site's SIDN is an 8-digit number preceded by the "letter S" that must appear in the "Paid Preparer's Use Only" section on all returns you prepare (Form 1040EZ, Form 1040A, and Form 1040)—both paper and electronic. Your Site Coordinator provides this number along with other necessary guidelines for completing the return.

More detailed information can be found in Lesson 32, Quality Review of Tax Return.

Am I legally liable for returns I prepare?

Because they accept payment for preparing a tax return, paid preparers are legally liable under federal law for the returns they prepare. VITA/TCE program volunteers are not considered paid preparers. 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 also 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 on the Internet by typing "Volunteer Protection Act of 1997" into any search engine.

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, Volunteer Agreement, Standards of Conduct, which states that you will adhere to these standards:

- Treat all taxpayers professionally, with courtesy and respect.
- Safeguard the confidentiality of taxpayer information.
- Apply the tax laws equitably and accurately to the best of your ability.
- Only prepare returns within the scope of your training and experience.
- Exercise reasonable care in the use and protection of equipment and supplies.
- Do not solicit business from taxpayers you assist or use knowledge you gained about them for any direct or indirect personal benefit for you or any other individual or organization.
- Do not accept payment from taxpayers for services provided. (Note: You may receive compensation as an employee of a program sponsor.)
- Ensure the returns you prepare follow the Intake/Interview Quality Review process.

Ensure the standards addressing return preparation are followed. These include becoming certified, using the intake and interview process, using reference materials, using the approved quality review process, completing the steps to electronically file tax returns, and adhering to the privacy and confidentiality guidelines.



Identity theft is a growing problem, and you need to do all you can to prevent taxpayer information from ending up in the wrong hands.



Do not solicit or accept payment from taxpayers for services you provide.

How do I maintain the taxpayer's trust?

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.



More information can be found in Publication 4299, Privacy and Confidentiality—A Public Trust.



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 at all about the validity of information provided by a taxpayer, or are uncomfortable with a taxpayer situation, discuss your concern with your Site Coordinator or another individual in charge of the site.

If you or a taxpayer should have a concern or issue regarding the operations of a site, call 1-877-330-1205, or e-mail WI.Voltax@irs.gov.

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 are also available and can be downloaded from www.irs.gov.

You should **not** use this training guide at your tax preparation site. It is designed for training purposes only. Take the Volunteer Resource Guide and Publication 17 with you for use at the site. Electronic versions of these products may also be used in lieu of paper products. Your Site Coordinator should be able to provide access to the following key resources as well:

- Instruction booklets, schedules, and worksheets for Forms 1040EZ, 1040A, and 1040
- Tax information publications that are frequently used at the sites (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
- Volunteer Tax Alerts



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

You may also reinforce your tax law training by viewing online training resources such as Link & Learn Taxes and Understanding Taxes – e-learning courses on www.irs.gov.

There is also a toll-free tax information hotline 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, you can call 1-800-829-8482 (1-800-TAX-VITA). If you call, be sure to identify yourself as a volunteer. **Do not give this phone number to taxpayers.** The volunteer hotline is generally available from February 1 until the filing deadline.

The Debt Indicator will no longer be available on acknowledgment files when submitting electronic returns. Taxpayers can call toll-free Financial Management System (FMS) for inquiries of refund offsets 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?

Many sites use the IRS-sponsored tax preparation software. The tax software assists in preparing returns and also includes a help feature to assist in understanding the application of tax law.

If you are working at a site that uses tax preparation software, you will need to become familiar with the particular software package being used at your site. IRS contracts with a specific software company to provide software for use in the VITA/TCE program.

Since the majority of sites use tax preparation software and is highly encouraged, IRS training materials are geared to the use of tax software in both desktop and online (Internet-based) versions.

Your instructor and/or Site Coordinator will provide you with the information and passwords required for logging into the program for training and/or tax preparation purposes. How to Use the Guide in the Volunteer Resource Guide will provide more information for making a comparison between the desktop and online versions.

Where do I find information about the tax software?

The Volunteer Resource Guide provides general information and helpful hints for using the tax software desktop version under the yellow tabs. Information specific to the online version 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 each taxpayer's supporting documentation (including an IRS-approved intake and interview sheet) supports the entries on the return
- Know your rights and responsibilities and uphold the integrity of the VITA/TCE program
- Prepare returns:
 - that are within the scope of the VITA/TCE program
 - for which you have been certified
- 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

Notes:



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 and Quality Review Sheet, or IRS-approved, partner-developed intake form. Publication 4012, Volunteer Resource Guide, 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 and 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?

- Form 13614-C, Intake/Interview and Quality Review Sheet or
- IRS-approved, partner-developed intake form and
- Publication 4012, Volunteer Resource Guide

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. This process must include the use of Form 13614-C or an IRS-approved, partner-developed intake form. Partner-developed intake sheets must be approved yearly.

Reference materials: Publication 4012, Volunteer Resource Guide; Publication 17, Your Federal Income Tax for Individuals; Volunteer Tax Alerts; or AARP Cyber Tax Messages are required resource tools and are a fundamental piece of the interview process.



Form 13614-C, Intake/Interview & Quality Review Sheet is the IRS version of the form.

What is Form 13614-C, Intake/Interview and Quality Review Sheet or an IRS-approved intake and interview sheet?

Form 13614-C, Intake/Interview and Quality Review Sheet or an IRS-approved intake and interview 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 or an IRS-approved intake and interview sheet for completion. It is important for taxpayers to thoroughly complete pages 1 and 2 of 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 should I do with 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 and/or update the intake and interview sheet if missing information or an error is identified.
- 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 Job Aid is available to assist you and taxpayers with completing Form 13614-C.



The 13614-C Job Aid can be found in the Volunteer Resource Guide and provides line-by-line instructions for using the form.

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.

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>	<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>
<i>Okay. Well I need to ask you a few questions to determine if you or your parents can claim you.</i>	<i>Sure, no problem.</i>
<i>Based on your date of birth, it looks like you are 23 years old. Were you a full-time student last year?</i>	<i>No, I am planning to go back to school in a year or so.</i>
<i>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.</i>	<i>Wonderful. That should help me out a bit.</i>

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

An incorrect answer on the intake and interview form that is not identified could affect a taxpayer's eligibility for a credit or deduction. Further research may be required to determine if the taxpayer qualifies for a credit or deduction.

Publication 4012, Volunteer Resource Guide; Form 13614-C, Job Aid; and Publication 17 are all excellent resource tools.

In addition, the intake and interview sheet, along with the income supporting documents (i.e., Forms W-2, Forms 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 and 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?

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

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.

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.

MS. CLARK RESPONDS...

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

Sure. Here's everything.

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

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

Okay. Well, thanks anyway.



CAUTION

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. Reviewing social security cards, a form/letter from the Social Security Administration, and/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, Volunteer Resource Guide (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 in the "Family and Dependent Information" section located on page one. 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>	<i>Hi, I'm Kerry. I'm doing just fine. How about you?</i>
<i>I'm doing very well. Thanks so much for visiting our site. How did you hear about us?</i>	<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>
<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>	<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>
<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>	<i>Sounds good to me. What do I need to do first?</i>

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...
<p>Okay, Ms. Sterling. Let's go over your <i>intake sheet</i> 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?</p>	I wasn't sure how to answer that question. My marital situation was kind of complicated last year.
<p>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]</p>	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.
<p>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.</p>	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



The introductory information in the Volunteer Resource Guide contains interview steps and suggested actions.

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 tool is available to help me conduct a probing interview?

Publication 4012, Volunteer Resource Guide, 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.

The Volunteer Resource Guide is divided into four major sections—General Information, Tax Law, the Tax Software, and the Tax Software Online.

- General information located in the front section and the covers of the book offer guidance as well as a copy of the Form 13614-C Job Aid.
- 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.

What do I do next?

Based on what you have learned from the taxpayers' IRS-approved intake and interview sheet 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 approved 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 approved 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 IRS or IRS-approved partner-developed tools, make the interview more effective and comfortable for you and the taxpayer. Remember, establishing rapport and educating taxpayers produces 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 or other IRS-approved, intake and interview sheet
- Volunteer Resource Guide
- Section C of Form 13614-C or other IRS-approved, quality review sheet

Helpful interview techniques are:

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



During the screening and interview process, strive to acquire the information needed to prepare 100% accurate returns. Make notes on the approved 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 or label on the return, 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
- Select the correct form to use
- Determine how to file the return
- Tell taxpayers how long they should keep certain records and documents

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Optional:** Publication 552

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 approved intake and interview sheet for the taxpayer's date of birth. Confirm this date during the interview. Refer to the sample approved 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 page 2 of the approved 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, or other income not reported on Form W-2 or Form 1099 and determine each amount. Take a look at Part III on Page 2 of the sample approved intake and interview sheet at the beginning of the Volunteer Resource Guide.



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.



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

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

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

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

Part II. Family and Dependent Information

1. As of December 31, 2010, your marital status was:

- Single
 Married: Did you live with your spouse during any part of the last six months of 2010? Yes No
 Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____
 Widowed: Year of spouse's death: _____

2. List the name of everyone below who lived in your home and outside your home that you supported during 2010.
If additional space is needed please check here and use page 4 for additional information.

Name (first, last) Do not enter your name or Spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Joe Smith	1/01/2003	Son	12	Yes		No	

Check the Taxpayer Information section of the approved 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. Turn there now and review the dollar amounts in Charts A and B.

example

Lucy is 36 years old and single, and her gross income is \$20,000. She must file a tax return and will use the Single filing status since her income is over \$9,350.

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 \$16,000 (which is under \$20,900), 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 the 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
- **Advanced earned income tax credit payment recipients** who have an amount in Form W-2, Box 9
- **Taxpayers who owe Special Taxes**



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



EXERCISES (continued)

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 can file as a Qualifying Widow with Dependent Child. 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 to get money back if they qualify in certain situations. Remember to use the interview techniques and tools discussed in the Screening and Interviewing lesson.

Who should file a federal tax return?

Although some individuals may not be *required* to file, they *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
- The first-time homebuyer credit
- 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.

These items are listed in the Volunteer Resource Guide (Tab A), Chart D—Who Should File.

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 Family and Dependent Information and Life Events sections of the approved 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



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 for these tax credits.

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.

How do I verify taxpayer identity?

To verify a taxpayer's identity, use the interview techniques and tools discussed in the Screening and Interviewing lesson.

What documents do I use to verify 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 approved intake and interview sheet.

- 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 approved 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

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



Identity documents consist of 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.

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)



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

Who has a social security number?

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

Who has an Individual Taxpayer Identification Number?

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

The ITIN contains nine digits and is formatted like an SSN (XXX-XX-XXXX), but begins with the number 9 and has a 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?

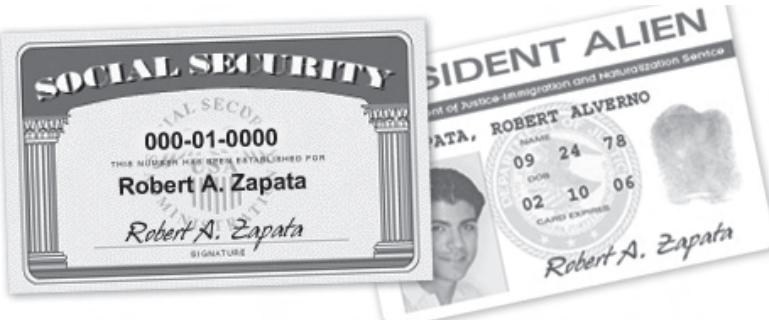
Taxpayers who are in the process of adopting a child and who are able to claim the child as their dependent or are able to claim the child and dependent care credit need an ATIN for their adoptive child.

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 wherever the child's social security number is requested.



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



Taxpayer, spouse, 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:

- An SSA letter
- An ITIN card or letter

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

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



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

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

TIP

If preparing the return on paper, leave the TIN spaces on the return blank and follow the W-7 procedures.

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

SSN or ITIN on the taxpayer's Form W-2 is expected to match the one you entered 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 tax 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 under 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 inputting the Form W-2(s), the mismatched SSN should be entered exactly as shown on the Form W-2 issued by the employer
- 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, turn to 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: If you are e-filing the tax returns, the software is defaulted to Form 1040. You should prepare all returns on Form 1040.

Form 1040EZ

Of all the tax return forms, Form 1040EZ is the simplest. 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.

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 tax year. She plans to itemize her deductions. Cynthia must file Form 1040.

Which tax form do I select?

When filling out a paper tax return, you can refer to the Volunteer Resource Guide (Tab A), Which Form to File table as you interview the taxpayer.



Tax Software Hint: When using tax software, always select Form 1040 from the Main Information Sheet.

TIP

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!



EXERCISES (continued)

Using the Volunteer Resource Guide, answer the following questions.

Question 5: Lenny and Lisa are filing a joint return and have no dependents. Their combined income was \$31,000, which included \$35 in taxable interest and two months of unemployment income for Lisa. They want to take the standard deduction. Which is the simplest form that Lenny and Lisa can use for their tax return?

Question 6: Ray is married, but he and his wife Stella are filing separate returns. Their combined income was \$105,000, but Ray's income was \$64,000, half of which was self-employment income. Ray is claiming only one exemption for himself, and he wants to itemize his deductions. Which is the simplest form that Ray can use for his tax return?

How do I file a return?

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

What is electronic filing?

IRS *e-file* is a quick and easy alternative to traditional paper returns. Most VITA/TCE volunteer sites are now set up for filing electronically using tax software.

Electronic filing is faster and more accurate than traditional paper filing. With *e-filing*, taxpayers receive their refund in half the usual time, and even faster with direct deposit.

TIP

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

How do the two filing procedures compare?

How do I file an IRS e-file return?	How do I file a traditional paper return?
Check the software forms tree for any red marks; review corresponding forms and complete red entries. Run diagnostics and correct errors.	Review all entries and check calculations manually.
The software automatically enters the site identification number in the Paid Preparer section of the return.	Enter the site identification number in the Paid Preparer section.
The software automatically collates and labels all of the return's forms, schedules, and attachments.	Assemble the return with all its properly labeled forms, schedules, and attachments in the correct sequence.
Create the e-file and submit for quality review. If needed, correct errors, re-run diagnostics, and recreate the e-file.	Submit for quality review. Correct errors as needed.
<ul style="list-style-type: none">• Print one copy of the return for the taxpayer.• Print 2 copies of Form 8879, if applicable (one for the taxpayer and one for the volunteer site).• Have the taxpayer sign both copies of Form 8879, if applicable.	Provide two copies of the tax return to the taxpayer. Have the taxpayer sign the return.
Electronically filed returns are transmitted to the correct IRS Processing Center. The taxpayer does not mail anything.	Provide instructions on where and when to send the tax return to the IRS.

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 552, Recordkeeping for Individuals.

How do I answer taxpayers' administrative questions?

The Volunteer Resource Guide and Publication 17 contain the answers to many administrative questions that are 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 a copy of 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 the answers to the taxpayers' inquiries for questions not answered in the Volunteer Resource Guide.



EXERCISES (continued)

Using your reference materials, answer the following question.

Question 7: 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 their web site at 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 from a company 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?

Turn to the chart that lists 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 completing a paper tax return, refer to the Volunteer Resource Guide (Tab A), Which Form to File table.

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

Most VITA/TCE volunteer sites are now set up for filing electronically using tax software. *E-filing* is faster and more accurate than traditional paper filing, and taxpayers receive their refund in 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 552, Recordkeeping for Individuals, for more information.



EXERCISE ANSWERS

Answer 1: Yes, Bob is required to file a return because his gross income was over \$9,350.

Answer 2: No, Janet and Harry are not required to file because their combined gross income was less than \$19,800.

Answer 3: Yes, Juanita must file because her gross income was over \$15,050.

Answer 4: True. To prevent processing delays, you should check the accuracy of each social security number, as well as the spelling of the name associated with the number.

Answer 5: Lenny and Lisa can use Form 1040EZ to file their tax return.

Answer 6: Ray will need to file Form 1040 for two reasons: because he had self-employment income and he is itemizing deductions.

Answer 7: The index in Publication 17 directs us to a paragraph in the chapter on Filing Information.

Notes



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.

Election Campaign ► Check here if you, or your spouse, file jointly, want \$3 to go to this fund (see page 14) ►		<input type="checkbox"/> spouse
Filing Status	1 <input type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) Check only one box. 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ►	4 <input type="checkbox"/> Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ► 5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 16)
Options	6a <input type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a Boxes checked on 6a and 6b	

Reporting of the correct filing status is handled differently, depending on which tax form you use:

- On Form 1040 or Form 1040A, check the box for taxpayer's filing status in the Filing Status section.
- On Form 1040EZ, there is no entry for filing status. Only taxpayers filing as Single or as Married Filing Jointly with no dependents use this form.

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 advantageous (and allowable) filing status 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.

What do I need?

- Approved Intake and Interview Sheet
- 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.

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 the information from the prior year, as it may have changed.

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

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

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?

There are different 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.

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



Avoid selecting a filing status that results in a higher tax for the taxpayer. For example, Single taxpayers with a qualifying person may qualify for Head of Household, which often results in a lower tax. The rules for who is a qualifying person are addressed in the Who is Head of Household? topic.



A citizen or resident alien married to a nonresident alien may be able to file a joint return. More information can be found in the Unique Filing Status and Exemption Situations lesson.

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

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. 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. This topic is beyond the scope of the VITA/TCE Program. Refer taxpayers in this situation to a professional tax preparer. For more information, see Publication 971, Innocent Spouse Relief. This publication can be downloaded from www.irs.gov.



Common law marriage rules are complex and differ from state to state. As a volunteer, it is not your responsibility to determine whether a couple is involved in a common law marriage. If taxpayers are not certain, refer them to a professional tax preparer.

Caution: A citizen or resident alien married to a nonresident alien may be able to file a joint return. More information can be found in the Unique Filing Status and Exemption Situations lesson.

What is Married Filing Separately?

The Married Filing Separately (MFS) status is for taxpayers who qualify as married under the definition provided above, and either:

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

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

Can Married Filing Separately taxpayers qualify for another status?

Some married taxpayers may qualify as 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. Filing as Head of Household 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 the taxpayer paying 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, retirement savings contribution credit, itemized deductions, and the deduction for personal exemptions.

If one spouse filing MFS is itemizing, the other spouse, if filing MFS, must itemize or take a standard deduction of zero.

TIP

The question of who is itemizing only comes into consideration when both taxpayers are filing as Married Filing Separately. If one spouse qualifies to file as Head of Household, the fact that the other one is filing as Married Filing Separately and is itemizing doesn't apply.

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

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

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

If your local 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 current spouse's outstanding prior debt. This includes past due child support, past due student loans, or a tax liability the current spouse incurred when they were not married to each other.

If a taxpayer wants to file separately, ask for the reason to elect this status. If a potential offset is the reason, inform the taxpayer about the possibility of avoiding at least his or her share of the refund offset and attaching Form 8379, Injured Spouse Allocation. See the Publication 17 Index, keyword, "Injured Spouse," for additional information. The Form 8379 instructions are also informative. This form can be e-filed.

Be aware of community property law requirements, which may affect the amount of tax owed by taxpayers living in community property states.

What if a spouse died during the tax year?

Remember, taxpayers whose spouses died during the tax year are considered married to that spouse for the entire year, providing the surviving spouse did not remarry. The surviving spouse is eligible to file as Married Filing Jointly or Married Filing Separately. A taxpayer whose spouse died during the year (even though they were not living together but were still legally married) and has a qualifying child, may also qualify as Head of Household (HOH).

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 HOH, she can choose to file as HOH for the year of her husband's death.

If the surviving spouse has remarried:

- He or she must file either jointly with the new spouse or separately from the new spouse
- 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 in a subsequent section.

Who is Head of Household?

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

- Are unmarried or considered unmarried and are not a qualifying widow(er) with dependent child on the last day of the tax year, and
- Paid more than half the cost of keeping up a home during 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)

For a married taxpayer to be considered unmarried, the taxpayer must also have a child who is claimed as a dependent. If the only reason the taxpayer is not claiming an exemption for the child is because the noncustodial parent can claim the exemption, this requirement is met.

Taxpayers may also choose the Head of Household filing status if they are not married and maintain a home for their parent(s). This home must be the principal place of abode for the parent(s), but it does not have to be the same home as that of the taxpayer. The parent(s) must qualify as the taxpayer's dependent(s).

Who is a qualifying person for Head of Household status?

Turn to the Volunteer Resource Guide (Tab B), Filing Status. Look at the Determination of Filing Status – Decision Tree.

A qualifying person is defined as:

- A qualifying child
- 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, Interview Tips, Table 2: Dependency Exemption for Qualifying Relative, Step 2.



A person may qualify as a "qualifying relative" dependent, but not qualify the taxpayer for Head of Household filing status.

For a married taxpayer, the qualifying person for Head of Household must be the taxpayer's dependent child. The exception is the noncustodial parent rule.

example

Justin is 20 and is not a full-time student in 2010. Justin made only \$4,000 last year and lived with his father, Michael, all year. Michael provided all the cost of keeping up the home and provided more than half of Justin's support as well. Michael cannot be Head of Household because he does not have a qualifying person. Justin does not meet the definition of a qualifying child or a qualifying relative.

example

Shelby is 19 and her only income was \$1,000 in unemployment. Shelby lived with her mom's friend Kate all year. Kate provided all the cost of keeping up the home and provided more than half of Shelby's support. Kate's husband moved out last March, but they are not divorced. Kate can claim Shelby as a dependent because she lived with Katie all year. However, even though she is a dependent, Shelby is *not* a qualifying person for Head of Household because she is not related to Kate.

example

Jane and Todd have one daughter together, Amanda. Jane and her daughter, Amanda, lived together all year in an apartment. Jane and Todd are not married. 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 the cost of Jane's apartment for rent and utilities. He also gave Jane extra money for groceries. Todd does not pay any expenses or support for any other family member. All are U.S. citizens and have valid SSNs. Todd did provide over half the cost of providing a home for Jane and Amanda, but he cannot file Head of Household since Amanda did not live with him over half the year. Jane cannot file HOH either because she does not provide more than one-half the cost of keeping up the home for her daughter, Amanda. See the Volunteer Resource Guide (Tab B), Filing Status for Head of Household.



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 2010. From March through July 2010, 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 2010?

Yes No

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

When you get to Step 7 of the Filing Status Interview Tips in the Volunteer Resource Guide, be sure to refer to the definitions of a qualifying person in this subtopic if you have any questions.

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. No one can claim Mary Ann as a dependent on his or her return. Joan falls under the definition of a "qualifying relative" and Mary Ann can claim Joan as a dependent on her return.

However, Joan would not qualify Mary Ann for Head of Household purposes, because she does not fall under the "other relative" definition stated in the Volunteer Resource Guide (Tab B), Filing Status.

For Head of Household, a qualifying child does not have to be a dependent of the taxpayer, unless the qualifying person is married.

If the child is not the taxpayer's dependent, enter the qualifying child's name on Form 1040A or Form 1040, line 4. Only enter one child's name.

TIP

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



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

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.

Can married taxpayers ever file as Head of Household?

Married taxpayers may be considered unmarried and file as Head of Household if they meet the tests for married persons living apart with dependent children. Taxpayers are considered unmarried and can file as Head of Household if they:

- File a return, separate from their spouse, for the tax year. If a joint return has been filed, the filing status cannot be changed if the due date of the return has passed.
- Have 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, under Head of Household.
- Have 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.
- Have provided the main home of a dependent child, stepchild, adopted child, or foster child placed by an authorized agency for more than half the year. This test is met if the taxpayer cannot claim the exemption only because the noncustodial parent can claim the child using the rules described under Qualifying Child or Qualifying Relative in Publication 17, Filing Status.

Taxpayers who are divorced or legally separated under a separate maintenance agreement are considered single. They can file as Single, or they might qualify for Head of Household. They would have to meet the same rules as a single person would for Head of Household.

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

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

A taxpayer, whose spouse died in one of the two tax years prior to 2010 and who has one or more dependent children, may claim the Qualifying Widow(er) with Dependent Child status. To qualify, the taxpayer must:

- Be entitled to file a joint return for the year the spouse died, regardless of whether the taxpayer actually filed a joint return that year.
- Have had a spouse who died in 2008 or 2009. The taxpayer must not have remarried before the end of 2010.
- Have a child, stepchild, or adopted child who qualifies as the taxpayer's dependent for the year.
- Have furnished over half the cost of keeping up a home for him- or herself and the qualifying child for the entire year, except for temporary absences.

TIP

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

In the year a taxpayer's spouse dies, if the taxpayer does not remarry, the Married Filing Jointly filing status can be used with the deceased spouse.

Taxpayers may be able to use the Qualifying Widow(er) with Dependent Child filing status for two years following the year of death, provided they do not remarry.

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 has not remarried.



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 and the Determination of Filing Status flow chart in the Volunteer Resource Guide (Tab B). Then enter the filing status on the approved intake and interview sheet.



EXERCISES (continued)

Check your understanding of each filing status. Feel free to review the lesson if you are not sure of an answer and use the Volunteer Resource Guide (Tab B). The answers are at the end of the lesson.

Question 2: Jane's husband died in 2010. She and her husband qualified to file a joint return in 2009, 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 2008. He filed a joint return for that year as the surviving spouse. In 2010, Sydney, who has not remarried, still maintains a home for his young children all year, and he provides their sole support. What filing status(es) can he use?

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

Question 6: An earlier question referred to Sydney, whose wife died in January 2008. He filed a joint return for that year as the surviving spouse. In 2010, Sydney, who did not remarry, maintained a home for his young children, and he provided their sole support. We determined that he could file as Single, Head of Household, or Qualifying Widow(er) with Dependent Child. Go back to the interview tips and use them to identify the recommended filing status for Sydney. Outline the answers to the interview steps. What filing status should he 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, as listed on the return. They are:

- 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 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.



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.

Because she was widowed in 2010 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 Children 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 2009, 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 and has no dependents living in his household, nor does he have dependent parents, Seth can only file as Single.

Answer 4: Because she is legally divorced, Tanya can file as Single. However because she has children, she may be able to file as Head of Household, which may result in a lower tax.

Answer 5: Sydney can file as Single, but he also meets the test for Head of Household and Qualifying Widow(er) with Dependent Child. Qualifying Widow(er) with Dependent Child will likely give him the lowest tax.

Answer 6: The interview tips say that he should use the Qualifying Widow(er) with Dependent Child status. The interview steps are:

- Step 1: No
- Step 5: Yes
- Step 6: Yes



Lesson 5: Personal Exemptions

Introduction

This is the first of two lessons covering the Exemption section of the tax return. Identifying and entering the correct number of exemptions is a critical component of completing the taxpayer's return, because each allowable exemption reduces their taxable income.

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

box.	and full name here ►				5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 16)
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:	(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	* lived with you * did not live with you due to divorce or separation (see page 18)
If more than four dependents, see page 17 and check here ► <input type="checkbox"/>					
d Total number of exemptions claimed				Dependents on 6c not entered above	
				Add numbers on lines above ► <input type="checkbox"/>	

Objectives

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

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

What do I need?

- Approved Intake and Interview Sheet
- 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 determine the personal exemptions that a taxpayer can claim, use the interview techniques and tools discussed in the Interview lesson. See the Volunteer Resource Guide (Tab C) for the Interview Tips referenced in this lesson. They can provide helpful probing questions.

To claim a personal exemption, the taxpayer must be able to answer "no" to the intake question, "Can your parents or someone else 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

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



Always use the Interview Tips in the Volunteer Resource Guide (Tab C) to determine the number of exemptions each taxpayer can claim.



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



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.

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

The Interview Tips for Personal Exemptions can help determine whether the taxpayer can claim any personal exemptions. Take a look at the Interview Tips in the Volunteer Resource Guide (Tab C). While you interview the taxpayer, use these questions as a guide to help you get the information you need from the taxpayer.

How do I enter the personal exemptions?

When filing a paper return, check the appropriate boxes and enter the number of exemptions claimed on Form 1040, line 6, or Form 1040A, line 6.

When filing a paper return for a taxpayer claiming both Head of Household filing status and an exemption for a nonresident alien spouse, check the box on line 6b and enter the spouse's first name, last name, and SSN or ITIN.



Tax Software Hint: The tax software will auto-fill the entries for lines 6a and 6b as well as for "Number of boxes checked on 6a and 6b" once the names and applicable filing status is selected. The software automatically checks the exemption box for the taxpayer and for their spouse, if Married Filing Jointly status is selected. Review the Main Information screen in the Volunteer Resource Guide (Tab 1), Main Information screen, for the required entries.

Taxpayer Interview and Tax Law Application

Ray Jackson is a widower whose wife died during the 2010 tax year. Ray's approved intake and interview sheet shows the following responses.

1. As of December 31, 2010, your marital status was:

- Single
 Married: Did you live with your spouse during any part of the last six months of 2010? Yes No
 Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____
 Widowed: Year of spouse's death: 12/31/2010

2. List the name of _____ below who lived in your home and outside your home that you supported during 2010

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...

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 December 31. I'm sorry for your loss, sir.

RAY RESPONDS...

Yes, she did.

Are you filing a joint return with your late wife this year?

Yes.

Can anyone else claim either of you as dependents?

Well, I don't think so. We lived off our own income.

Based on your answers, you can claim an exemption for yourself and for your late wife.

[On the approved intake and interview sheet, volunteer should check "No" for the question, "Can your parents or someone else claim you or your spouse on their tax return?" which Ray left blank.]

If you are preparing a paper return, write "Deceased" along with the deceased spouse's name and date of death across the top of the return. Once you complete the date of death in the software, the program will automatically print "Deceased" on the taxpayer's copy of the return.

Because Ray can claim himself and his late wife as personal exemptions, you will enter both their names and SSNs in the Main Information Sheet in the tax software. The software automatically checks the boxes on lines 6a and 6b and enters "2" for "Number of boxes checked on 6a and 6b." You will also enter the Date of Death under the spouse in the Taxpayer Information area of the Main Information Sheet in the tax software and will complete Name line 2 with Ray's first and last name.

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 and 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.
- When preparing a paper return for a taxpayer filing as Head of Household and claiming an exemption for a nonresident alien spouse, check the box on line 6b and write in the spouse's full name and SSN or ITIN on the line.



Lesson 6: Dependency Exemptions

Introduction

This is the second and final lesson covering the Exemptions section of the tax return. 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.

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Exemptions																													
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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 approved intake and interview sheet. This information will be the basis of your entries in the tax software.

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.

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?

- Approved Intake and Interview Sheet
 - Volunteer Resource Guide
 - Publication 17
- Optional:**
- Publication 501
 - Form 2120
 - Form 8332

Who may be claimed as a dependent?

A dependent may be either a qualifying child or a qualifying relative. The requirements for both have much in common, but there are some tests that are specific to qualifying child or qualifying relative.

In addition to the tests specific to qualifying child and qualifying relative, all of the following tests must be met for both:

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



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

Use caution when preparing this section of the taxpayer's return. The interview tips in the Volunteer Resource Guide (Tab C), Exemptions section cover the requirements for all the dependency tests. Avoid using information from the taxpayer's prior year documents to complete this section.

How do I apply the dependency tests?

The Family and Dependent Information section of the approved 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 the Volunteer Resource Guide (Tab C) for guidance on asking probing questions to verify the information on the approved intake and interview sheet. Use the interview tips to apply the dependency tests.

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.



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?

One way to apply the dependency tests is to refer to the interview tips for each dependency test.

What are the tests for qualifying children?

To determine if the taxpayer has a dependent, begin by applying the rules for a qualifying child. If these tests are not met, then you can continue on to the tests for a qualifying relative. Remember, a person must meet the requirements of either a qualifying child or a qualifying relative to be claimed as a dependent.

Relationship

Review step 2 in the Volunteer Resource Guide (Tab C), Table 1, Interview Tips.

This step determines if the child is related to the taxpayer in one of the following ways:

- The taxpayer's child, stepchild, or adopted child or their descendant (grandchild)
- The taxpayer's brother, sister, stepbrother, or stepsister or their descendant (niece or nephew)
- A foster child placed with the taxpayer by an authorized placement agency or court order

Age

The next step is determining the child's age. Review steps 1 and 3 in the Volunteer Resource Guide (Tab C), Table 1, Interview Tips.

The child must be at least one of the following:

- Under age 19 and younger than the taxpayer (or the taxpayer's spouse, if filing Married Filing Jointly) at the end of the tax year
- Under age 24, a full-time student (as defined by the school) for at least 5 months of the year, and younger than the taxpayer
- Any age and permanently and totally disabled



To be considered a student, the taxpayer's child must attend school full time (as determined by the school) for some part of each of five calendar months of the year. School does not include an on-the-job training course, correspondence school, or a school offering courses only through the Internet.

Support

Step 4 of the interview tips in the Volunteer Resource Guide determines the level of support by the child, not the person who wants to claim the child as a dependent. A child cannot have provided more than half of his or her own support during the tax year. A person's own funds are not support unless they are actually spent for support.

example

Bob, 22, is a full-time student and lives at home 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 at home 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.

Residence

Step 5 of the interview tips examines residency. The child must have the same principal residence as the taxpayer for more than half the year. The child is considered to have the same place of residence as the taxpayer even if the child (or the parent) is temporarily absent due to special circumstances such as education, illness, vacation, business, or military service. The taxpayers' home can be 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.



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 in. Refer to the Publication 17, Filing Information chapter.

Special Exceptions for the Residence Test

Taxpayers may claim an exemption for a child who has been kidnapped, a child who was born alive at any time during the year and then died, or any other dependent that died during the year, as long as the dependent meets other dependency tests.

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.

Refer to the Personal Exemptions and Dependents chapter of Publication 17 for detailed information regarding the residency test.

Special rules that apply to custodial and noncustodial parents will be discussed later in this lesson.

Additional Rules

The first five steps covered above apply specifically to qualifying children. The next five interview tips cover additional rules for considering a qualifying child as a dependent. Some of these steps will also apply when we talk about qualifying relatives.

Citizenship or Residency

Step 6 is sometimes referred to as the citizen or resident test. Do not get it confused with step 5, which refers to who the child is living with (residency test). To pass the citizen or resident test, the dependent must be either a U.S. citizen, U.S. national, or resident of the U.S., Canada, or Mexico. Note that:

- Children are usually citizens or residents of the country in which their parents are citizens. So, if either parent is a U.S. citizen, a child born in a foreign country can be recognized as a U.S. citizen for tax purposes.
- If a U.S. taxpayer 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 the other dependency tests are met, the taxpayer can claim the child as a dependent.
- Foreign exchange students generally are not U.S. residents and do not meet the citizen or resident test, so they cannot be claimed as dependents.

example

Joan, who is a U.S. citizen, adopted an infant boy from Cambodia who has 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.

Joint Return

Look at steps 7 and 8 in the Volunteer Resource Guide (Tab C), Table 1, Interview Tips for qualifying child. To pass the joint return test, the dependent must not file a joint return for the year, unless:

- The joint return is filed only to claim a refund of taxes withheld and
- No tax liability would exist for either spouse on separate returns

example

Ruth had no income. She married in November of the tax year. Ruth's husband had \$16,700 income, and they claimed two personal exemptions on their return. Even though 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 they are filing a return just to claim a refund of taxes withheld, Ruth's husband would have tax liability if he filed a separate return.

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

Review step 9 and the associated footnotes in the Volunteer Resource Guide.

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

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

No other taxpayer can take any of these six tax benefits unless they have another qualifying child. If any taxpayer can claim the child as a qualifying child, the following rules apply:

- If only one of the taxpayers is the child's parent, the child is treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child is treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2010. If the child lived with each parent for the same amount of time, the child is the qualifying child of the parent who had the higher Adjusted Gross Income (AGI) for 2010.
- 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 higher AGI for 2010.
- If a parent can claim the child as a qualifying child but no parent does so, 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 can claim the child. If the child's parents file a joint return with each other, this rule can be applied by dividing the parents' combined AGI equally between the parents.

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.

See the Volunteer Resource Guide (Tab C) and Publication 501 for more information and examples about a qualifying child of more than one person.

If the qualifying child is actually claimed on more than one tax return in a given year, the IRS will apply the Qualifying Child of More Than One Person rules listed in Publication 17, Personal Exemptions and Dependents.

Dependent Taxpayer

The final interview question for a qualifying child is step 10 in the Volunteer Resource Guide (Tab C). Look at the question in Part I on the taxpayer's approved intake and interview sheet that asks "Can your parents or someone else claim you or your spouse on their tax return?" To claim a dependency exemption, a taxpayer cannot be a dependent on another person's tax return. If a taxpayer can be claimed as a dependent by another person, the taxpayer may not claim anyone else as a dependent, even if the taxpayer has a qualifying child or qualifying relative.

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. The tests are:

- Not a qualifying child test
- Member of household or relationship test
- Citizenship or residency test
- Gross income test
- Support test (to be a qualifying relative)
- Joint return test
- Dependent taxpayer test

Turn to the Volunteer Resource Guide (Tab C), Qualifying Relative Interview Tips.

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 other taxpayer is not required to file an income tax return and:

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

Special rules that apply to custodial and noncustodial parents are covered later in this lesson.

example

Todd has lived with his girlfriend, Eva, and her two children all year in his home. Eva is not required to file a 2010 tax return and does not file a 2010 tax return. Todd has provided more than half of their support for the entire year. Eva and her two children are Todd's qualifying relatives because they meet the member of household or relationship test, gross income test, and support test. (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 2009, Sally has been supporting her friend, Ann, and Ann's young son, Bobby. Ann and Bobby lived with Sally all of 2010 and meet all the tests to be Sally's qualifying relatives. Ann worked part-time and made \$3,100 in wages during 2010. 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 did not file her return only 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 has to have a close familial relationship with the taxpayer or have lived with the taxpayer for the entire year. It is important to note that a close relative of the taxpayer does not have to live in the same household to meet this test.

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. Step 3 probes to determine if the person is an individual (other than a spouse) who had the same principal place of abode as the taxpayer and was a member of the taxpayer's household for the entire year, regardless of relationship. 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:

- Temporary absences due to illness, education, business, vacation, military service, and placement in a nursing home are acceptable.
- A relationship established by marriage, such as mother-in-law or sister-in-law, does not end with divorce or death of a spouse; they are qualifying relatives even if they do not live with the taxpayer.
- 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.

The Dependency Exemption Interview Tips, steps 2 and 3, can help you determine if a person passes the qualifying relative, member of household, or relationship test.

Citizenship or Residency Test

Step 4 will guide you to determine citizenship or residency. Also look at Part II, Family and Dependent Information of the taxpayers' approved intake and interview sheet, which asks the taxpayer about citizenship or residency. A dependent must be a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico.

This is a general rule for dependents. It applies to both qualifying child and qualifying relative.

Gross Income Test

Step 5 of the interview tips addresses the gross income test. The dependent's gross income for the tax year must be less than the personal exemption amount (\$3,650 for 2010). There is an exception if the person is disabled and has income from a sheltered workshop. Gross income is defined in Publication 17, Personal Exemptions and Dependents. Remember this test does not apply to qualifying children, only qualifying relatives.

example

Joe is 65 years old and lives with his son and daughter-in-law. In 2010, 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 2010, which is \$3,650.

Support

Step 6 of the interview tips asks about support. The taxpayer must have provided more than 50% of the dependent's total support for the tax year. Note that this support test is different than the one for a qualifying child.



Publications 17 and 4012 (C-8) contain a worksheet for determining support.

When calculating the amount of total support, taxpayers should compare their contributions with the entire amount of support their dependent received from all sources (such as taxable income, tax-exempt income, and loans). Review the list of valid support expenses and the worksheet in Publication 4012, C-8, 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

Mary is 35 years old and lost her job in November 2009. In December 2009 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 2010 year. Ellen is single and does not provide support or pay household expenses of any family member. 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 2010. Ricky's father died in 2007. Ellen is a school teacher and earned \$49,000 in 2010. All are U.S. citizens and had valid SSNs.

Ellen can claim both Mary and Ricky as dependents. Even though they are not related to Ellen, both meet the tests to be her dependents under the rules for "Qualifying Relative." See the Volunteer Resource Guide (Tab C), table 2—Exemptions/Dependency.

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. Just because Mary and Ricky lived with Ellen all year in 2010 does not qualify her to file as Head of Household. See the Volunteer Resource Guide (Tab B), Filing Status, Who Is a Qualifying Person Qualifying You To File as Head of Household, and Determination of Filing Status—Decision Tree.



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.

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

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

If the taxpayer provides over half the person's total support, you can skip steps 7–10 and go directly to step 11. If the taxpayer has not provided over half the person's support, go to step 7 to see if someone else is providing over half the support.

Multiple Support Agreements (Form 2120)

If one person has not provided over half the support, go to step 8 to determine if multiple support exists. Multiple support means that two or more people together, who could claim the person as a dependent except for the support test, provide more than half the dependent's support. However, *only one taxpayer* can claim the exemption for a dependent with multiple support. In this situation, the individuals who provide more than 10% of the person's total support (step 9), and who meet the other tests for a qualifying relative, can agree that one of them will take the person's exemption.

Step 10 guides you in asking if the taxpayer has the appropriate documentation.

- The taxpayers who are claiming the exemption for the dependent must attach to their tax return Form 2120, *Multiple Support Declaration* or similar statement.
- The other supporting taxpayers must sign this written statement agreeing *not* to claim the exemption for that year. The person who claims the exemption must keep 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, and 9% from Charlie's friend. Either Fred or Charlie's brother can take the exemption for Charlie because they each provided more than 10% of Charlie's support, and together contributed more than 50% towards his support. Whoever is not going to take the exemption must sign a statement agreeing not to take the exemption.

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.

Joint Return

To pass the joint return test (steps 11 and 12), the dependent must *not* file a joint return for the year, unless:

- The joint return is filed only to claim a refund and
- No tax liability would exist for either spouse on separate returns

This is a general rule for dependents. It applies to both a qualifying child and qualifying relative.

Dependent Taxpayer

The final interview question for a qualifying relative is step 13. Look at the question on the taxpayer's approved intake and interview sheet that asks "Can your parents or someone else claim you or your spouse on their tax return?" To claim a dependency exemption, a taxpayer cannot be a dependent on another person's tax return. If a taxpayer can be claimed as a dependent by another person, the taxpayer may not claim anyone else as a dependent, even if the taxpayer has a qualifying child or qualifying relative.

Special Rule for Children of Divorced, Separated, or Never Married Parents

Special rules apply if the dependent is supported by parents who are divorced or separated; these rules also apply to parents who were never married. After first starting with Table 1, use the Volunteer Resource Guide (Tab C), Table 3, Children of Divorced, Separated, or Never Married Parents, to determine which parent is entitled to claim the child as a dependent.

In general, the child will be considered a dependent of the custodial parent, assuming the child meets all the rules for a qualifying child or qualifying relative. However, the custodial parent can agree to allow the noncustodial parent to treat the child as a qualifying child or qualifying relative if certain conditions are met. A signed Form 8332 or equivalent is required and must be attached to the noncustodial parent's return, or attached to Form 8453 if filing electronically.

What are the rules for children of divorced or never married parents?

Revocation of Release of Claim to an Exemption after July 2, 2008

For tax years after July 2, 2008 (the 2009 calendar year for most taxpayers), new rules allow the custodial parent to revoke release of claim to exemption previously filed on Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or similar form. 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 provides notice of revocation to the noncustodial parent in 2009, the earliest the revocation can take effect is the 2010 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.

Use of Divorce Decree or Separation Agreement Instead of Form 8332

If the divorce decree or separation agreement went into effect after 1984 and before 2009, the noncustodial parent can still attach certain pages from the decree or agreement instead of Form 8332 or similar form.

Beginning with divorce decrees granted in 2009, the noncustodial parent will no longer be able to attach pages from the decree or agreement. Form 8332, or a copy of the form, must be filed if the decree or agreement was made after 2008.

Pre-1985 decree of divorce or separate maintenance or written separation agreement is still applicable for 2009 when the decree gives the exemption to the noncustodial parent and the parent pays at least \$600 in child support *only if the child is permanently and totally disabled*.

The Special Rule for Children of Divorced or Separated Parents is described in detail in Publication 17, Personal Exemptions and Dependents.



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.

example

The taxpayer has a 2000 divorce decree that states he or she can claim the child as a dependent. Since the divorce decree was created prior to 2009, the divorce decree can be attached to the tax return and the taxpayer can claim the dependent.

example

The taxpayer has a 2010 divorce decree that states he or she can claim the child as a dependent. The taxpayer cannot attach a copy of the divorce decree to the tax return even if it states the taxpayer can claim the child as a dependent. The taxpayer must attach a signed Form 8332 to the tax return to claim the child as a dependent.

How do I enter the exemptions in the tax software?

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

Be sure to include and verify all the family and dependent information on the taxpayer's approved intake and interview sheet before entering the following 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.

Form 13614-C should look like this:

<input type="checkbox"/> Widowed: Year of spouse's death: _____							
2. List the name of everyone below who lived in your home and outside your home that you supported during 2010. If additional space is needed please check here and use page 4 for additional information: <input type="checkbox"/>							
Name (first, last) Do not enter your name or Spouse's name below	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Lisa Smith	12/1/2005	granddaughter	12	yes	yes	yes	no
Brian Smith	12/1/2005	grandson	12	yes	yes	yes	no
Michael Smith	3/17/1983	son	12	yes	yes	no	yes
Todd Smith	9/5/1981	son	12	yes	yes	no	yes

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.

Dependents/Nondependents Determinations

Elaine can claim her two grandchildren as dependency exemptions, but not her adult sons. Therefore, use the Family and Dependent Information section of Elaine's approved 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

- You cannot claim any dependents if you, or your spouse if filing jointly, could be claimed as a dependent by another taxpayer.
- You cannot claim a married person who files a joint return as a dependent unless that joint return is only a claim for refund and there would be no tax liability for either spouse on separate returns.
- You cannot claim a person 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.)
- You cannot claim a person as a dependent unless that person is your *qualifying child* or *qualifying relative*.



Tax Software Hint: After verifying that the dependents are qualified, enter the taxpayer's dependents' information in the Dependents/Nondependents section of the tax software Main Information Sheet. The tax software will use this information to calculate the taxpayer's exemption deduction.

Notes



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 service members or others whose spouses are nonresident aliens (not U.S. citizens or permanent resident aliens).

This lesson also covers exemption issues related to taxpayers who want to claim an exemption for:

- A nonresident alien spouse who does not qualify to be a resident alien for tax purposes or
- Nonresident alien stepchildren

Tax situations involving nonresident aliens can be complex. If the taxpayer has a J, Q, F, or M visa, ask the site coordinator if there is a volunteer who is trained and certified to prepare these types of returns.

If there isn't a certified volunteer at the site or if you are faced with a situation not covered in this lesson, refer the taxpayer to a professional tax preparer.

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?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 519

Optional:

- Publication 3
- Publication 54
- 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 nonresident alien, including filing status and exemption issues. Resident aliens and U.S. citizens must report worldwide income on their tax return.

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 approved 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 approved intake and interview sheet, you must determine if the person can be treated as a resident alien for tax purposes before continuing. An individual must meet **one** of the following tests to be considered a *resident alien for tax purposes*:

- Green card test
- Substantial presence test

What is the green card test?

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

More information about 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 2008, 2009, and 2010. Is Dante a resident alien under the substantial presence test for 2010?

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

2010: 150 days 2009: $\frac{1}{3}$ of 150 = 50 days 2008: $\frac{1}{6}$ of 150 days = 25 days

Total = 225 days

Who is exempt from the substantial presence test?

People who are in the U.S. on valid F, J, M, or Q visas are usually considered exempt from the substantial presence test. Taxpayers must follow the rules described in the instructions for Forms 1040NR or 1040NR-EZ.

For individuals with valid visas, do not count the days present in the U.S. for purposes of the substantial presence test. In general, they will be considered *nonresident aliens for tax purposes*. Other examples of exempt individuals include:

- Nonresident aliens with medical conditions that prevent them from leaving the country and
- Certain commuters between the U.S., Canada and Mexico

Publication 519 has more detailed information on who is an exempt individual.



CAUTION
Most volunteer sites do not prepare returns for individuals with F, J, M, or Q valid visas. Ask the site coordinator if there is a volunteer who is certified to prepare these types of returns. If not, refer the taxpayer to a professional tax preparer.



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.



CAUTION
An individual with an ITIN is not entitled to the Earned Income Credit. This will be covered in the Earned Income Credit lesson.



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

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

If an unmarried nonresident alien does not meet the green card or substantial presence test, refer the taxpayer to a volunteer who has been trained and certified to prepare returns for nonresident aliens or 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 2010. 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 2010 (from September to December) as a nonresident alien. She was also in the U.S. for 120 days in each of the years 2008 and 2009. 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.

2010: 120 days 2009: 1/3 of 120 days = 40 days 2008: 1/6 of 120 days = 20 days

Total = 180 days

What are the filing status options?

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

1. The taxpayer may choose to file as Married Filing Separately
2. The couple may choose to file as Married Filing Jointly
3. 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

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. This information can be found in Publication 519, U.S. Tax Guide for Aliens.

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 must be reported, and a signed declaration is 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

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.



Make a note by step 2 in the Volunteer Resource Guide, Personal Exemptions chart that, if a spouse is a nonresident alien, the taxpayer can choose to make the declaration.

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.



Tax Software Hint: Follow the Volunteer Resource Guide (Tab B), filing status interview tips to see if the citizen spouse qualifies to file as Head of Household.

Can citizens or resident aliens who live with their nonresident alien spouse ever file as Head of Household?

There is an exception that allows U.S. citizens and resident alien spouses who live with nonresident aliens 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 the nonresident alien spouse
- The nonresident alien spouse does not meet the substantial presence test
- The nonresident alien spouse does not choose to file a joint return



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 does Gloria have for 2010?

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?

Taxpayers who are considered unmarried for Head of Household purposes because they are married to a nonresident alien are still considered married for purposes of the Earned Income Credit (EIC). Taxpayers are only entitled to the credit if they file a joint return and meet the EIC qualifications.

TIP

In the Volunteer Resource Guide (Tab B), Filing Status—Decision Tree, note the fact that, if a spouse is a nonresident alien, the living apart rule does not apply to the citizen spouse. You will also find this information in Publication 17, under *Head of Household, nonresident alien spouse*.



In this situation, the 2010 Form 1040 Instructions say to enter "NRA" on the Head of Household line of Form 1040. When preparing a paper return for such a nonresident alien taxpayer, also write "No" on the dotted line next to the Earned Income Credit line of Form 1040.

Who can claim an exemption for a nonresident alien spouse?

A citizen or resident alien taxpayer can claim the personal exemption of the nonresident alien spouse who does not meet the substantial presence test and does not choose to file a joint return if certain tests are met.

Use the Volunteer Resource Guide Interview Tips to determine if the citizen spouse can claim the personal exemption of the nonresident alien spouse. It does not matter if the citizen spouse is filing as Married Filing Separately or as Head of Household. For a nonresident alien spouse, income is defined as U.S.-sourced 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 of 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 2010, 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.-sourced 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.

A taxpayer filing as Married Filing Separately claims the exemption by checking the spouse's exemption on Form 1040. The taxpayer enters the name of the spouse in the space to the right of the box. The SSN or ITIN of the spouse is written 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.

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

A child born overseas to U.S. citizen parents is considered to be 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 for the purpose of establishing an official record of the child's claim to U.S. citizenship at birth. Form FS-240, Consular Report of Birth, establishes official evidence that the child is a U.S. citizen.



Turn to the Volunteer Resource Guide (Tab 1), Main Information Sheet screen shots. Mark on the appropriate pages how to claim the nonresident alien spouse's personal exemption.

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, 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 nor 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. Of course, the children would have to obtain SSNs, ITINs, or ATINs to be claimed on his tax return.

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 the case of a foreign adoption when the child already possesses a green card or a certificate of citizenship, which is a form claiming citizenship because a child was born overseas to a U.S. citizen.

See Publication 17, Chapter 3, Citizen or Resident test, for more information, 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 met 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 who has been in the U.S. Army for 13 years, is stationed 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

Before filing a tax return, U.S. citizens married to a spouse who is not a U.S. citizen, national, or resident alien must determine what filing status options are available and whether the noncitizen spouse will be treated as a resident alien for tax purposes or as a nonresident alien.

Resident aliens follow the same tax laws as U.S. citizens. Nonresident aliens follow another set of tax laws, most of which are outside the scope of the volunteer program.

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

A married couple, where a citizen or resident alien is married to a person who does not meet the green card or substantial presence test, still has the option of electing to treat the nonresident spouse as a resident alien and file as Married Filing Jointly.

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.-sourced 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 who does not meet the green card or substantial presence test cannot be claimed as a dependent of the U.S. citizen or resident alien because the child does not pass the citizenship test.

An adopted nonresident alien child can usually be claimed as a dependent of a U.S. citizen or resident alien if the child lives with the U.S. citizen the entire year.



EXERCISE ANSWERS

Answer 1: Gloria can file as either Married Filing Jointly or Married Filing Separately. Since Dante meets the substantial presence test, he is a U.S. resident alien for tax purposes. He and Gloria can file as Married Filing Jointly, or they can both file as Married Filing Separately. Dante must follow the U.S. tax laws since he is considered a resident alien.

Answer 2: Yes. Raul can claim Head of Household status since his spouse is a nonresident alien, she does not choose to file a joint return with him, and Raul meets the other qualifications for Head of Household. If Raul had not met the other qualifications for Head of Household, he would have to file as Married Filing Separately.

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. He would answer "Yes" to step 6 in the interview tips. 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 take her personal exemption.

Notes



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			
Income		7	
7 Wages, salaries, tips, etc. Attach Form(s) W-2		8a	
8a Taxable interest. Attach Schedule B if required		8b	
b Tax-exempt interest. Do not include on line 8a		9a	
9a Ordinary dividends. Attach Schedule B if required		9b	
b Qualified dividends (see page 22)		10	
10 Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		11	
11 Alimony received		12	
12 Business income or (loss). Attach Schedule C or C-EZ		13	
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ► <input type="checkbox"/>		14	
14 Other gains or (losses). Attach Form 4797		15a	b Taxable amount (see page 24)
15a IRA distributions		16a	b Taxable amount (see page 25)
16a Pensions and annuities		17	
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		18	
18 Farm income or (loss). Attach Schedule F		19	
19 Unemployment compensation (see page 27)		20a	b Taxable amount (see page 27)
20a Social security benefits		21	b Taxable amount (see page 29)
21 Other income. List type and amount (see page 29)		22	22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ►

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?

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

Optional:

- Form 1040 Instructions
- Schedule B
- Publication 531
- 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	■	■

*Pensions/Annuities are Intermediate if the taxable amount is already determined.

There are income topics that are not included in the VITA/TCE training program:

- Other Gains/Losses
- Farm Income
- Dependent child under the age of 18 (age 24 if a full-time student), who has investment income of more than \$1,900

Taxpayers with income from these sources should be referred to a professional tax preparer.

How are taxable and nontaxable income determined?

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 will not be taxable. 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 not taxable.

What are types of nontaxable income?

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

Other nontaxable income—exempt income

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.

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 reported on Form 1040, Schedule C, Profit or Loss From Business or Schedule C-EZ, Net Profit From Business
- Unearned income—any income produced by investments, such as interest on savings, dividends on stocks, or rental income

How do I get started?

To determine a taxpayer's income, discuss and review the Income section of the approved 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. (Note: 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. 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 out Forms W-2, but they must make them available to the employees. Employees may need to pick up Form W-2 from their employers.



For guidance and assistance to Gulf Oil Spill Victims, see Publications 4873 and 4873-A. According to current law, BP payments for lost income are taxable in the same way that the wages or business income these payments are replacing would have been. 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.

NEW What about loan repayment assistance programs (LRAP) for Health Care Professionals?

Health care professionals participating in LRAP programs who reported income from repaid or forgiven loan amounts on their 2009 returns (possibly after receiving a Form W-2 or Form 1099), may be due refunds. Those who believe they qualify for this relief may want to consult their state loan program offices to determine whether the program is covered by new legislation.

The Affordable Care Act of 2010 included a change in the law that expands the exception to the general rule of the inclusion of canceled debt in income for amounts received by health professionals under loan repayment and forgiveness programs. Prior to the new law, only amounts received under the National Health Service Corps Loan Repayment Program or certain state loan repayment programs eligible for funding under the Public Health Service Act qualified as an exception.

The Affordable Care Act expands the exception to include any state loan repayment or loan forgiveness programs intended to increase the availability of health care services in underserved areas or health professional shortage areas and makes this exception retroactive to the 2009 tax year.

Health care professionals may need to file Form 1040X, Amended U.S. Individual Income Tax Return, to claim this expanded exception. See IR-2010-74, Affordable Care Act Provides Expanded Tax Benefit to Health Professionals Working in Underserved Areas, and www.irs.gov for more details.

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

If the taxpayers do not receive Form W-2 by January 31, they should first contact the employer and find out if, or when, Form W-2 was mailed or if the taxpayers can pick up Form W-2 in person. Some employers make Form W-2 available online to their employees as an option.

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

If, after requesting Form W-2 from the employer, the taxpayers do not receive it in sufficient time to file the return, they should file the 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 used 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.



Tax Software Hint: Refer to the Volunteer Resource Guide (Tab 2) for instructions on entering income into the software. 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. The tax software automatically transfers necessary information for credits, deductions, withholding, etc., from forms to other sections of the tax return.

example

In 2010, 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 program separately.

Entering Forms W-2 information when preparing a paper Form 1040

- The amount in box 1 should be entered on Form 1040, line 7.
- The amount in box 2 should be entered on Form 1040, line 61.
- The amount in box 8 should be included on Form 1040, line 7, and on Form 4137, line 7.
- The amount in box 9 should be included on Form 1040, line 59, and check box a, Form(s) W-2, box 9.
- The amount in box 10 should be included on Form 2441, line 14.
- If there is an amount in box 12 labeled "D," complete Form 8880 when you get to the nonrefundable credit section to see if the taxpayer is eligible for the retirement savings contributions credit. Other codes may impact eligibility for the Retirement Savings Contributions credit; check the reverse side of the taxpayer's copy of Form W-2.

TIP

You always want to stress to the taxpayer that, when they finally receive the employer's Form W-2, if the numbers are different from those on their Form 4852, they need to amend their returns to report the correct amounts.

TIP

NEW Form 1040, line 59, box a, "Form W-2, box 9" replaces the box for AEIC payments.

TIP

Tips received by taxpayers who are self-employed are to include their tips in gross receipts on Schedule C-EZ/C. Examples include self-employed hair stylists or manicurists.

Tip Income

If the taxpayer has a job in which tips are normally received (e.g., waiter/waitress, bellhop, or motel maid), 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 who receive more than \$20 per month in tips, while working one job, report their tip income to their employer, the tips will be included in wages on Form W-2, box 1.
- 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 were more than \$20 a month, the taxpayer must also pay social security and Medicare taxes on this money. If these were reported to the employer, then they are included in Form W-2, boxes 6 and 7. If they were not reported to the employer, then complete Form 4137 for the taxpayer.
- Tips of less than \$20 per month or noncash tips must be reported as income on Form 1040, line 7, but are not subject to social security and Medicare taxes.

Information on how to report unreported tips and pay social security and Medicare taxes on qualifying unreported tips is covered in the Other Taxes lesson. Also, the Volunteer Resource Guide (Tab 2) provides detailed information on how to enter unreported tips.

Allocated Tips

For some businesses, giving employees tips is customary. These businesses include restaurants, bars, and similar businesses. 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 this amount is not correct, based on the taxpayer's records, an adjustment will need to be made on Form 4137.

Allocated tips are also subject to social security and Medicare taxes. Report the allocated tip amount on Form 4137, along with any unreported tips to calculate social security and Medicare taxes.



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, if a taxpayer, working as a household employee, earned less than \$1,700 a year while working in the employer’s home, the employer is not required to provide the taxpayer with Form W-2 and no social security or Medicare taxes are owed. Regardless whether Form W-2 is issued, the income must be included on Form 1040, line 7. However, if the employer withheld federal income taxes from the taxpayer’s wages, the employer must issue Form W-2.

If you are preparing a paper return and the taxpayer’s household employer is not required to issue Form W-2, enter “HSH” and the amount on the dotted line next to line 7 and then include the amount in the total on line 7.



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

Are scholarships and fellowships taxable income?

Form W-2 and Form 1098-T

Scholarships and fellowships may be fully, partially, 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, just as you would for any other Form W-2. This income is included in the total on Form 1040, line 7.

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 Volunteer Resource Guide, Tax Treatment of Scholarships and Fellowship Payments (Tab D) and Publication 970, Tax Benefits for Education. Education credits will be discussed in a later lesson.



Tax Software Hint: After asking questions about the scholarship/fellowship money, record the taxable portion in the software. See the Volunteer Resource Guide (Tab 2) for guidance on where to enter the income.

When preparing a paper return, if the taxpayer did not receive Form W-2 for the scholarship or fellowship, report the taxable portion of the scholarship or fellowship on Form 1040, line 7. Write “SCH” and the amount on the dotted line next to Form 1040, line 7, and include the amount in the total for line 7.

Are distributions from Educational Savings Accounts, such as a Coverdell ESA and a 529 plan, taxable?

Coverdell ESA (section 530 plan) and Qualified Tuition Program (section 529 plan) 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.

When a distribution is made, none of the money will be taxable as long as it is a qualified distribution. If it is not used for qualified education expenses, some of the money that was never taxed (the earnings) becomes taxable income and may be subject to an extra penalty tax.

Qualified education expenses include 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 Educational Savings Accounts and Qualified Tuition Programs (under Sections 529 and 530) are reported on Form 1099-Q. Coverdell ESA distributions can be used to pay for qualified elementary, secondary, and postsecondary expenses. Qualified Tuition Program (QTP) plan distributions can only be used to pay qualified postsecondary expenses.

Additional information about educational savings accounts, distributions, and qualified education expenses can be found in Publication 970, Tax Benefits for Education.



Tax Software Hint: Form 1099-Q is not available in the software because the form does not contain enough information to determine how much, if any, of the distribution is taxable.

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. You do not report anything 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



A choice can be made to report the taxable part of the distribution (if any) and claim the American opportunity credit or lifetime learning credit on the whole distribution. See Publication 17 and Publication 970, Tax Benefits for Education, for more details.



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.

Original Issue Discount (OID), long-term obligations that pay no interest before maturity, is considered to be issued at a discount and is fully taxable.

If the taxpayers cashed in Series EE or Series I bonds, they should have a form 1099-INT from the bank. Most taxpayers do not report savings bond interest as it accrues every year. They report the total interest when they cash the bonds. Some taxpayers may report savings bond interest as it accrues. 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 under Interest Income.

- If the taxpayer has Series HH bonds, they 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.



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.



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.

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. Bob 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 each account is \$1,700. Hazel reports the total amount of interest on Schedule B of 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, so read the form carefully. (And sometimes the reverse is true, some 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

The taxpayer's Form(s) 1099-INT may list both taxable and tax-exempt interest. Read the form(s) carefully. 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, the taxpayer must report all tax-exempt interest on the tax return on Form 1040, line 8b. In some situations, tax-exempt interest, while not taxable, is used in calculating the taxability of other income items, such as social security income.

What about the interest on an IRA?

Generally interest on a Roth IRA is not taxable. However, if the criteria for the distribution are not followed, the interest is taxable. Refer to lesson 11 on retirement income for details.

Interest on a traditional IRA is tax deferred. Do not include that interest until the taxpayer makes withdrawals from the IRA. The taxpayer will be issued a Form 1099-R to report a distribution. See lesson 11 on retirement income for the proper way to report this income.

See Publication 17 and Publication 590 for more information on IRAs.

example

Mike holds municipal bonds issued in his state, as well as a traditional IRA to which he makes contributions each year. For each of these, he gets statements listing the interest earned. Although not taxable, Mike reports his tax-exempt interest from the municipal bonds on Form 1040, line 8b. He does not report any of the interest income on his traditional IRA on his tax return.

How do I report the interest income?



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.

Effective as of 2009 tax year, Form 1040A, Schedule 1, Interest and Ordinary Dividends, is obsolete. Form 1040A taxpayers will use Form 1040, Schedule B.

If preparing a paper return, complete Schedule B, Part I, if the taxpayer has any of the following:

- Over \$1,500 of taxable interest
- Nominee interest (taxpayer is nominee for interest that actually belongs to someone else)
- A seller-financed mortgage
- Tax-exempt interest
- A distribution from a foreign trust or foreign bank account
- Educational savings bond exclusion

Otherwise, you would enter the interest income directly on Form 1040 or 1040A, line 8a or line 8b, or Form 1040EZ, line 2. 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. Be sure that any other entries on the Form 1099-INT are entered in their proper places on Form 1040; for example, box 2 goes in the Adjustments section, box 4 goes in the Payments section, and box 6 goes in the Credits section. If any other boxes contain amounts, refer the taxpayer to a professional tax preparer.

On Form 1099-OID, Original Issue Discount, report the interest amounts in boxes 1, 2, and 6. Box 3 is the early withdrawal penalty and reported in the Adjusted Gross Income section of Form 1040. Box 4 is federal income tax withheld and is reported in the Payments section of the return. Box 7 is the deductible expenses as an itemized deduction subject to the 2% limit. If the taxpayer indicates there are adjustments needed for any of the amounts listed on Form 1099-OID, refer the taxpayer to a professional tax preparer. In some cases, taxpayers may tell you they have income from original issue discount but did not receive Form 1099-OID. Refer these taxpayers 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?

Oh, no, never.

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?

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

Well, did you redeem any bonds in 2010, or did any of them mature that year?

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

[On page 2 of the approved 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 2010. In January 2011 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 Form 1040 Instruction booklet, line 9b, for the 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 in Form 1099-DIV, box 2a.



"Capital gains" and "Capital gain distributions" are not the same. A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than the cost and realizes a capital gain. A capital gain *distribution* is the owner's portion of the capital gains realized when the mutual fund or REIT sells assets. If the taxpayer has actually sold their mutual fund shares, or other shares of stock, and you are not certified in this area, you should refer them to a VITA/TCE tax preparer who has been trained to handle capital gains and losses.

example

During 2010, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. In January 2011, she received Forms 1099-DIV listing these capital gain distributions.

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.)

How do I report dividend information?

Generally, all dividend income is reported on these forms:

- Form 1040A, lines 9a and 9b
- 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.



Tax Software Hint: Look at the Volunteer Resource Guide (Tab 2). Find How/Where to Enter Income. Follow the 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. Also, correct use of the worksheet ensures that the income will be taxed correctly and that other entries from Form 1099-DIV will be distributed to the proper locations on the return.

If you are preparing a paper return, be sure the amounts in Form 1099-DIV, boxes 1a and 1b, are recorded on the correct lines on the return. Be sure that any other entries on the Form 1099-DIV are entered in their proper places on the Form 1040; for example, box 2a goes on the Capital Gain line in the Income section unless a Schedule D is required, box 4 goes in the Payments section, and box 6 goes in the Credits section. If any other boxes contain amounts, refer the taxpayer to a professional tax preparer.

If the taxpayer has received a qualified dividend or capital gain distribution and you are preparing a paper return, the Qualified Dividends and Capital Gain Tax Worksheet is required. The worksheet can be found in Form 1040 Instructions.

Taxpayer Interview and Tax Law Application

Leonard Stark, Gloria's spouse, is self-employed. They 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.

Yes.

Are these the only Forms 1099-DIV that you received?

We will enter the information from each of these on the Dividend Statement. It will add everything up and display it as your dividend income.

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



What should be reported on line 10 of Form 1040?

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.

Only those taxpayers who itemized deductions and received a tax benefit for deducting their state or local income taxes have to include their state/local tax refunds in income. If they itemized deductions 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 2009 federal return. She included the income taxes she had paid to her state during 2009. However, she received a refund in 2010 on the overpaid portion of those taxes. 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 then calculates the taxable part of the refund (if any) on Form 1040, line 10.

When preparing a paper return, complete the State and Local Income Tax Refund Worksheet in Form 1040 Instructions when required.



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.

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.

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.

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.

How do I report alimony?



Tax Software Hint: On 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.

When preparing a paper return, record the alimony received by the taxpayer on Form 1040, line 11.

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 some general concepts on income for Form 1040, lines 7–11, including how to determine what is considered taxable and nontaxable income. Review the list of taxable and nontaxable income in the Volunteer Resource Guide (Tab D), Income.

How to determine what income is considered earned and unearned was covered. Earned income is any income accumulated by personal effort, such as wages or business income reported on Schedules C or C-EZ. Unearned income is any income produced by investments, such as interest on savings or dividends on stock.

How to report income was also covered. Following is information on how to report income on Form 1040, lines 7–11.

- Line 7 income includes wages, salaries and tips, and scholarships. This income is generally reported to the taxpayer on Form W-2.
- Lines 8a and 8b, interest income, is reported to the taxpayer on Form 1099-INT. Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, or U.S. government bonds. 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 line 8b.
- Lines 9a and 9b 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.
- Line 10 is for taxpayers who itemized deductions in the previous year and received a tax benefit from deducting their state or local income taxes. Taxpayers who receive Form 1099-G may have to include part or all of their state refund on this line.
- Line 11 is used to report alimony received. Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument.



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<.

Notes



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 operated or a profession practiced as a sole proprietor.

NEW Beginning in tax year 2010, Schedule C is in scope on a limited basis for volunteer preparers. Schedule C completion is only in scope for VITA/TCE sites if all of the criteria for Schedule C-EZ are met, except for the limitation on \$5,000 of expenses. Volunteers can complete Schedule C with expenses of up to \$10,000.

The lesson also covers recordkeeping requirements for taxpayers with business income and expenses. See 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



What do I need?

- Approved Intake and Interview Sheet
 - 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

Where do I get business income or loss information?

Based on your interview and the completion of the taxpayer's approved intake and interview sheet, you may discover that the taxpayer or spouse had business income; this includes income as a self-employed person or independent contractor.

Even if taxpayers say they did not have self-employment income, be sure to ask again, rephrasing your questions to probe deeper. Many taxpayers have jobs on the side or have a small home-based business and do not think of themselves as "self-employed" if they make most of their money from W-2 wages. 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).



For guidance and assistance to Gulf Oil Spill Victims, see Publication 4873 and 4873-A. According to current law, BP payments for lost income are taxable in the same way that the wages or business income these payments are replacing would have been. 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.

How is business income reported?

Form 1040

Form 1040, line 12, is used to report income from a business operated or a profession practiced as a sole proprietor. 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. To report income from a nonbusiness activity, see the instructions for Form 1040, line 21.

Also, Form 1040, line 12, is used to report wages and expenses the taxpayer had as a statutory employee or certain income shown on Form 1099-MISC, Miscellaneous Income.



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.

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, 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.



Volunteer tax preparers who complete this lesson may, at the discretion of the site coordinator, assist self-employed individuals who qualify to use Schedule C-EZ or limited Schedule C.

Who can use Schedule C-EZ?

There are a number of conditions that the 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
- Do not have prior year unallowed passive activity losses from this business

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.

In your probing interview, explain that there are a number of conditions that the taxpayers must meet in order to use Schedule C-EZ, and then walk through each of these conditions with the taxpayers. If taxpayers do not meet these conditions, explain that volunteers are not trained to handle the preparation of Schedule C. However, a Schedule C can be completed if the taxpayers meet all conditions except that their expenses can be between \$5,000 and \$10,000. Apologize for being unable to complete the return, and explain that they should seek help from a professional tax preparer to complete their return.

Who can use Schedule C for purposes of the VITA/TCE Program?

Schedule C can be completed for a taxpayer with expenses up to \$10,000 if the taxpayer meets all the conditions above.

Taxpayer Interview and Tax Law Application

As you use the approved 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 anything.
<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 don't have any employees, so I spend a lot of money on gas, 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? Did you have a net loss? In other words, did you make a profit?</i>	That's correct. No losses.
<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> [On page 2 of the approved intake and interview sheet, indicate Jason's responses to these questions.]	My receipts totaled \$30,762.



EXERCISE

Question 1: Based on this information, 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 Expense

The operating costs of a business vehicle are in the car and truck expense. This may be actual expenses or the standard mileage deduction. 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.

The current standard mileage rate is multiplied by the number of business miles. Only parking and tolls can be added to the deduction for standard mileage rate. 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. It is 13 miles from the first office to the second office and 5 miles from the second office to the third office. Dana drives a total of 33 miles each work day; 18 miles are deductible.

Commissions and Fees

Commissions are paid to both individuals and businesses. Insurance sales are a prime example where commissions are paid.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property, automobile (business vehicles only), and malpractice or errors and omissions.

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 the front of the Form 1040, subject to qualifications.

Other Interest

Interest not includable in mortgage interest is included in this category. This includes interest paid on operating loans.

Legal and Professional Services

Expenses included on this line are for 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 pens, paper, and postage.

Rent or Lease—Vehicle, Machinery, and Equipment

This category includes the rent 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 contains costs for general operating supplies not associated with cost of goods sold. This may be a catchall type of account for the taxpayer.

Taxes and Licenses

Taxpayers can deduct taxes and licenses 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 the taxpayer's business. Examples of deductible travel, meal, and entertainment expenses are in the Volunteer Resource Guide (Tab D).

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. Billing statements should reflect the service address.

Other Expenses

Taxpayers may also be able to deduct the following expenses. See Publication 535 for more information.

- Donations to business organizations (see charitable contributions)
- Education expenses
- Environmental cleanup costs
- Gifts (see Bonuses)
- Impairment-related expenses
- Interview expense allowances
- Licenses and regulatory fees
- Moving machinery
- Penalties and fines paid for late performance or nonperformance of a contract
- Repairs that keep the property in normal, efficient operating condition
- Repayments of income
- Subscriptions to trade or professional publications

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.

Part II: Figure Net Profit

Enter total gross receipts on line 1. This includes all the income paid to the business, whether or not it was reported on a Form 1099-MISC. If any of the income was reported on Form W-2 and the "Statutory employee" box on the form was checked, check the box on line 1 of Schedule C-EZ.

If preparing a paper return, total all income from Form 1099-MISC and other taxpayer records and enter the amount on Schedule C-EZ, line 1.

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 these 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.

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.

If preparing a paper return, total all the deductible business expenses including auto expenses, calculated by using the standard mileage rate. Record the amount on Schedule C-EZ, line 2. Calculate the net profit by subtracting line 2 from line 1. The net profit is reported on Form 1040, line 12.



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 total 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 the business location and the lunch place. 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 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. The calculation of depreciation 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 (.50/mile for 2010) is multiplied by the number of business miles to calculate the vehicle expense. Add the total vehicle expenses to all nonvehicle expenses in line 2. The standard mileage rate is deemed to include 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 on Schedule C.

- 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 business name, if no separate name, leave blank.
- Line D: Employer ID Number (EIN), if any.
- Line E: Enter 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. If the taxpayer does not meet any of the tests, the answer is “No,” or if there is uncertainty about the taxpayer materially participating in the business, refer the taxpayer to a professional tax preparer.
- Line H: Check the box if business was started or acquired in 2010.

Part I: Income

Enter gross receipts from the taxpayer’s trade or business. Include amounts received in the trade or business that were properly shown on Forms 1099-MISC.

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 1, attach a statement explaining the difference.

Statutory Employees

If the taxpayer received Form W-2 and the “Statutory employee” box in box 13 of that form was checked, report the income and expenses related to that income on Schedule C or C-EZ. Enter the statutory employee income from of Form W-2, box 1, on line 1 of Schedule C or C-EZ and check the box on that line. 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 line 1 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.

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.


CAUTION
 Caution: Be sure you probe to find out if the taxpayer received business income that was not reported on Form 1099-MISC.

Recordkeeping

Why keep records?

Everyone in business must keep records. See the Volunteer Resource Guide (Tab D) 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 you need to be recorded in the books.

It is important to keep these documents because they support the entries in the books and on the tax return. Keep them in an orderly fashion and in a safe place. For instance, organize them by year and type of income or expense.

How long to keep records

Generally, taxpayers must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which a taxpayer can amend their 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 Lesson 28, Other Taxes.

Self-employed taxpayers may claim an adjustment to income of half of the social security and Medicare taxes they pay. Enter the amount from Schedule SE, line 6, to Form 1040, line 27, as an adjustment to income.

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



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.



Lesson 10: Income – Capital Gain or Loss; Form 1040, Line 13



Introduction

This lesson will help you assist taxpayers who must use Schedule D, Capital Gains and Losses, to report capital gains and/or losses on the sale of assets. In this lesson we will discuss 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 lesson, Screening and Interviewing. The approved intake and interview sheet lists income from the sale of property such as stock, bonds, or real estate. It is important to ensure that all income is accurately reported on the return. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year.

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 whether or not 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?

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

Optional:

- Publication 523
- Publication 544
- Publication 550
- Publication 551
- Form 1040 Instructions
- Form 1040 (Schedule D)
- Form 1099-B
- Form 1099-DIV
- Form 1099-S

What information must I have to report a capital gain or loss?

To report capital gain or loss on Form 1040, Schedule D, 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)
- 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
- 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 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, you will need to 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.
- Stock splits are decided by the corporation as a way to bring down 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.

TIP

Although stock splits and stock dividends do not occur often, always ask taxpayers if they received any additional shares from a stock split or stock dividend.

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 – The basis of inherited property 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.

NEW The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the estate tax for decedents dying after December 31, 2009 and before January 1, 2011. As a result, the basis of the assets inherited from decedents who died in 2010 is calculated differently. Generally, for the estates of decedents dying after December 31, 2009 and before January 1, 2011, the basis of assets acquired from the decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. However, there are some exceptions to the general rule. This change is only for the year 2010. The law providing for estate tax is scheduled to be reinstated on January 1, 2011. Determining the basis of property inherited from a decedent who died in 2010 can be very complex. Refer the taxpayer to a professional tax preparer.

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 property was received as a gift or inherited in 2010 and the taxpayer needs assistance to compute the basis, refer the taxpayer to a professional tax preparer. If the taxpayer knows the basis of the property, you can provide assistance.

How do I determine the holding period?

Long-Term or Short-Term

Schedule D requires entries for the stock purchase and sale date. Taxpayers must provide the date the stock was acquired and Form 1099-B will indicate the date the stock was sold. These two dates will determine the holding period. Schedule D classifies capital gains and losses as 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
- Stock held for 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).

NEW There are special rules for property inherited in 2010. As a result of the repeal of the estate tax for decedents dying after December 31, 2009, and before January 1, 2011, the automatic more than one year or long term for the holding period does not apply to property inherited in 2010. If the taxpayer sells property inherited from someone who died in 2010, refer the taxpayer to a professional tax preparer.



The special rules for inherited property only apply to property inherited in 2010.

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.

example

Erma bought stock on January 11, 2009 (trade date). Her holding period began the next day, January 12, 2009. If she sold that stock on January 11, 2010, 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, 2010 or later, the holding period would be one year and one day, which constitutes long-term.

example

On February 18, 2004, Lenny bought 500 shares of XYZ Corporation stock for \$1,500, including his broker's commission. On April 6, 2010, XYZ distributed a 2% nontaxable stock dividend (10 shares). Three days later, 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 that allows investors to take 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 gains distributions from sales of stock held by the mutual fund. Profits of these sales are reported to the shareholders of the fund as capital gains distributions. If taxpayers (owners) decide to sell any of their shares in the mutual fund itself, then 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 Form 1040, 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. Therefore, figuring the basis can be more difficult. 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 sell 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 sold are treated as coming from the earliest block purchased (FIFO method – or First In, First Out).

example

In 1999, Marie bought 100 shares of Antrim Corporation stock for \$2,000. In 2000, she bought another 100 shares of Antrim for \$2,300. In 2010, 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 bought in 2000, 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 3, 9, 10, 11, or 12 has an entry, refer the taxpayer to a professional tax preparer. To see a copy of Form 1099-B, refer to Publication 4491-W.

Sale Date

In box 1 on Form 1099-B, the stockbroker reports the date the stock was sold. Use this date, along with the purchase date provided by the taxpayer, to determine the holding period.

Sale Price

In box 2 on Form 1099-B, the stockbroker reports the sale price of the stock and checks a box to indicate if the amount in box 2 is gross proceeds or net proceeds:

- If Gross proceeds is checked, ask the taxpayer for the amount of commissions/fees paid and add it to the taxpayer's basis
- If gross proceeds 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 gross proceeds, so:

- Box 2 of Form 1099-B showed \$2,300
- The box next to "Gross proceeds" is checked

Because box 2 shows gross proceeds, you need to add the broker's commissions and fees (\$35) to Richard's basis in the stock.

<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 CUSIP no.	2010
		2. Stocks, bonds, etc.	Form 1099-B
		\$ 2,300	Reported } <input checked="" type="checkbox"/> Gross proceeds to IRS <input type="checkbox"/> Gross proceeds less commissions and option premiums
PAYER'S federal identification number	RECIPIENT'S identification number	3. Bartering	4. Federal income tax withheld

If preparing a paper return, add the broker's commission and fees (\$35) to the basis and enter the total in column e in Part I or Part II of Form 1040, Schedule D.



Tax Software Hint: You will need to add the broker's commissions and fees (\$35) to Richard's 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 “Gross proceeds” is checked. What is the amount Kevin reports as his sale price on Schedule D?

- A. \$925
- B. \$1,000
- C. \$850
- D. \$75

Other Information

Form 1099-B does 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 you with the information.



Some brokers do not issue standard Forms 1099-B. Instead they issue a statement, sometimes entitled a “1099 Consolidated Statement,” which shows stock sales and other types of distributions, such as dividends and interest. The tax reporting statement is sometimes referred to as a “Substitute 1099.”

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	2010 12-31-10			
<hr/>					
Substitute 1099-B <u>Date of Sale</u> <u>Box 1a</u>	<u>Stocks, Bonds-Proceeds</u> <u>Box 2 (less commission)</u>	<u>Description</u> <u>Box 7</u>			
2-23-10	\$ 2,100.00	20 shares Tractor Company			
6-1-10	\$ 900.00	100 shares Car Company			
6-22-10	\$14,000.00	500 shares Couch Company			
7-5-10	\$ 2,000.00	25 shares Technology Company			
<hr/>					
Substitute 1099-DIV <u>Payer</u>	<u>Ord. Div.</u> <u>Box 1a</u>	<u>Qual. Div.</u> <u>Box 1b</u>	<u>Cap. Gain, Dist.</u> <u>Box 2a</u>	<u>FIT Withheld</u> <u>Box 4</u>	<u>Foreign Tax</u> <u>Box 6</u>
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 Schedule D, Parts I and II?

Information from Form 1099-B is entered on Schedule D. Part I is for short-term sales and Part II is for long-term sales.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), Capital Gain or Loss Transactions Worksheet.

When preparing a paper return, determine the holding period for each block of stock sold. This will indicate whether the sale should be reported in Schedule D, Part I (short term) or Part II (long term). Record the information on each sale in columns a-e and calculate the gain or loss for column f.

How do I report capital gain distributions?

Capital gains distributions are reported to the taxpayer on Form 1099-DIV. If there are no capital gains from the sale of property, the Form 1099-DIV amount is entered on Line 13 of Form 1040.

If a taxpayer has both a 1099-DIV and a Form 1099-B, then capital gains distributions are added to Schedule D in 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 Part II of Schedule D.

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 sale price of \$1,200 on the sale of 600 shares of ABC Group, Inc. He bought the stock on February 19, 2004, and sold it on August 25, 2010. 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?

Combining all the amounts in column f on Schedule D, Part I, results in a net short-term capital gain or loss. Combining all the amounts in column f 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:

$$\text{Basis} = (\$15,000 \div 1,000) \times 600 = \$9,000$$

Sale Price = \$7,800

$$\text{Gain or Loss} = \text{Sale Price} - \text{Basis} = \$7,800 - \$9,000 = -\$1,200$$

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 sale price.

$$\text{Basis} = (\$1,500 + \$25 + \$25) = \$1,550$$

Sale Price = \$2,000

$$\text{Gain or Loss} = \text{Sale Price} - \text{Basis} = \$2,000 - \$1,550 = \$450$$

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 in June 2003 and sold in March 2010 was \$2,400. 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 sale price for the shares and the amount of capital gain?

- A. \$4,400 sale price and \$2,000 gain
- B. \$4,400 sale price and \$1,900 gain
- C. \$4,500 sale price and \$2,100 gain
- D. \$4,300 sale 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 2009 to 2010, use the Capital Loss Carryover Worksheet from the 2010 Schedule D instructions. To complete the worksheet, you will need information from the 2009 return.

If tax software was used to prepare the 2009 return, ask the taxpayer for a copy of the software's Schedule D Worksheet 2 (Capital Loss Carryovers from This Year to Next Year) to determine the carryover amounts from 2009 to 2010.

- Enter short-term capital loss carryovers (from Schedule D Worksheet 2, Line 8) on Schedule D, Part I, line 6
- Enter long-term capital loss carryovers (from Schedule D Worksheet 2, Line 14) on Schedule D, Part II, line 13

If the taxpayer's 2010 capital loss exceeds the deduction limit and the remainder must be carried forward to 2011, remind the taxpayer to bring a copy of the 2010 return when the 2011 return is prepared. Make a note on the outside of the taxpayer's tax return record envelope to help alert next year's preparer. Next year, whoever assists the taxpayer will use the Capital Loss Carryover Worksheet in the 2011 Schedule D instructions or the printed copy of the Schedule D Worksheet 2 to figure how much capital loss the taxpayer can carry over from 2010 to 2011.

If preparing a paper return, complete the Capital Loss Carryover Worksheet in the Form 1040 instructions. 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 approved intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	JEREMY RESPONDS...
<i>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?</i>	Yes, I sold some stock this year.
<i>Do you have a 1099 for that?</i>	Yes, I have this Form 1099-B and this stockbroker's statement.
<i>[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 on Schedule D Capital Gain or Loss Worksheet. I see the broker's statement has the sale details I need, but do you know when you purchased the Purdue stock?</i>	I bought the Purdue stock back on July 13, 2000.
<i>I see the sale date was March 10, 2010. That means the holding period for the stock was more than one year. They call that long-term, and it determines both where we enter the information on Schedule D and the tax rate for any gain. Now, do you know the basis for the stock?</i>	What is that?

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

JEREMY RESPONDS...

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 sale 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 approved intake and interview sheet.]

Who must file Schedule D for the sale of a home?

Now we will discuss if the sale of the taxpayer's residence will need to be reported on Schedule D. You will need to 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 information to help you make this determination, refer to the Selling Your Home Chapter in Publication 17 or Publication 523.



CAUTION

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 topic, 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 whether or not you should be certified in this topic.

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. It is important to ensure that all income is accurately reported on the return. 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.



CAUTION

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 28, Other Taxes, Lesson 29, Payments, 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:

1. The taxpayer does not meet the ownership test.
2. The taxpayer does not meet the use test.
3. During the two-year period ending on the date of the sale, the taxpayer has excluded the gain from the sale of another home.
4. The gain from the sale is more than the amount that the taxpayer may exclude: \$250,000 for individual taxpayers, \$500,000 for Married Filing Jointly.

What is considered a “main” home?

Only a gain from the sale of a taxpayer's main home may be excluded from the taxpayer's income; a gain from a sale of a home that is *not* the taxpayer's main home will generally have to be reported as income.

So the first step is to find out if the home meets the definition of a “main” home. A taxpayer's main home is where the taxpayer lives 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 and must have cooking, sleeping, and bathroom facilities. The taxpayer's main home may also be a rented house or apartment. Taxpayers who have 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. For over half the year, she lives in Denver. Lucille's main home is her rental apartment in Denver, because she lives there most of the time, even though she does not own the apartment in Denver.

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 2002, Helen lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2007. In 2008, Helen became ill and on April 14 of that year she moved into her daughter's home. On July 10, 2010, 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, 2005, to July 10, 2010, the date she sold the apartment. She owned her apartment from December 1, 2007, to July 10, 2010 (over two years). She lived in the apartment from July 11, 2005 (the beginning of the five-year period), to April 14, 2008 (over two years).



EXERCISES (continued)

Question 4: Emily, who is single, bought a home in 1997. She lived in the home until May 31, 2008, when she accepted an assignment with the Peace Corps in Venezuela and left the house vacant. Emily returned to her home on May 31, 2009 and lived there until she sold the house on January 10, 2010. 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 2008. In December 2009, the company she worked for notified her that she would be transferred to another town by the end of 2010. She continued to live in the home until June 2010, 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 current sale of the 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 2 years after the date of the deceased spouse's death, and all other requirements are met.

How do I figure the gain (or loss) from the sale of a home?

Once you've determined that a taxpayer is eligible for the exclusion, you can 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 (\$250,000 if Single, \$500,000 if Married Filing Jointly), you do not need to calculate the gain on the sale of the home. None of the gain will be taxable. Loss on the sale of a residence is not reported on the return. For more information, see the Selling Your Home section in Publication 17.

Selling Price

The selling price is the total amount taxpayers (the seller) received for their main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received.

If the taxpayer received Form 1099-S, *Proceeds from Real Estate Transactions*, use it to 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 used the home for business purposes or as rental property after May 6, 1997, refer the taxpayer to a professional tax preparer. The taxpayer cannot exclude the part of the gain equal to the depreciation allowed or allowable as a deduction.



A loss on the sale of a personal residence is not deductible.



If the taxpayer can exclude the entire gain from the sale of a personal residence, the person responsible for closing the sale (i.e., a real estate broker or settlement agent) generally will not issue a Form 1099-S. If a Form 1099-S is issued and you determine that the gain is excludable, the sale should be shown on Schedule D to notify IRS that the gain is excludable.



If the taxpayer has a loss on the sale of a main home for which a Form 1099-S was received, you must report the loss on Schedule D even though the loss is not deductible. Report the transaction on line 1 or 8, depending on how long the taxpayer owned the home. Complete columns (a) through (e). Enter -0- in column (f).

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, Gain or (Loss), Exclusion, and Taxable Gain on Sale of Home, in Publication 523. (A similar worksheet is available in the tax software.)

$$\text{Amount realized} = \text{Selling price} - \text{Selling expenses}$$

$$\$246,000 = \$250,000 - \$4,000$$



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.



Caution: There are special rules for property inherited in 2010. Taxpayers selling property that was inherited in 2010 should be referred to a professional tax preparer.



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 installing a recreation room or putting on a new roof. 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 needs to be referred to a professional tax preparer.



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, you 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 are Married Filing Jointly may exclude up to \$500,000.



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 no longer excludable from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period after 2008 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 553. To figure the portion of nonqualified use, multiply the gain by the following fraction:

$$\frac{\text{Total nonqualified use during period of ownership after 2008}}{\text{Total period of ownership}}$$

This issue can be complex. Refer taxpayers with "nonqualified use" issues to a professional tax preparer.



Use Worksheet 2, Gain or (Loss), Exclusion, and 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.

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 and must be reported on Schedule D, Capital Gains and Losses. 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. A loss on the sale of your main home cannot be deducted.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).

If preparing a paper return, complete Schedule D, Part II, as shown in the following illustration.

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 Main home	9/03/2004	7/07/2010	\$789,000	\$226,000	\$563,000
Section 121 Exclusion					(\$500,000)

Taxpayer Interview and Tax Law Application

Jeremy and Janice Smith checked the "Yes" box for selling some real estate on the approved intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

JEREMY RESPONDS...

Did you sell a home during 2010?

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. We bought it in January 2007 and sold it in June 2010.

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 from June 2007 to December 2007 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 approved 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 2001 and lived in it for 2½ years. Beginning in 2004, he was on qualified official extended duty in the U.S. Army. He sold his home in 2010 and had a \$12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2005–2010). Peter can disregard those five years. The test period consists of 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 2010. 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 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.

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.



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. You never adjust the sale price. If box 2 shows gross proceeds, you need to 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 sale 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 the taxpayer to exclude the gain is if he can extend the five-year period due to official extended military duty.

Notes



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:

- 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.

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.

What do I need?

- Approved Intake and Interview Sheet
- 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

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.

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.

If preparing a paper return, record the amounts 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, or on Form 1040A, line 12a
- If the IRA/SEP/SIMPLE box is checked on Form 1099-R, report the gross amount on Form 1040, line 15a, or on Form 1040A, line 11a
- 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, or on Form 1040A, line 12b
- If the IRA/SEP/SIMPLE box is checked on Form 1099-R, report the taxable amount on Form 1040, line 15b, or on Form 1040A, line 11b

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 that is 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.

TIP

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



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.

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.



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. In 2010, 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 it on Form 1040A, lines 11a and 11b or on Form 1040, lines 15a and 15b. If not, the distribution is partially taxable. In that case, refer the taxpayer to a professional tax preparer.



An early distribution from a traditional or Roth IRA may be subject to a 10% additional tax. Refer to lesson 28, Other Taxes, for more information.



Distributions from a SIMPLE IRA and from a SEP IRA are generally fully taxable and are out of scope for VITA/TCE.

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.

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 1040A, line 11a or on Form 1040, line 15a. To show that this is a qualified rollover and none of the amount is taxable, enter zero on Form 1040A, line 11b or on Form 1040, line 15b, and write "Rollover" next to line 11b or 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 includable as income
- B. The entire distribution is excludable from income
- C. The distribution is eligible for the ten-year tax option
- D. The distribution is eligible to be taxed at a special rate

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



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 in 2010 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.

If preparing a paper return, use the Simplified Method Worksheet found in the Form 1040A and Form 1040 Instructions to calculate the taxable portion to be reported on line 12b/16b of the return. Do not forget 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)
- 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.

TIP

If disability pay is treated as wages, it might affect Earned Income Tax Credit.

If preparing a paper return and the taxpayer has not reached the minimum retirement age, report the disability income as wages on line 7 of Form 1040A or Form 1040. If the taxpayer has reached the minimum retirement age, report the disability income as a taxable pension on the appropriate lines of Form 1040A or 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.

NEW 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 28, 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 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 and qualifies 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. If preparing a paper return and the penalty is applicable, enter 10% of the taxable amount in the Other Taxes section of Form 1040 and write "No" on the line to indicate Form 5329 is not required.

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 Lesson 28, Other Taxes.

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.



Temporary Waiver of RMD in Tax Year 2009: For 2009, taxpayers were not required to take a minimum distribution from a traditional IRA (as well as most defined contribution plans). This waiver applied to IRA participants as well as beneficiaries. The waiver also applied if the taxpayer turned 70½ in 2009 and delayed the 2009 required minimum distribution until April 1, 2010.



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, 2009. He is not required to take a minimum distribution for 2009. His first required minimum distribution would be for 2010. Peter has until December 31, 2010, to take the 2010 distribution.

example

Ralph retired in 2003. He turned 70½ in 2010. He must begin taking minimum distributions from his qualified plans by April 1, 2011.

example

Myrna was 72 when she retired in 2010. 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, 2010 to take her 2010 minimum distribution..

example

Irving was still employed when he turned 72 on March 12, 2010. He was required to begin taking minimum distributions from his traditional IRA after age 70½ even though he was not yet retired. He turned 70½ on September 12, 2008 and began taking minimum distributions before April 1, 2009. Irving has until December 31, 2010 to take his 2010 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. 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.

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, 2010. 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, 2010
- B. Take a distribution of \$1,479 by April 1, 2010, and another \$1,479 by December 31, 2010
- C. Take a distribution of \$2,958 by December 31, 2010
- D. Take a distribution of \$1,479 by April 1, 2011, and another \$1,479 by December 31, 2011

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 that they can request federal income tax to 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 have enough federal income tax paid 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.



Taxpayers who receive a very large refund may make better use of their funds if the withholding is lowered. Explain ways they can reduce their withholding.



EXERCISES (continued)

Question 9: Faith comes to your site to get her 2010 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, 2011. 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.



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 28.)

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 ($6 \times \$1,679$) 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 2010. She should take a distribution of \$1,479 for tax year 2010 by April 1, 2011, and another distribution of \$1,479 for tax year 2011 by December 31, 2011.

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.

Notes



Lesson 12: Income – Rental and Schedule K-1s



Introduction

This lesson will help you identify and report certain income from Schedule K-1s; Form 1041, Form 1065, and Form 1120S. This lesson also covers rental income and expenses for the Military and International courses.

Last year, interest, dividends, capital gains and losses, and tax exempt interest topics from Schedule K-1s were included into scope. Royalty income on Schedule K-1 is treated in a similar manner. Schedule K-1, royalty income, is being added to the scope for the 2011 filing season. This is an Advanced level topic.



The at-risk and passive activity issues in this lesson are beyond the usual scope of volunteer training, with the exception of assisting military and other government employees living abroad and with limited access to both 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 approved intake and interview sheet lists income from rental property but does not list income from Schedule K-1s. 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.



This lesson does not apply to taxpayers who are in the business of renting properties.

Objectives

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

- Identify Schedule K-1 income items that are within the scope of the VITA/TCE program
- Determine how to report Schedule K-1 income items
- Determine which types of rental income must be reported
- Identify how to report rental expenses

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Publication 527
- Schedule A
- Schedule E

Optional:

- Publication 541
- Publication 551
- Publication 559
- Publication 925
- Publication 946
- Form 8582
- Schedule K-1 (Form 1041 and Instructions)
- Schedule K-1 (Form 1065 and Instructions)
- Schedule K-1 (Form 1120S and Instructions)



Schedule K-1s

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. Accurate filing of the forms is important because the IRS matches income from Schedule K-1 to other tax returns. The income, other distributions, deductions, and credits will be reported on Forms 1041, 1065, or 1120S by the payee.

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 (Schedule B)
- Dividend income (Schedule B)
- Net short-term capital gains and losses (Schedule D)
- Net long-term capital gains and losses (Schedule D)
- Tax-exempt interest income (Form 1040, line 8b)
- **NEW** Royalty income (Schedule E)



CAUTION
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.



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.

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. Although the partnership is not subject to income tax, taxpayers are liable for tax on their share of the partnership income, whether or not that income is distributed.

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 taxpayer is liable for tax on their share of the corporation's income, whether that income is distributed or not.

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 the taxpayers' income from these sources should be reported.



Schedule K-1s are not filed with the tax return. Advise taxpayers to keep Schedule K-1s 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?

Renting a room or a home to a tenant is an income-producing activity. 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; the accrual method reports income when earned and expenses when incurred. Most individuals use the cash basis method.



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.



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.

What qualifies as a rental expense?

Taxpayers who reside in homes they own generally deduct mortgage interest and property taxes as itemized deductions 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

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
- Property taxes
- Mortgage interest and points
- 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



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.

What about 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.



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.



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 into 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. For 2010, the standard mileage rate of operating your car for rental-related trips is 50 cents per mile.

TIP

This lesson discusses only the standard mileage rate. If taxpayers wish to use the actual method, refer them to a professional tax preparer.

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 is 50 cents per mile. 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.

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, 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).

TIP

Additional information on rental income can be found in Publication 527, Residential Rental Property, and Publication 946, How to Depreciate Property.

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

**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 2007 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, 2009. Repairs were made to the condo in January and February 2010. On March 1, 2010, 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 \$6,578.00. (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, 2010, 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



EXERCISES (continued)

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 on which it sits. 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 built their own home or acquired it 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 2010, they were transferred overseas and decided to rent out the home, which was their personal residence. The value of the house and land in 2010 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

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.



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
- D. A rental home located outside the U.S.

Taxpayer Interview and Tax Law Application

As you use the approved 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...

I see you were stationed overseas last year from March through December. Did you rent out your home during that time?

TONY RESPONDS...

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?

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, most 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.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

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?

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.

TONY RESPONDS...

Yes, just before I left the country, I spent \$1,000 having the place painted and I installed a new 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:

- 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 house to a tenant. The total square footage of her house is 1,200 square feet. 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



Regardless of whether the **Yes** or **No** box is checked on Schedule E, question 2, 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% ($7 \div 70$ total days, where 7 personal days + 63 rented days = 70 total days) of Charles' expenses are not rental expenses and cannot be deducted on Schedule E.



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?

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, 2009, 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, 2009, to May 14, 2010. On June 1, 2010, 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. The taxpayer uses the dwelling unit as a home if the taxpayer meets the personal use test: On Schedule E, question 2 (related to personal use), the **Yes** box should be checked if the taxpayer used the unit for personal purposes in 2010 **more than the greater of:**

- 14 days or
- 10% of the total days it was rented to others at a fair rental price

Otherwise, the **No** box should be checked.

If the **No** box is checked 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 **Yes** box is checked and the taxpayer rented the unit for **fewer than 15 days** in 2010, 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 **Yes** box is checked and the taxpayer rented out the unit **at least 15 days** in 2010, 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 2011 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 ($170 - 10$) days. 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 as described above when the **Yes** box is checked on Schedule E, question 2.

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 law

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 is the passive activity law?

The passive activity law states 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 vs. active

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.

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 \$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)

Refer taxpayers with an AGI over \$100,000 to the IRS or a professional tax preparer.



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 law
- 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.



EXERCISES (continued)

Question 12: Which taxpayer is most likely required to file Form 8582, *Passive Activity Loss Limitations*?

- A. Chelsea, who owns two rental dwellings with no net loss and has an AGI of \$111,000
- B. Lance, who owns one rental dwelling with a loss of \$1,444 and has an AGI of \$34,000
- C. Sean, who owns one rental dwelling with a loss of \$800 and has an AGI of \$103,000

Summary

Taxpayers receive Schedule K-1 (Form 1065 or Form 1120S) reporting their share of income from interest, dividends (ordinary and qualified), capital gains (net short-term and net long-term), and royalties from partnerships and corporations. 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.

The taxpayer's income of interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term) should be reported on the appropriate forms and schedules as listed on Form 1041, Schedule K-1, page 2.

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. Those who do live in and rent out their homes:

- 15 days or more during the year may not be able to deduct rental expenses that exceed rental income
- Fewer than 15 days during the year should not report any of the income or deduct any of the rental expenses

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.

The passive activity law states 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.



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.

Answer 12: C. If Sean had an AGI of less than \$100,000, he would not have to file Form 8582 because he had only one passive rental loss.



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?

- Approved Intake and Interview Sheet
- 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 the approved 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.

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:

- Line 3 of Form 1040EZ
- Line 13 of Form 1040A
- Line 19 of Form 1040

The amount of withholding from Form 1099-G, box 4 should be entered on:

- Line 7 of Form 1040EZ
- Line 38 of Form 1040A, or
- Line 61 of Form 1040



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 approved 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
- Report social security and railroad retirement benefits on the tax return

What are social security and railroad retirement benefits?

Social Security Benefits

Social security benefits are payments made under Title II of the Social Security Act. They include Old-Age, Survivor, and Disability Insurance (OASDI) benefits 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.

What do I need?

- Approved Intake and Interview Sheet
- 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

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 approved 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 are also taxable if the taxpayer is Married Filing Separately and lived with his or her 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. Go to the Volunteer Resource Guide (Tab 2), Railroad Retirement, Civil Service, and Social Security Benefits, for software entries.

If you are preparing a paper return, first complete the other income and certain adjustment items on Form 1040, page 1. Next, calculate the taxable amount of social security benefits by entering the box 5 amounts from all Forms SSA-1099 and RRB-1099 into the Social Security Benefits Worksheet in the Form 1040 Instructions. On Form 1040, enter the total amount of benefits received on line 20a and the taxable portion on line 20b. If none of the benefits are taxable, enter "0" on Form 1040, line 20b. If the taxpayer is itemizing deductions, include Medicare premiums (Part B and D) from the Forms SSA-1099 and RRB-1099 on Schedule A. Additionally, be sure to report any federal income tax withholding on the appropriate line of Form 1040, page 2.



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 in 2009. In 2010, 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 in 2010. This payment could be for the current tax year and for prior tax years. Box 5 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 in 2010, 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 (2010) and included on Form 1040, line 20b.

If the taxpayer chooses to spread the payments back to earlier years, only 2010 income will be adjusted. The taxpayer does not file amended returns for the earlier years. However, a special procedure must be used to figure the taxable portion of the benefits assigned to the earlier years. If taxpayers want to use this option, refer them to a professional tax preparer or to Publication 915.



EXERCISES (continued)

Question 2: Joan presents you with her Form SSA-1099 that includes a lump-sum benefit payment for both 2009 and 2010. For which option would you refer her to a professional tax preparer?

- A. Averaging the benefit over the number of years
- B. A special procedure used to figure the taxable portion of the benefits assigned to the earlier years
- C. Reporting the whole payment in 2010
- D. Reporting half the payment in 2009 and the other half in 2010

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. Refer taxpayers who want to use the latter option to a professional tax preparer or Publication 915.



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.

Answer 2: B. There are only two options available for figuring the taxable portion of social security benefits paid as lump-sum benefit payments. The first option allows the taxpayer to report the whole payment in the year it was received. The other option is a special procedure that must be used to figure the taxable portion of the benefits assigned to the earlier years. Refer taxpayers who want to use this option to a professional tax preparer or to Publication 915.

Notes



Lesson 15: Income—Other Income; Form 1040, Lines 21-22



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 cancellation of debt for credit cards is now in scope for the 2011 filing season. This topic is limited to nonbusiness credit card debt involving solvent taxpayers.

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 requires using the contemporaneous exchange rate or, if not known, an average annual exchange rate.

This lesson will help you determine who is eligible for the foreign earned income exclusion and how to calculate the excludible amount by using Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

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?

- Approved Intake and Interview Sheet
- 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 anything that does not have its own line on Form 1040. Here are examples:

- Prizes and awards
- Gambling winnings, including lotteries and raffles
- Jury duty fees
- Alaska Permanent Fund dividends



For guidance and assistance to Gulf Oil Spill Victims, see Publications 4873 and 4873-A. According to current law, BP payments for lost income are taxable in the same way that the wages or business income these payments are replacing would have been. 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.

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.

To ensure that all taxable income has been included, use the interview techniques and tools discussed in the Screening and Interviewing lesson.

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.



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 information.)



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).

NEW There is a specialty course on cancellation of debt 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 topic, 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 whether you should be certified in this topic.



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.

example

In 2010, Alfredo Kendall earned \$40,000 while working in Dallas, Texas, for Dade Corporation. In September 2010, 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; enter \$70,000 on his Form 1040, line 7.

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 the taxpayer on forms or in ways that are not used in the United States. Question the taxpayer closely to ensure that the taxpayer is reporting all worldwide income. Review the income records to ensure that includable amounts are accurate and complete.



EXERCISES

Answers are listed following the lesson summary.

Question 1: Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her 2010 income included \$22,000 in wages earned in Germany. She earned \$300 in interest from her U.S. bank. What is Marta's total income?

- A. \$0
- B. \$22,300
- C. \$300
- D. \$22,000

Question 2: Mary Carleton, a U.S. citizen, lives in Belgium. Her 2010 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.



The exchange rates used here are just examples. You should use the exchange rates in effect when the income was actually 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: $\text{€}3000 \div 0.74855 = \$4,007.75$

In other words:

$$\frac{\text{Amount of foreign currency}}{\text{Exchange rate of foreign currency to one U.S. dollar}} = \text{Amount in U.S. dollars}$$

$$\frac{3,000 \text{ Euros}}{0.74855} = \$4,007.75$$



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

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, so the exchange rate is determined by the date of transaction. The date of transaction is either the date on the check or the date the money is credited to the taxpayer's account.

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 2010. 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 2010 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 215-516-2000 (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.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2).

What is the foreign earned income exclusion?

Certain taxpayers can exclude income earned in, and while living in, foreign countries. For 2010, the maximum exclusion amount is \$91,500. 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.

The Foreign Earned Income Tax Worksheet from the Form 1040 Instructions must be used to calculate the tax. The tax software will do this automatically.

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.



Form 6251, Alternative Minimum Tax, is out of scope. Refer the taxpayer to a professional tax preparer if Form 6251 is applicable.

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 \$91,500 (on qualified income) for 2010.



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 2002. 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- or ship-based. **Generally, most U.S. military members and their dependents do not qualify for the foreign earned income exclusion.**

example

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2005. Their tax home for 2010 is Germany.



EXERCISES (continued)

Question 6: Alan has lived and worked in China since August 16, 2003. For 2010, 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 2010. 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 2010 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 2004. His mother still lives in the U.S. Charles came to the U.S. for two weeks in 2010 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

Margaret, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2008. 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. In 2010, 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.



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 \$91,500 or less
- Have no business or moving expense deductions

Taxpayers who do not meet these restrictions should file Form 2555 to claim the exclusion.

example

Michael and his wife, Eva, have been stationed in Australia since 2007. 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 approved intake and interview sheet for taxpayers Hudson and Hope Howard (see Military Practice Exercises, Exercise 16, in Publication 4491-W).

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.
<i>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?</i>	No, Bavaria Advertising is a foreign company owned by a family right there in Munich.
<i>Great. That would qualify, but Hudson's military pay won't. [Volunteer links to Form 2555-EZ on the tax software.]</i>	Yeah, that all sounds right.
<i>Let's see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than \$91,500. 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.</i>	
<i>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.</i>	I sure hope you know what you are doing; it sounds complicated to me.
<i>Don't worry, I just need to ask you a few questions. How long did you say you were in Germany?</i>	We moved on base in Germany on March 3, 2009 and just returned to the states on January 10, 2011.
<i>No problem then. You were living in Germany for the entire year so you are considered a bona fide resident in 2010. Since your home and place of employment were both in Germany, you meet the tax home test.</i>	1567 Albion Street, Munich.
<i>Now, what was your address while you were living in Germany?</i>	
<i>What did you do for Bavaria Advertising?</i>	I was a copywriter.
<i>Do you have Bavaria Advertising's address?</i>	I sure do; it is right here on this statement.
<i>Were you present in the U.S. during 2010? I have to enter the dates on this form.</i>	Not in 2010. But we did come home for the holidays in 2009.

Summary

Total income from all sources is entered on:

- Line 22 (Form 1040, lines 7–21)
- Line 15 (Form 1040A, lines 7–14)
- Line 4 (Form 1040EZ, lines 1–3) (total income is the same as adjusted gross income)

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. The exchange rates used should reflect the closest accurate rate.

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 excludable amount will be entered as a negative number on line 21 to offset the income reported on line 7 or line 12.

There is an optional specialty course on cancellation of debt on Link & Learn Taxes for volunteers with an Advanced, Military, or International Certification.



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 \$91,500, she can file Form 2555-EZ.

Notes



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?

- Approved Intake and Interview Sheet
- 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 excludable 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 taxpayer's 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.



If the amount shown in Form W-2, box 1, differs from the last Leave and Earnings Statement for 2010, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

What income is excludible?

Excludible income does not have to be reported as income on Form 1040EZ, Form 1040A, or Form 1040. 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 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 excludable 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.

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 service 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 service of the veteran 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. The amount of the disability benefit is calculated by the VA, based on the percentage of disability and other factors.

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 2009. Here are the payments she reported on her 2009 tax return:

<i>Payments</i>	<i>Amount</i>
• Disability severance pay	\$10,000
• Service pension	\$33,000
• Active duty pay	\$ 5,000

In 2010, the VA determined that she was retroactively entitled to a VA disability pension of \$837 each month from the date of her discharge (February 2009). She can amend her 2009 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 2010 Form 1099-R will not include the nontaxable VA disability retirements received during 2010.

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.

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 the Form W-2 when inputting in the tax software.

What qualifies as service in a combat zone?

Service in a combat zone includes periods that military members are absent from duty because of illness, wounds, or leave. If, as a result of serving in a combat zone, military members become prisoners of war or are missing in action, they are considered to be serving in the combat zone as long as they remain in that status for military pay purposes.

When does service outside a combat zone qualify as service inside a combat zone?

Military service outside a combat zone is considered to be performed in a combat zone if the service:

- Is in direct support of military operations in the combat zone, and
- Qualifies a member for hostile fire/imminent danger pay due to dangers or risks from the combat zone

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

What is nonqualifying presence in a combat zone?

The following military service does not qualify as service in a combat zone:

- Presence in a combat zone while on leave from a duty station located outside the combat zone
- Passage over or through a combat zone during a trip between two points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience



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.

example

Sgt. Bobby Osage was not assigned to a combat zone but he did duty that was qualified for hostile fire pay. He can exclude that income.



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 if it's only 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 Form W-2, 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 Child Tax Credit or the Earned Income Tax Credit. If using the tax software, be sure to enter all fields on Form W-2. If filing a paper return, be sure to consider the combat pay amount when calculating these credits. When figuring these credits, you may need to compare the credit 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 a taxpayer that has combat pay:

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	MRS. FANNIN RESPONDS...
<i>Let's talk for a minute about where your husband was stationed.</i>	My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything?
<i>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 Operation Iraqi Freedom?</i>	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 were domiciled in a community property state.

How do community property laws affect Armed Forces pay?

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.

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.

For military members residing in community property states, the key word is **domicile**. Domicile describes someone's legal, permanent residence. It is not always where the person presently lives.

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



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. The line items under the Adjusted Gross Income section of the tax return are all Intermediate topics, except the penalty on early withdrawal of savings, which is a Basic topic.

Adjusted Gross Income	22 Combine the amounts in the far right column of lines 7 through 21. This is your income ►	
	23 RESERVED (see page 29)	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 One-half of self-employment tax. Attach Schedule SE	27
	28 Self-employed SEP, SIMPLE, and qualified plans	28
	29 Self-employed health insurance deduction (see page 30)	29
	30 Penalty on early withdrawal of savings	30
	31a Alimony paid b Recipient's SSN ►	31a
	32 IRA deduction (see page 31)	32
	33 Student loan interest deduction (see page 34)	33
	34 RESERVED (see page 35)	34
	35 Domestic production activities deduction. Attach Form 8903	35
	36 Add lines 23 through 31a and 32 through 35	36
	37 Subtract line 36 from line 22. This is your adjusted gross income ►	37

Attachment
Line 22
See page 21
Line 36
See page 35
Cat. No. 1040 (2010)

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 approved intake and interview sheet.

What do I need?

- Approved Intake and Interview Sheet
- 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

During the tax year did the taxpayer or spouse:

- Receive income from self-employment?
- Pay a penalty for early withdrawal of savings?
- Pay alimony?
- Make contributions to a traditional IRA?
- Pay student loan interest?
- 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, SEP, SIMPLE, and qualified plans and domestic product activities deductions. In general, 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.

NEW There is a specialty course on health savings accounts 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 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 self-employment tax?

Self-employed taxpayers can subtract half of their self-employment tax from their income. (This is equal to the amount in social security tax and Medicare tax that an employer pays for an employee, and which is excluded from an employee's income.)

If, based on the interview, you establish that the taxpayer and/or spouse has self-employment income, work with the taxpayer to calculate the self-employment tax using Form 1040 (Schedule SE), Self-Employment Tax; this is covered in Lesson 28, Other Taxes.



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.

If you're using tax software, you should have entered the early withdrawal penalty amount when you entered the interest received on the electronic Interest Statement, Schedule B. Enter the penalty amount on line 30 of Form 1040.

example

In 2010, 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 in 2010. 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 2006. 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. In 2010, 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. In 2010, 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 approved intake and interview sheet. To meet the age requirement for 2010, a taxpayer must have been born on, or after, July 1, 1940.
- 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 18, 2011.



Be sure the taxpayer knows that if a contribution is reported on the 2010 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 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 includable 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. In 2010, 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 2010 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. In 2010, 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, found in the Form 1040 Instructions, 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 2010 (worksheet step 1). If so, their deduction may be limited. Employees covered by a retirement plan will have box 13 on Form W-2 checked.

If the taxpayer (or spouse, on a joint return) is not covered by a retirement plan, step 1b on the IRA Deduction Worksheet will direct you to line 7 of the worksheet, where you enter the maximum IRA contribution limit—that is, the most the taxpayer can deduct. For a joint return, complete worksheet line 7b for the spouse.

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 on line 2 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, line 6 of the worksheet tells you that 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. The entry on line 7a (and line 7b if a joint return) represents the maximum allowable deduction for that taxpayer.

Line 8 of the worksheet asks you to enter the earned income shown on the return. This calculation determines the amount of compensation earned by the taxpayer(s). If the taxpayers are married and filing jointly, and their compensation is less than the maximum IRA contribution allowed, you will have to go to Publication 590 to figure their deduction. Otherwise, continue with the worksheet.

Next, on line 11, enter the total contributions to traditional IRAs that were made (or will be made) by April 18, 2011. The worksheet then helps you figure the amount that can be deducted from income.

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).



CAUTION
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.

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 Lesson 28, Other Taxes.

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

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 withdrawal was made.

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 in 2010. 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 2009 and paid \$2,400 in student loan interest in 2010. 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.

To figure the deduction when preparing a paper return, use the Student Loan Interest Deduction Worksheet in the Form 1040 Instructions. You need 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. Since you are filing as Single, and your income before adjustments is not more than \$55,000, your income 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 approved 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, none of those.

Heavens, no, I wish I had!

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.

What about other adjustments to income?

There are additional adjustments to income on Form 1040. In general, these are beyond the scope of the VITA/TCE program. If you believe a taxpayer could benefit from one of these adjustments, encourage the taxpayer to consult a professional tax preparer.

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, follow the instructions on the Form 1040:

1. Add the amounts in the far right column of the Income section (lines 7 through 21) and enter the result on line 22. This is the taxpayer's total income.
2. Add the Adjustments to Income (the amounts in lines 23 through 35) and enter the result on line 36. These are the total Adjustments.
3. Subtract line 36 from line 22. 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...
<i>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?</i>	No, it all makes sense.
<i>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?</i>	No, I don't.
<i>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 half 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.</i>	Cool!

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

DANIELA RESPONDS...

<i>Did you pay any alimony?</i>	No, I've never even been married.
<i>Now, did you contribute to an IRA?</i>	I put in \$2,000 right after Christmas.
<i>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>	I don't think so, but that's good to know.
<i>Was it a traditional, Roth IRA, or a SIMPLE IRA?</i>	It was just a plain old IRA. Here's the statement.
<i>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 2010?</i>	No, none.
<i>Because you weren't covered by a retirement plan, you will be able to deduct the full \$2,000 you contributed.</i>	
[The volunteer reviews all expenses listed on the approved 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.]	
<i>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.</i>	That's great! This program makes it really easy!
[On the approved intake and interview sheet, note that you have addressed this adjustment.]	

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:

- One-half of self-employment tax
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Student loan interest deduction
- 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 Advanced, Military, or International Certification.

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.



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 approved 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?

- Approved Intake and Interview Sheet
- 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 expenses are military moving expenses that 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.

How do I handle military reimbursements?

You need to 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 most common form of military 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). 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 the amount of 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: 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...	MRS. FANNIN RESPONDS...
<p>You said you just moved here during June of this year. Was this a PCS move?</p>	<p>Yes, my husband was transferred here shortly before he deployed. I have family close by, so I'd rather stay here while he's overseas.</p>
<p>If your expenses were more than the Armed Forces reimbursed you for, 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?</p>	<p>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.</p>
<p>Did you drive directly here, or did you take any side trips?</p>	<p>We came right here so we could settle in before he deployed.</p>
<p>The IRS will let you take a standard 16.5 cents a mile, or we can use actual expenses, if you kept track. The standard rate would be \$165.</p>	<p>I only kept the gas receipts, so the standard would probably be best.</p>
<p>The IRS allows lodging costs, but not food. So your total allowable expenses would be \$465, which includes \$300 for the motels and \$165 for your mileage expenses. The travel voucher shows a total of \$400 in reimbursements—did you receive any other reimbursements or allowances?</p>	<p>No, that's it.</p>
<p>Then you'll get to deduct \$65, the amount you spent that was more than your reimbursements.</p> <p>[On the approved intake and interview sheet, be sure to note that you've addressed this adjustment.]</p>	

Form 3903		Moving Expenses	
Department of the Treasury Internal Revenue Service (99)	Name(s) shown on return	OMB No. 1545-0074	2010 Attachment Sequence No. 62
		► Attach to Form 1040 or Form 1040NR.	
		Your social security number	
<p>Before you begin:</p> <ul style="list-style-type: none">✓ See the Distance Test and Time Test in the instructions to find out if you can deduct your moving expenses.✓ See Members of the Armed Forces in the instructions, if applicable.			
<p>1 Transportation and storage of household goods and personal effects (see instructions)</p> <p>2 Travel (including lodging) from your old home to your new home (see instructions). Do not include the cost of meals.</p>		1	
		2	

When should an Armed Forces member claim the deduction?

Armed Forces members who use the cash method of accounting and who are reimbursed for their expenses can deduct the expenses either in the year they were paid or in the year the reimbursement was received. They can choose to deduct the expenses in the year of reimbursement even if they paid the expenses in a different year.

If expenses are deducted and the reimbursement is received in a later year, the reimbursement must be included in income.

Armed Forces members who use the cash method of accounting (the most common) can deduct moving expenses in the year of reimbursement if the expenses were paid in the year:

- Before the year of reimbursement or
- Immediately after the year of reimbursement but by the due date, including extensions, for filing the return for the reimbursement year



EXERCISES (continued)

Question 3: In November 2010, 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. 2011 only
- B. 2010 only
- C. Either 2010 or 2011

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 . . .

So, you were transferred from Maxwell Air Force Base to Scott Air Force Base last year, right?

Did you receive any other allowances?

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?

Any other expenses?

AMANDA RESPONDS...

Yes, I was reimbursed \$400 for travel expenses on the way to Scott Air Force Base.

Yes, I also received a \$1,000 dislocation allowance.

I spent \$575 on travel and lodging and another \$200 for meals along the way.

Yes, I gave a \$350 security deposit to my new landlord.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS . . .

AMANDA RESPONDS...

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 nine lessons (lessons 19–27) covering the Tax and Credits section of the taxpayers' return. After completing this lesson on standard deductions and Lesson 20, Itemized Deductions, 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 and others may be required to use Schedule L to figure their standard deduction.

Form 1040 (2010)

Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	
	39a	Check { <input type="checkbox"/> You were born before January 2, 1946, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1946, <input type="checkbox"/> Blind. checked ► 39a	39a	
	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ► 39b	39b	<input type="checkbox"/>
	40	Itemized deductions (from Schedule A) or your standard deduction (see page 35)	40	
	41	From line 39	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 when Schedule L or the standard deduction worksheet is required to compute the standard deduction
- Identify how taxable income and income tax are computed and reported

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040
- Schedule L
- 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. \$11,400
- B. \$8,400
- C. \$3,650

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. \$5,700
- B. \$8,400
- C. \$5,400

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 chapter.

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: Tax software will automatically calculate the standard deduction based on the information collected 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 and/or spouse is 65 or older. It is also higher 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/or spouse's age and level of blindness as described below.



Tax Software Hint: Tax software will automatically check these boxes 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 years old and blind, you should enter a "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 also considered to be 65 on the day before their 65th birthday. In other words, a person born on January 1 of any calendar year is considered to be 65 on December 31 of the previous calendar year. Therefore, taxpayers are entitled to a higher standard deduction for 2010 if they were born before January 2, 1946.

The standard deduction for decedents is the same as if the taxpayers had lived the entire year, with one exception: if the taxpayers died before their 65th birthday, the higher standard deduction for being 65 does not apply to the decedents.

example

Armando died on November 24, 2010. He would have been 65 if he had reached his birthday on December 12, 2010. He does not qualify for a higher standard deduction for being 65, even though he was born before January 2, 1946.

Who qualifies as blind?

A taxpayer must be totally or partially blind on the last day of the year to qualify as blind. Taxpayers are entitled to a higher standard deduction if they are considered totally or partially blind and they do not itemize their deductions. A taxpayer who claims to be partially blind must have a certified statement from an eye doctor or registered optometrist that states either of these conditions:

- 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 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.

If the eye condition will never improve beyond these limits, the statement should include that fact. Taxpayers should keep the statement in their records.

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?

Standard deduction amounts for taxpayers who are 65 or older, and/or are blind, increases by \$1,100 or \$1,400 if single or head of household for each box checked for age or blindness. It can also be computed using the Standard Deduction Chart for People Born Before January 2, 1946, 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 \$7,100.

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 \$12,500.



EXERCISES (continued)

Use the Standard Deduction Chart for People Born Before January 2, 1946, 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, 1946. 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. \$7,900
- C. \$15,800

Question 5: Leticia died May 1, 2010. She was born on April 3, 1945. 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 on another person's tax return. 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: Tax software will automatically calculate a dependent's standard deduction, as long as the box indicating that the taxpayer can be claimed as a dependent on another person's tax return 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 2010 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).

What if the taxpayer paid state or local sales or excise taxes in 2010 for a new motor vehicle purchased in 2009?

Taxpayers who paid taxes in 2010 on a newly purchased qualified motor vehicle in 2009 may be entitled to deduct state and local sales and excise taxes paid on their income tax returns. A qualified motor vehicle includes a passenger automobile, light truck, or motorcycle, with a gross vehicle weight rating of 8,500 pounds or less. A qualified motor vehicle can also be a motor home. To be eligible, the original use of the qualified motor vehicle must begin with the taxpayer. The vehicle must be purchased after February 16, 2009, and before January 1, 2010, to qualify for the deduction.

Taxpayers who live in states that do not have state sales taxes are still entitled to deduct other fees or taxes imposed by the state or local government. The fees or taxes that qualify are for the purchase of a new motor vehicle and are based on the vehicle's sales price or as a per-unit fee.

The deduction is limited to the taxes paid on the first \$49,500 of the purchase price of each vehicle. There is no limit on the number of cars for which the taxpayer can claim the deduction, provided each car is a qualified vehicle under the law. The amount of the deduction is phased out for taxpayers whose modified adjusted gross income is between \$125,000 and \$135,000 for single taxpayers and between \$250,000 and \$260,000 for joint taxpayers.

TIP

Some taxpayers who purchased a vehicle in 2009 did not have to pay their new motor vehicle taxes until 2010. In these instances, they may be eligible to deduct the amount paid on their 2010 income tax return.

TIP

Purchases made in states without sales taxes, such as Alaska, Delaware, Hawaii, Montana, New Hampshire, and Oregon, can also qualify for the deduction.

example

Laura purchased a new motor vehicle on December 3, 2009, for \$56,500 before taxes. She paid the sales tax on February 3, 2010. The state where Laura purchased the vehicle imposes a fixed sales tax rate of 5%, and the locality also charges a fixed rate of 1%, for a combined fixed sales tax rate of 6%. The amount of sales tax she can include on line 9 is \$2,970, which is $\$49,500 \times .06$ (6%).



Tax Software Hint: All qualified taxes paid on a new motor vehicle must be included on Schedule L. The amounts will carry over to the standard deduction amount if it is more advantageous for the taxpayer to use the standard deduction.

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



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.

If the taxpayer's expenses qualify, itemizing may be a better choice.



Tax Software Hint: Tax software automatically calculates the taxpayer's standard deduction and displays the amount on page 2 of the Form 1040 screen. The tax software will automatically select 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?

Taxable income and tax are determined by using the taxpayer's adjusted gross income, exemption amount, and standard deduction or itemized deductions.

Taxable income is determined by subtracting certain items from the adjusted gross income (AGI).

These include:

- Personal and dependency exemptions and
- Standard or itemized deductions



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.



Tax Software Hint: Tax is based on the amount of taxable income. There are several methods for finding the tax amount. Regardless of the taxpayer's situation, figuring the tax is easy with tax software. The program has all the information necessary to compute the tax on the return based on previous information that has been input. It is important to enter all income, deduction, and credit information correctly for the tax software to compute the tax accurately. The tax software also automatically calculates the exemption amount, applies any limitations, and displays the result on line 42.

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, purchase of a new motor vehicle, 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.



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. \$11,400

Answer 2: A. \$5,700

Answer 3: No. Roderick is only 64. To qualify for the higher standard deduction, his birthday must be before January 2, 1946.

Answer 4: B. \$7,900. This is calculated by multiplying \$1,100 by 2 (she is blind and 65) to get \$2,200, which is added to her standard deduction of \$5,700.

Answer 5: Yes. Leticia qualifies for the higher standard deduction given to those 65 or older because she was 65 when she died in 2010.

Notes



Lesson 20: Itemized Deductions



Introduction

This lesson will assist you in determining if a taxpayer should itemize deductions. Generally, taxpayers should itemize their deductions 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

Who must itemize?

Taxpayers who have a standard deduction of zero should itemize their deductions. Taxpayers who normally fall within this category are taxpayers who 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

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.

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.

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. Use the Interview Tips in the Volunteer Resource Guide (Tab F) to determine if itemizing deductions would be more beneficial for the taxpayer.

What do I need?

- Approved Intake and Interview Sheet
- 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
- Certain taxes the taxpayer paid
- Mortgage interest
- Gifts to charity
- Casualty and theft losses and certain 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.



A married taxpayer, filing separately, whose spouse itemizes deductions is not allowed to claim the standard deduction; if one spouse itemizes, the other must itemize (even if the amount is 0).



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Form 1040, Page 2, Deductions.

How do I handle medical and dental expenses?

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 is more than 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).

Which medical and dental expenses are deductible?

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



The standard mileage rate allowed for out-of-pocket expenses for a car when used for medical reasons is 16.5 cents per mile. You 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.

Review Whose Medical Expenses Can You Include? in the Medical and Dental Expenses chapter of Publication 17.

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.



If you and a taxpayer disagree as to whether a particular expense is deductible, then 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	?

How do I handle taxes that may be deductible?

Taxpayers can deduct certain taxes if they itemize their deductions. To be deductible, the tax must have been imposed on the taxpayer and paid by the taxpayer during the current tax year. Taxes that are deductible include the following:

- State and local taxes:
 - State and local income taxes include withheld taxes, estimated tax payments, or other tax payments such as a prior year refund of a state or local income tax that the taxpayers chose to have credited to their estimated state or local income taxes.

- Real estate taxes:
 - State, local, or foreign real estate taxes that are based on the assessed value of the taxpayer's real property, such as the taxpayer's house or land, are deductible.
 - Real estate taxes are generally reported on Form 1098, *Mortgage Interest Statement*, or a similar statement from the mortgage holder. 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, itemized charges for services, transfer taxes, rent increases due to higher real estate taxes, and homeowners' association fees.
- Motor vehicle taxes: Some taxpayers who purchased a vehicle in 2009 did not have to pay their new motor vehicle taxes until 2010. In these instances, they may be eligible to deduct the amount paid on their 2010 income tax return. Use the Worksheet for Line 7, New motor vehicle taxes, of Schedule A, page 2, to compute the deduction. For more information, refer to Lesson 19, Standard Deduction and Tax Computation.
- Foreign income taxes can be deducted on income that is not exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.
- Other taxes: Any other qualified deductible taxes that are not included above.
- Personal property taxes are deductible if they are state or local taxes that 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

Which expenses are not deductible?

Not all taxes are deductible and some items aren't actually classified as taxes. See the Taxes chapter in Publication 17.

example

Suppose Wayne brings in records showing the following tax payments: state income tax, \$2,000; real estate taxes, \$900; homeowners' association fee, \$250. Wayne's total tax deduction is \$2,900 ($\$2,000 + \$900 = \$2,900$). The \$250 homeowners' association fee is not deductible.

How do I deduct the taxes?

State and local income taxes

If the taxpayer can deduct state and local income taxes on Schedule A, include tax withheld, estimated tax payments made in good faith 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.

Real estate taxes

Real estate taxes are reported on Form 1040, Schedule A.

Motor vehicle taxes

Sales and excise taxes will be calculated on Schedule A, New Motor Vehicle Tax Deduction Worksheet. The amount from line 11 of the worksheet is carried over and reported on line 7 of Schedule A.

Other taxes

Other taxes, including personal property taxes, are reported on line 8 of Schedule A.



State and local taxes withheld are shown on Form W-2 in either box 17 or 19.

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.



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?



Using the flow chart—Is My Home Mortgage Interest Fully Deductible?—in Publication 17 will help you determine if the interest should be included on Schedule A.

Generally, the taxpayers receive Form 1098, Mortgage Interest Statement, which shows the deductible amount of home mortgage interest paid by the taxpayers. 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.



Members of the clergy and military can deduct qualified mortgage interest even if they receive a nontaxable housing allowance.

Certain types of interest are deductible 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.



Use the interview techniques to probe taxpayers to determine if nontaxable amounts such as sanitation pickup and water fees are included in their Form 1098. These items are not deductible as real estate taxes and should be deducted from the real estate taxes amount shown on Form 1098.

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 2010 (\$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 ($\$230,000 - \$30,000 = \$200,000$)



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.

What about 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

Only points paid as a form of interest (for the use of money) can be deducted on Schedule A. This interest, even if it qualifies for home mortgage interest, must generally 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 the taxpayer paid them, unless the points are paid in connection with the improvement of a main home and certain conditions are met.

When are points fully deductible?

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 the points are fully deductible.

What about qualified mortgage insurance premiums?

Taxpayers can deduct Private Mortgage Insurance (PMI) premiums paid or accrued during the tax year on Form 1040, Schedule A, Line 13. PMI paid or accrued on a mortgage insurance contract for coverage during 2010 is deductible.

What qualifications are required to deduct PMI?

- Paid or accrued January 1, 2010, to December 31, 2010
- 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

Amounts taxpayers paid during 2010 for qualified mortgage insurance can be treated as home mortgage interest. 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 2011 for coverage in effect during 2010.

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. Taxpayers must itemize their deductions to deduct a charitable contribution. Taxpayers can deduct contributions to the following types of **qualifying organizations**:

- Organizations that operate exclusively for religious, charitable, educational, scientific, or literary purposes
- Organizations that work to prevent cruelty to children or animals
- Organizations that foster national or international amateur sports competition if they do not provide athletic facilities or equipment
- War veterans' organizations
- Certain nonprofit cemetery companies or corporations
- The United States, or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions



To be deductible, contributions must be made to a qualifying organization, not an individual.

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 should be referred to a professional tax preparer.

Which gifts to charity are *not* deductible?

Organizations that do *not* qualify for deductible contributions include:

- Business organizations, such as the Chamber of Commerce
- Civic leagues and associations
- Political organizations and candidates
- Social clubs
- Foreign organizations
- Homeowners' associations
- Communist organizations



Charitable Contributions for Haiti Relief: Taxpayers were allowed to deduct on their 2009 tax return certain cash contributions made for the relief of Haiti earthquake victims. The contributions must have been made after January 11, 2010, and before March 1, 2010. If taxpayers took a deduction for these contributions on their 2009 tax return, they cannot claim the same deduction in 2010.

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 total contributions are 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 prove the amount of the cash and noncash contributions they make during the year. Cash, check, and noncash contributions should be reported on Schedule A, line 16 and line 17, respectively. For each contribution, tell 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.

What records should the taxpayer keep for noncash contributions?

Noncash contribution deductions less than \$250

For each single contribution of less than \$250, tell the taxpayer to keep:

- 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



Deductions are not allowed for the charitable contribution of clothing and household items if the items are not in good used condition or better.



If the taxpayer is reducing the fair market value by appreciation or donating capital gain property, refer the taxpayer to a professional tax preparer.

Noncash contribution deductions 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 contribution deductions 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 are casualty and theft losses?

The deduction for casualty and theft losses is complex, with many rules and exceptions, so you should refer the taxpayer to a professional tax preparer.

What are miscellaneous deductions?

What types of miscellaneous expenses are deductible?

Miscellaneous itemized deductions are expenses a taxpayer pays in order 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 kept a record of their losses.)
- Work-related expenses for individuals with a disability that enable 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?



Some taxpayers may ask about mileage expenses to and from their regular place of work. This is a commuting expense and not deductible.

The types of miscellaneous expenses that are not deductible include:

- Commuting expenses
- Political contributions
- The cost of entertaining friends
- Lost or misplaced cash or property
- Travel as a form of education



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

Deductible medical and dental expenses are reported and calculated on lines 1 through 4 of Schedule A.

Qualified medical and dental expenses are those the taxpayer paid during the tax year for the taxpayer, spouse, and dependents.

Taxes

Deductible taxes are reported on lines 5 through 9 of Schedule A. Taxpayers can deduct the following:

- State and local income taxes
- State, local, or foreign real estate taxes
- State and local personal property tax payments

Some taxpayers who purchased a vehicle in 2009 did not have to pay their new motor vehicle taxes until 2010. In these instances, they may be eligible to deduct the amount paid on their 2010 income tax return. Use the Worksheet for Line 7 - New motor vehicle taxes, on page 2 of Schedule A to compute the deduction.

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 by the taxpayer. 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. This interest, even if it qualifies for home mortgage interest, must generally 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 Publication 17 for more information.

Points paid to refinance a mortgage are generally not deductible in full the year the taxpayer paid them, unless the points are paid in connection with the improvement of a main home and certain conditions are met.

Taxpayers can treat qualified mortgage insurance premiums paid or accrued during the tax year as home mortgage interest.

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 were allowed to deduct on their 2009 tax return certain cash contributions made for the relief of Haiti earthquake victims. If the deduction for these contributions was taken on the 2009 tax return, taxpayers cannot claim the same deduction in 2010.

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. See Publication 17 for the chapter on Miscellaneous Deductions not subject to the 2% limitation.



CAUTION
Taxpayers are required to keep receipts and records of all their contributions.



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 that are related to working as a member of the Armed Forces. 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 business-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.

TIP

Although the approved intake and interview sheet does not list military employee business expenses, it is important to ensure that service members take advantage of deductions to which they are entitled. Ask taxpayers if they had any unreimbursed military work-related expenses.

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 3
- Publication 4491-W
- Form 2106
- Form 2106-EZ
- Schedule A

Optional:

- Publication 463
- Publication 970
- Form 2106 Instructions

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

For example, although members of the Armed Forces are required to wear uniforms when they are on duty, they are generally allowed to wear their uniforms in place of regular civilian clothing when they are off duty. Therefore, 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.

TIP

The same rules apply for active duty personnel and reservists.

Are professional dues deductible?

Professional 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.

TIP

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



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.



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

For 2010, the standard mileage rate for miles driven for business purposes is 50 cents per mile. 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.



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.



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 2010, 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

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 the taxpayer to a professional tax preparer.

TIP

The standard mileage rate can be found on Form 2106, Part II, Section B, and Form 2106-EZ, Part II.



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 assigned to 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?



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.

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.

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.



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Schedule A - Itemized Deductions (continued).

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. It's different for the drills at the other base, since they're not as far from your home. Did you leave from your regular job to go to Baker, or would it be 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, the expenses for traveling more than 100 miles for reserve duties adds up to \$1,080, along with the hotel rooms at \$648, and half the meals at \$90 totals \$1,818, we'll deduct that right on the front of the return. The other mileage from trips to Baker add up to \$160, and the \$100 out of pocket for the class will give us a total of \$260 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 approved 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 2010, 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.

No, those were short meetings on weeknights, so I would just drive 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.

2106Form
Department of the Treasury
Internal Revenue Service (99)**Employee Business Expenses**

► See separate instructions.
► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2010Attachment
Sequence No. 129

Your name

Occupation in which you incurred expenses

Social security number

Part I Employee Business Expenses and Reimbursements**Step 1 Enter Your Expenses**

- 1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)
- 2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work
- 3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment
- 4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment
- 5 Meals and entertainment expenses (see instructions)
- Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5

	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1	\$1,240	
2		
3	\$648	
4	\$500	
5		\$180
6	\$2,388	\$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	\$1,988		\$180	
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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.)
- 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 9). (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.) ►

9	\$1,988		\$90	
10			\$2,078	

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11700N

Form **2106** (2010)

Of the \$2,078 on Form 2106, line 10, \$1,818 will be entered on Form 1040, line 24, and the remaining \$260 will be entered on Schedule A, line 21.

Part II Vehicle Expenses		(a) Vehicle 1	(b) Vehicle 2
Section A—General Information (You must complete this section if you are claiming vehicle expenses.)			
11	Enter the date the vehicle was placed in service	11 03 / 15 / 2009	/ /
12	Total miles the vehicle was driven during 2010	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.)			
22	Multiply line 13 by 50¢ (.50). Enter the result here and on line 1	22 \$1,240	\$1,240
Section C—Actual Expenses		(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, repairs, vehicle		

Summary

This lesson explained 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.



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.

Notes



Lesson 22: Business Travel Expenses



Introduction

This lesson provides information on deducting the ordinary and necessary business-related expenses a taxpayer may have for travel, entertainment, gifts, or transportation. An ordinary expense is one that is common and accepted in the taxpayer's field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for a taxpayer's business.

Objectives

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

- Compute business-related travel deductions
- Determine if a taxpayer must file Form 2106

What qualifies as a deductible business travel expense?

Deductible travel expenses include ordinary and necessary business expenses associated with a taxpayer's job. These are expenses incurred *while conducting business* and cannot include personal expenses for family members, such as sightseeing or nonbusiness entertainment.

Examples of deductible business travel expenses include:

- Fares for taxis, trains, airplanes, etc.
- Rental car expenses
- Costs of operating and maintaining an automobile
- Baggage charges
- Meals and lodging
- Cleaning and laundry expenses
- Telephone expenses
- Tips and gratuities
- Other necessary and ordinary expenses related to travel

What do I need?

- Approved Intake and Interview Sheet
 - Volunteer Resource Guide
 - Publication 17
 - Form 1040
 - Form 2106
 - Form 2106 Instructions
 - Form 2106-EZ
 - Schedule A
- Optional:**
- Publication 463
 - Publication 516

Lodging and transportation connected with overnight travel away from one's tax home are deductible, but the expense of commuting to and from work is not considered a business travel expense.

What is considered a taxpayer's tax home?

Generally, the "tax home" is the entire city or general area where the taxpayer's main place of business or work is located, regardless of where the family home is maintained. If the taxpayer regularly works in more than one place, the tax home is the general area where the main place of business or work is located. One cannot deduct expenses for travel away from one's tax home for any period of temporary employment of more than one year.

example

Barton lives with his family in Chicago, but works in Milwaukee where he stays in a hotel and eats in restaurants. Although he returns to Chicago every weekend, he may not deduct any of his travel, meals, or lodging in Milwaukee because it is his tax home. His travel on weekends to his family home in Chicago is not for his work, so these expenses are also not deductible.

Who is eligible for home leave?

The Foreign Service Act provides that the head of a foreign affairs agency may order a member of the Foreign Service who is a citizen of the United States to take home leave upon completion of three years of continuous service abroad. Because members of the Foreign Service are required by law to take a leave of absence, they are allowed to deduct amounts paid for travel, meals, and lodging while on home leave as employee business expenses. The taxpayers who are eligible for this leave will deduct these expenses on Form 2106, Employee Business Expenses, just like an employee who is conducting business away from home. As with all deductible employee business expenses, records and receipts must be maintained to support the deductions that are taken. Any expenses paid for on behalf of a Foreign Service member's family are personal expenses and therefore are not deductible.



United States Foreign Service employees who are on mandatory "home leave" are allowed to deduct amounts paid for travel, meals, and lodging while on home leave. However, amounts paid on behalf of the taxpayer's family while on home leave are personal living expenses and are not deductible. For more information on home leave, see Publication 516, U.S. Government Civilian Employees Stationed Abroad.

example

Jocelyn's permanent duty station for the U.S. Foreign Service is in Korea. Her husband and children could not accompany her and have remained at their home in the United States. After three years of continuous duty, she comes back to the United States for five weeks of mandatory home leave. She can deduct the cost of her transportation, lodging, and meals while traveling home. She can also deduct her meals and transportation once she is home on leave, and her transportation, lodging, and meals while traveling back to her office in Korea.

Are reimbursements reported?

Taxpayers must report both business travel expenses as well as any employer-provided reimbursement. In some cases, this results in a net expense of zero. In other cases, excess reimbursements may be taxable income. When taxpayers combine personal and business travel, they must strictly separate the expenses.

example

Bob Smith traveled to a conference in Cleveland, Ohio, that lasted from Wednesday through Friday. His employer reimbursed him for his transportation to and from the conference, his rental car expenses, and his meals. He postponed his travel home until Sunday afternoon so he could visit a luxury spa in Coshocton, Ohio. He may report the expenses for the conference and the reimbursement, but he cannot claim any costs related to visiting the spa.

What records must the taxpayer have?

Taxpayers must keep records in order to deduct travel expenses, which include meals (unless using the standard meal allowance), entertainment, gifts, or use of an automobile or other listed property. The records must document the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of each expense. Generally, taxpayers must have receipts for all lodging expenses, regardless of the amount, and for any other expenses of \$75 or more.



Taxpayers who travel for business should keep records of all expenses and any advances received from their employer. A log, diary, notebook, or any other written records are necessary to keep track of expenses.

Are there alternative methods for figuring some expenses?

There are alternative ways of reporting some expenses, such as:

- Vehicle expenses can be reported by using the actual expense method or the standard mileage rate
- Meals and incidental expenses can be reported by using the actual amounts, or a standard amount can be used to report these expenses

What are vehicle expenses?

Vehicle expenses are expenses incurred when taxpayers use their vehicles for business purposes. If a taxpayer has qualified vehicle expenses, figure those in Part II of Form 2106.

One of the two following methods can be used to figure a taxpayer's deductible expenses.



This lesson discusses only the standard mileage rate. If the taxpayers wish to use the actual method, refer them to a professional tax preparer.

- The actual expense method figures the deduction based on a variety of factors including gasoline, oil, repairs, insurance, and rentals. It may even involve depreciation or the value of a vehicle provided by the taxpayer's employer.
- The standard mileage method is very simple: it multiplies the miles driven for business by a standard cost. For 2010, the standard mileage rate for miles driven for business purposes is 50 cents per mile. Taxpayers may use the standard mileage rate only if they meet one of these requirements:
 - Owned the vehicle and used the standard method the first year the vehicle was put into service
 - Leased the vehicle and is using the standard method for the life of the lease

If the taxpayer reports vehicle expenses, regardless of the method used, complete the General Information section in Part II of Form 2106. As with other business expenses, the taxpayer must keep records to prove the time, place, and business purpose of the travel.

How are meals, entertainment, and incidental expenses figured?

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 (DOT) hours of service.



See the instructions for Form 2106 to determine if a taxpayer is subject to DOT hours of service.

Taxpayers may report the actual amounts for meals, entertainment and incidental expenses. Alternatively, they may use a standard amount to claim meals and incidental expenses.

In either case, the taxpayer must have records to prove the time, place, and business purpose of the travel.



Special rules apply to travel outside the United States. See Publication 463 for details on how to figure deductions using the standard meal allowance, including special rules for partial days of travel and for transportation workers.



EXERCISES

Answers are after the lesson summary.

Question 1: Which of the following is true for meals and entertainment expenses?

- A. Taxpayers may deduct meal expenses for family members if the travel can be proven to be primarily business related.
- B. Taxpayers can deduct 100% of meal and entertainment expenses that are not subject to DOT hours of service.
- C. Taxpayers may report the actual amounts for meals and entertainment and for incidental expenses or use the standard method.
- D. All of the above.

Question 2: True or False: Taxpayers who can use the standard method for calculating business mileage need not produce records proving the time, place, and business purpose of the travel.

- True False

How do I report business expenses?

Business expenses are reported on Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses. The result from Form 2106 or 2106-EZ is reported as a miscellaneous itemized deduction on Schedule A of Form 1040.



Tax Software Hint: For software entries, go to the Volunteer Resource Guide (Tab 4), Schedule A - Itemized Deductions (continued).



The final deduction amount on Form 2106 may be reduced when you apply the 2% AGI limit on Schedule A.



Special rules apply to figuring the final amount for business travel expense deductions for ministers, armed forces reservists, certain state and local officials, qualified performing artists, and disabled employees. See Form 2106 Instructions to determine if a taxpayer will qualify under any of these categories.

Summary

When assisting taxpayers, calculate business-related travel expenses, the tax preparer must identify deductible expenses. These are affected by the taxpayers' "tax home" and other factors. Also, taxpayers cannot deduct expenses for a family member who accompanies them for pleasure on a business trip.

Not all taxpayers must file Form 2106; some may file Form 2106-EZ, and others do not need to file either form. Be sure the taxpayer has proper records for expenses and correctly reports any reimbursement amounts.



EXERCISE ANSWERS

Answer 1: C. Taxpayers may report the actual amounts for meals/entertainment and for incidental expenses or use the standard method for one or the other.

Answer 2: False. All business expenses must be supported by records.

Notes



Lesson 23: 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?

- Approved Intake and Interview Sheet
- 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 refundable credit is added to the federal income tax withheld and any estimated tax payments. If the total is more than the total tax, the excess will be refunded to the taxpayer. 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.



NEW For Tax Year 2010, the Alternative Minimum Tax (AMT) exemption amounts decreased. Certain nonrefundable credits, including the credit for child and dependent care expenses, are not allowed against the AMT, and a new tax liability limit applies. Under current law, the process for claiming certain nonrefundable credits will require Form 1040 taxpayers to complete certain lines of Form 6251, Alternative Minimum Tax, and require Form 1040A taxpayers to complete the Alternative Minimum Tax Worksheet.

At the time this publication went to print, Congress was considering legislation to increase the alternative minimum tax exemption amounts and change the procedure for applying nonrefundable credits. Additional guidance will be provided in Publication 4491-X, Supplement, scheduled to be issued in mid-December.

For the latest in tax law changes and to find out if the legislation was enacted, visit www.irs.gov.



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 an approved intake and interview sheet and resource materials.

What is the child and dependent care credit?

The 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 unable to care for him- or herself
- Dependent who is unable to care for him- or herself

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 an approved 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 other 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. Only the custodial parent can take the child and dependent care credit. If the child is not being claimed as a dependent by the taxpayer because the noncustodial parent is taking the exemption 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 \$3,650 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 2010 return.
- Spouses who were physically or mentally unable to care for themselves and lived with the taxpayer more than half the year.



See the rules for Qualifying Child and the special rules for children of divorced and separated parents 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 approved intake and interview sheet. The sample interview shown uses these questions.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

DOROTHY RESPONDS...

I see you indicated on your intake sheet that you had child and dependent care expenses.

Yes, I did.

You may qualify for the child and dependent care credit. Let me ask you a few questions about that. Which of your dependents received the care?

My daughter.

Now, she is 16 years old, correct?

Yes, but she 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 approved 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 unable to care for him- or herself, 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 approved 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 so that Roger can go to 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 homes 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 he or she 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 approved intake and interview sheet. Here is how a volunteer might interview a taxpayer about the work-related test.

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	DOROTHY RESPONDS...
<i>Did the caregivers assist your daughter only when you and your husband were at work?</i>	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.
<i>Do you pay your mother to care for your daughter?</i>	No, we don't. She just does it because she loves her granddaughter.
<i>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.</i>	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



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. You wonder whether he can take the child and dependent care credit. Bill is claiming his granddaughter as a dependent, as noted in the Family/Dependent Information section of his approved intake and interview sheet. She is 18 and takes care of herself.

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...
<i>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.</i>	Oh, okay.
<i>Why don't you tell me about your wife's illness and care?</i>	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>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.]</i>	Yes, it is ... well, sometimes she has good days, and I'm thankful for that.
<i>Did you pay someone to take care of your wife so that you could go to work?</i>	Yes, I pay my granddaughter Lucy, who just graduated from high school, to take care of Helen.
<i>Oh, I see. Well unfortunately, I was wrong. You won't be able to take the credit for your wife because you are claiming Lucy as a dependent.</i>	Oh, that's okay. Thanks for looking into it for me.
<i>You're welcome. Just trying to help!</i> [On the approved intake and interview sheet, indicate that the taxpayer doesn't qualify for this credit, and why.]	

Bill does not pass the work-related expenses test because his expenses were paid to a dependent relative.

How do I determine the amount of the credit?

If preparing a paper return, follow the instructions on Form 2441. 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 approved 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 23.

Summary

For Tax Year 2010, the Alternative Minimum Tax (AMT) exemption amounts decreased. Certain nonrefundable credits, including the credit for child and dependent care expenses, are not allowed against the AMT, and a new tax liability limit applies.

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 of either Form 1040 or 1040A.



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 24: 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 an approved 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?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 8863
- 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. However, taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met. There are general rules that apply to these credits, as well as specific rules for each credit.



NEW For Tax Year 2010, the Alternative Minimum Tax (AMT) exemption amounts decreased. Certain nonrefundable credits, including the lifetime learning credits, are not allowed against the AMT, and a new tax liability limit applies.

Under current law, the process for claiming certain nonrefundable credits will require individuals to complete certain lines of Form 6251, Alternative Minimum Tax, or to complete an Alternative Minimum Tax Worksheet.

At the time this publication went to print, Congress was considering legislation to increase the alternative minimum tax exemption amounts and change the procedure for applying nonrefundable credits. Additional guidance will be provided in Publication 4491-X, Supplement, scheduled to be issued in mid-December.

For the latest in tax law changes and to find out if the legislation was enacted, visit www.irs.gov.

Who can take an education credit?

A taxpayer can take education credits for the taxpayer, 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 dependent on the return to claim 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. This will be discussed later in the lesson.

Ask to see documentation, such as receipts or the 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)
- 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.

<input type="checkbox"/> 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
		2 Amounts billed for qualified tuition and related expenses \$
		OMB No. 1545-1574 2010 Form 1098-T
FILER'S federal identification no. 92-XXXXXX	STUDENT'S social security number XXX-XX-XXXX	3 If this box is checked, your educational institution has changed its reporting method for 2010 <input type="checkbox"/>
STUDENT'S name Joan Smith		4 Adjustments made for a prior year \$
Street address (including apt. no.) 32 Pine St.		5 Scholarships or grants \$ 1,500
City, state, and ZIP code Anchorage, AK 99508		6 Adjustments to scholarships or grants for a prior year \$
Service Provider/Acct. No. (see instr.)	8 Checked if at least half-time student <input checked="" type="checkbox"/>	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2011 ► <input type="checkbox"/>
		9 Checked if a graduate student <input type="checkbox"/>
		10 Ins. contract reimb./refund \$

Form **1098-T** (keep for your records) Department of the Treasury - Internal Revenue Service

Tuition Statement

Copy B For Student

This is important tax information and is being furnished to the 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 2010 for qualified tuition for the winter semester that begins in January 2011. He can use the \$1,500 paid in December 2010 to compute his credit for 2010. He cannot count it again in 2011.

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 for which the taxpayer can claim the credit based on the same student's expenses.
- Course-related books, supplies, fees, and equipment are included in qualified education expenses only if the fees and expenses 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 2010 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 2010? Yes
- Has the student been convicted of a felony for possessing or distributing a controlled substance? No



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 in 2009 and 2010 only. Mindy started college in 2009. She can only claim the American opportunity tax credit for 2009 and 2010. She may be eligible for the lifetime learning credit for any tuition and fees required for enrollment that she pays after 2010.

example

Mindy's brother, Jim, started college in 2007. He claimed the Hope credit for his first two years of college (2007 and 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 2009 and 2010.

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 now a refundable credit, which means the taxpayer can receive up to \$1,000 even if no taxes are owed. 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 the 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 credits?

Taxpayers cannot take multiple credits (either education credits or elsewhere in the return) on 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.
- Do not take both an American opportunity credit and a lifetime learning 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 life-time learning credit is more suitable. (See the requirements discussed earlier.)
2. In the 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).



CAUTION
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 all or part of the credit. This is beyond the scope of the VITA/TCE program. Information can be found in Publication 970. 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 RESPONDS...
<i>Barbara, are you familiar with education credits?</i>	They have something to do with tuition.
<i>Yes, they apply to certain expenses for post-secondary education. Did anyone in the family attend college or vocational school during the tax year?</i>	My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.
<i>There are two kinds of credits—here's a chart comparing the two education credits. [Explains the differences.]</i>	Looks like American opportunity for Carla and lifetime for me!
<i>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?</i>	Yes, these are for Carla's tuition, fees, and books for the tax year. These are for extracurricular field hockey.
<i>This year, 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?</i>	Only \$5,000 from her grandfather.
<i>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.</i>	All I have are tuition and fees for two classes in accounting, spring and fall semesters.
<i>Are these to improve your job skills?</i>	Yes, but my boss doesn't reimburse me.
<i>Are all of these required expenses?</i>	Yes.
<i>You'll be eligible for the lifetime learning credit.</i> [On the approved intake and interview sheet, indicate that you've addressed education benefits.]	I'm so glad you were here to help me!

Which education benefit is better for the taxpayer?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- Business expenses on Schedules C and C-EZ
- Itemized deduction on Schedule A (employee-related expenses only)
- American opportunity credit or lifetime learning credit

Compute all of the above to determine which gives the taxpayer the lowest tax. Do not claim multiple deductions for the same education expense but use the credit most beneficial to the taxpayer.

To ensure that the taxpayer's return is accurate, you will need to compare the tax effects of the various education benefits.

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 approved 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 credits are best for them. When you get to this section of the return, always check the approved 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 used with those credits or on Schedules C and C-EZ, or 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 now 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.



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

Notes:



Lesson 25: 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, the entire Form 1116 may not need to be completed.

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 an approved 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 approved 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?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 514
- Publication 4491-W
- Form 1116
- Form 1116 Instructions

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. If this is true and the total of these amounts from all documents is not more than \$300 (or \$600 for filing status Married Filing Jointly), then taxpayers may qualify to enter the total amount on the appropriate line of Form 1040, page 2, instead of filing Form 1116. If the amounts are more than \$300 (or \$600 for filing status Married Filing Jointly) and they do not meet the other conditions to make the election, then taxpayers must file Form 1116.

Some taxpayers may choose the election to claim the foreign tax credit without filing Form 1116, if certain conditions are met. Besides the dollar limitations, all of the foreign source gross income must be "passive category income" (which includes most interest and dividends) and reported on a qualified payee statement. A qualified payee statement includes Form 1099-INT, Form 1099-DIV, Schedule K-1 (for Forms 1041, 1065, 1065-B, 1120S), or similar substitute statement. This election is not available to estates or trusts. Additional information can be found in the Form 1040 Instructions, Form 1116 Instructions, Publication 17, and Publication 514.

Taxpayers who must complete Form 1116 because they cannot qualify for the election, must be referred to a volunteer with an International certification or a professional tax preparer.



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 2010 Form 1099-DIV that shows \$219 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 \$423 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 26, Child Tax Credit.



What is the Foreign Tax Credit (FTC)?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens potentially having to pay tax twice on the same income: once to the government of the foreign country where the income was earned and again to the U.S. government.

The Foreign Tax Credit (FTC) 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 able to take a credit against their U.S. taxes for taxes paid to other countries. Like other nonrefundable credits, the FTC allows taxpayers to take a dollar-for-dollar reduction in the amount of U.S. tax owed. However, there are cases in which not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the foreign tax credit.

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 the taxpayer 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.



For additional information, see the instructions for Form 1116 and refer to Publication 514.

In this situation, refer the taxpayer to a professional tax preparer. For more information, see Publication 514, Foreign Tax Credit for Individuals.

For a paper return, enter the foreign tax paid directly on Form 1040, line 47, keeping in mind the \$300/\$600 limitations.



The foreign earned income exclusion is different from the foreign tax credit, and taxpayers can choose the approach that results in the lowest tax paid overall.

- The exclusion rules allow a portion of the foreign earned income to be excluded from taxable income, so it is not taxed
- The credit rules add 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)
- You should try both methods to see which results in the lower tax

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



A credit for foreign taxes can be claimed only for foreign tax imposed by a foreign country or U.S. possession.

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
- For which the taxpayer can take only an itemized deduction
- From international boycott operations, and
- Of U.S. persons controlling foreign corporations and partnerships



See Publication 514, Foreign Tax Credit for Individuals, for more detailed information.

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 compute 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 compute 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



According to Publication 514, Foreign Tax Credit for Individuals, a taxpayer is considered to receive a specific economic benefit if he or she conducts 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, 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



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 the taxpayer to a professional tax preparer.



EXERCISES (continued)

Question 6: Adele lived and worked in Iran until August 2010, 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

Passive category income includes passive income and specified passive category income, assuming the income is from another country and the taxpayer has paid taxes on it.



A separate Form 1116 must be completed for each type of income; each Form 1116 can include income earned in as many as three foreign countries.

Passive 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.



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 and did not elect to claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain on his earnings from 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 2010, the highest U.S. income tax rate was 35%. Therefore, if a taxpayer pays more than 35% income tax on the foreign-sourced passive income for which he or she 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 income under the heading on Form 1116, "General Category Income," since the rate of income tax 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 countries outside the United States. 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 2010, 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 a tax paid to a foreign government is eligible for the foreign tax credit. You will need to ask the taxpayer questions to determine:

- 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...

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.

That's why the foreign tax credit was created. Since you earned income and paid taxes on that income to Argentina, but did not claim the foreign earned income exclusion, you may qualify for the credit.

BONNIE RESPONDS...

Yes, I hope I can avoid paying taxes twice on that income!

That's a relief!

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

BONNIE RESPONDS...

There are a few more requirements. 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.

What does that mean?

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.

Do I have to file Form 1116?

If the following three conditions are met, the taxpayer can make the election to report foreign tax on Form 1040, page 2, without filing Form 1116. The total qualified foreign taxes must be:

- \$300 or less (\$600 or less if Married Filing Jointly), and
- Derived from passive income (e.g., interest, dividends, or royalties), and
- Reported on Forms 1099-INT/1099-DIV, Schedule K-1 (Forms 1041, 1065, 1065-B or 1120S) or a similar substitute statement



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 5), Nonrefundable Credits.

How do I complete Form 1116?

If the taxpayer does not qualify for the election, 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 on the tax return 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 during 2010 (“paid”) or if the tax was billed in one year but paid in another (“accrued”). A taxpayer using the cash basis 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 had to use more than one Form 1116 due to more than one type of income and/or reporting 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 (FTC) for taxes paid. Generally, to claim the FTC, taxpayers are required to file Form 1116, Foreign Tax Credit (Individual, Estate, or Trust).

However, taxpayers do not have to file Form 1116 if they meet certain requirements. The VITA/TCE Program may help only those taxpayers who are not required to file Form 1116. (International VITA sites are excepted from this rule.)

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The foreign tax credit is computed and reported on Form 1116. Part I of Form 1116 is used to figure the taxable income from foreign sources in each income category; a separate copy of 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 paid overall.

The foreign tax credit is reported on Form 1040, page 2.



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. The \$300 limitation applies to whether a taxpayer has to complete Form 1116. A taxpayer does not have to file Form 1116 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 seek the assistance of a professional tax preparer.

Answer 3: Yes. If the foreign taxes for a married couple who files a joint return are less than or equal to \$600, then the couple is not required to complete Form 1116. Judy and Mark do not have to complete Form 1116 because their foreign taxes are less than \$600.

Answer 4: C. On Anne's tax return, she can compute a foreign tax credit to offset the taxes she paid to Japan on the 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 26: Child Tax Credit



Introduction

This lesson covers a credit that first took effect in 1998. 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.

An approved intake and interview sheet and 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 do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 972
- Publication 4491-W
- Form 8812 and Instructions
- Optional:** Form 1040 Instructions

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, 2010, 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 2010.

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.

Are there special rules for children of divorced, separated, or never married parents?

There are special rules for children of divorced or separated parents, as well as for children of parents who have never married. 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.



CAUTION
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 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, or Form 1040A, line 21. For more information on MAGI as it applies to the child tax credit, refer to Publication 17.



CAUTION

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) 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



EXERCISES (continued)

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 Family and Dependent Information section of the taxpayer's approved 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 6 months of the year (remember the special rules for divorced, separated, or never married parents)
- 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 Family and Dependent 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?

What is the amount of the 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.

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 additional child tax credit. The credit will appear 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. Their earned income credit amount is \$457. 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 ensure that the taxpayer has been interviewed thoroughly to correctly identify eligible children. If preparing a paper return, be sure to use the worksheets to figure the credit, and determine if the additional child tax credit should be included.



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 26.

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, if preparing a paper return.

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 2010; he meets the relationship requirement, lived with Laura for at least 6 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 to qualify for the additional child tax credit. Keep in mind the Earned Income Credit amount will affect the final calculation.

Notes



Lesson 27: 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, *U.S. Individual Income Tax Return*.

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 nonbusiness energy property credit by completing Form 5695, *Residential Energy Credits*
- Calculate the credit for the elderly or the disabled by completing Schedule R (Form 1040 or 1040A) Credit for the Elderly or the Disabled

Remember to use the interview techniques and tools discussed in the Screening and Interviewing lesson. Use the information from an approved intake and interview sheet, along with the documents provided by the taxpayer to determine eligibility for these credits.

What do I need?

- Approved Intake and Interview Sheet
- 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

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.



NEW For Tax Year 2010, the Alternative Minimum Tax (AMT) exemption amounts decreased. Certain nonrefundable credits, including the credits for the elderly or the disabled and nonbusiness energy property, are not allowed against the AMT, and a new tax liability limit applies.

Under current law, the process for claiming certain nonrefundable credits will require individuals to complete certain lines of Form 6251, Alternative Minimum Tax, or to complete an Alternative Minimum Tax Worksheet.

At the time this publication went to print, Congress was considering legislation to increase the alternative minimum tax exemption amounts and change the procedure for applying nonrefundable credits. Additional guidance will be provided in Publication 4491-X, Supplement, scheduled to be issued in mid-December.

For the latest in tax law changes and to find out if the legislation was enacted, visit www.irs.gov.



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 an approved intake and interview sheet and resource materials.

What is the retirement savings contributions credit?

The retirement savings contributions credit is a nonrefundable credit a qualifying taxpayer may claim if they made a contribution to a qualified plan.

If the contribution is tax deferred, the taxpayer obtains the benefit of the tax deferral and a credit against their taxes. A “double” benefit such as this is rarely allowed. For example, a taxpayer may be able to claim this credit *and* a deduction for an IRA contribution. 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. Review the flowchart in the Retirement Savings Contribution Credit—Decision Tree for the qualifications.

What is the modified AGI limit?

For 2010, taxpayers may be able to claim the retirement savings contribution credit if their modified AGI is not more than:

- \$55,500 for Married Filing Jointly
- \$41,625 for Head of Household
- \$27,750 for Single, Married Filing Separately, or Qualifying Widow(er)

What are qualified plans for the purpose of the retirement savings contributions credit?

In order to be eligible for the credit, the taxpayer must have contributed to a qualified plan. Plans that qualify are listed in the Other Credits chapter of Publication 17.

How do I know if the taxpayer has made a qualifying contribution?

When you review page 2 of the approved intake and interview sheet, pay special attention to the Expenses section and be sure to ask if the taxpayer made a contribution to an IRA or other retirement account. The other 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, AA, BB, or S. For military personnel, there may be an amount in box 14 coded with Q or E.



Tax Software Hint: If Form W-2 is entered into the software correctly and completely, the program will do the credit calculation. If box 14 amounts are contributions to a retirement plan that qualify for the retirement savings contributions credit, check the *qualifies for Form 8880* box. 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 401(k). These after-tax contributions are listed on Form W-2, box 12 with a code AA or BB.



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 that is included in the taxpayer's gross income from a qualified retirement plan or from an eligible deferred compensation plan
- 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



You must question the taxpayer to determine if there have been 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 amount of \$2,000 each. If either spouse has 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 2008 and 2009, and plan to do so in 2010. Joe received a distribution from a qualified plan in 2008 and a distribution from an eligible deferred compensation plan in 2009. Mary received distributions from a Roth IRA in 2009.

Both Joe and Mary made eligible contributions to an IRA in 2010 and otherwise qualify for the retirement savings credit. They must reduce the amount of their qualifying contributions in 2010 by the total of the distributions they received in 2008 and 2009. This calculation is completed on Form 8880.

How do I determine the amount of the credit?

Form 8880 is used to figure the amount of the credit.



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.

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.



EXERCISES

Question 1: Which of the following taxpayers, who contributed to their employers' 401(k) plans, is possibly eligible for the retirement savings credit?

- 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 \$49,500
- C. Bert, who is married, files separately, and has an adjusted gross income of \$28,300
- D. Carl, who is a qualifying widower with a dependent child, and has a modified AGI of \$29,000



Refer to Form 8880 in the Volunteer Resource Guide (Tab 5), Retirement Savings Contributions Credit.

Taxpayer Interview and Tax Law Application

Our volunteer is working with Ryan, a taxpayer at the site. 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. Refer to the Volunteer Resource Guide (Tab G), Retirement Savings Contributions Credit—Decision Tree, as she determines if Ryan is eligible 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 2010?

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 2010, 2009 or 2008 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 2009 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!



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. Review the Life Events section of the approved intake and interview sheet to see if any purchases of energy-efficient items are indicated, as these items may qualify taxpayers for the nonbusiness energy property credit. See the Volunteer Resource Guide (Tab G) for key points on Energy Credits.



Tax Software Hint: Tax software will do all the math calculations and enter the total on the appropriate line of Form 1040. Remember, at any time you need to see the form instructions, access the program's help feature.

5695 Form Department of the Treasury Internal Revenue Service Name(s) shown on return	Residential Energy Credits ► See instructions. ► Attach to Form 1040 or Form 1040NR.	OMB No. 1545-0074 2010 Attachment Sequence No. 158 Your social security number
Part I Nonbusiness Energy Property Credit (See instructions before completing this part.)		1 <input type="checkbox"/> Yes <input type="checkbox"/> No
1 Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions)		2a
<i>Caution: If you checked the "No" box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.</i>		2b
2 Qualified energy efficiency improvements (see instructions).		2c
a Insulation material or system specifically and primarily designed to reduce the heat loss or gain of your home		2d
b Exterior windows (including certain storm windows) and skylights		3a
c Exterior doors (including certain storm doors)		3b
d Metal roof with appropriate pigmented coatings or asphalt roof with appropriate cooling granules that are specifically and primarily designed to reduce the heat gain of your home, and the roof meets or exceeds the Energy Star program requirements in effect at the time of purchase or installation		3c
3 Residential energy property costs (see instructions).		
a Energy-efficient building property		
b Qualified natural gas, propane, or oil furnace or hot water boiler		
c Advanced main air circulating fan used in a natural gas, propane, or oil furnace		

What is the nonbusiness energy property credit?

Taxpayers may be able to claim a nonbusiness energy property credit of 30% of the cost of certain energy-efficient property or improvements placed in service in 2010. This property can include energy-efficiency windows, doors, insulation materials, and certain metal or asphalt roofs. Taxpayers *cannot* include the cost of on-site preparation or installation for these items.

Nonbusiness energy property can also include high-efficiency heat pumps, air conditioners, water heaters, and stoves that burn biomass fuel. Amounts paid for these items can include the cost of on-site preparation and installation.



Be sure to note that costs for on site preparation and installation depend on the type of qualified property.

Items on Form 5695, line 2, do not include the costs for on site preparation and installation. The items on Form 5695, line 3, **can** include these costs.

The credit is limited to a total of \$1,500 for tax years 2009 and 2010. The credit is claimed on Form 5695, Part I. If the taxpayer claimed a \$1,000 credit in 2009, the taxpayer could only claim up to a \$500 credit in 2010. The nonbusiness energy credit is a nonrefundable credit that reduces a taxpayer's tax liability. If the taxpayer has no tax liability, then the taxpayer cannot use the credit and it is not carried over to the next year.

If the taxpayer is eligible for the credit for the elderly or the disabled, compute that credit first.



IRS provides guidance for property that qualifies for the energy credits. Homeowners generally can rely on manufacturers' certifications. Refer to www.irs.gov or www.energystar.gov 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 qualify for an energy credit for qualified solar electric property costs, qualified solar water heating property costs, qualified small wind energy property costs, and qualified geothermal heat pump property costs. Refer taxpayer with these expenses to a professional tax preparer.



Even though the credit for these expenses is out of scope, you should review the energy property that qualifies, so you can properly refer the taxpayer to a professional tax preparer.

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. This credit can also be claimed on Form 1040A.

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



For 2010, the credit is carried from Schedule R to Form 1040, line 53 and box c is checked. Schedule R is noted in the space to the right of box c.

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.

Besides being a qualified individual, their 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.

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.

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.

**CAUTION**

Since the tax software automatically calculates the credit for the elderly or the disabled, it is critical that all social security and railroad retirement benefits be entered on the worksheet for social security benefits line of Form 1040. Amounts must be entered even if no social security is taxable.



Tax Software Hint: The tax software will complete most of Schedule R based on the data from the Main Information Sheet and income amounts entered on the return. 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.



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 2010
 - Retired on permanent and total disability
 - Not the normal retirement age on January 1, 2010, and
 - Receiving taxable disability income for 2010
- True False

Taxpayer Interview and Tax Law Application

Determining Albert's Eligibility

Albert comes into the tax center. He has almost completed his Form 1040 but 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 other energy incentives of which I should be aware?

- Alternative Motor Vehicle Credit: Form 8910, Alternative Motor Vehicle Credit, is used to claim a credit for alternative motor vehicles, such as qualified hybrid or advanced lean-burn-technology vehicles, put in service for business or personal use and which meet other requirements.
- Plug-In Electric Vehicle Credit: The law modifies the credit for qualified, plug-in electric drive vehicles purchased after December 31, 2009. The law also creates a special tax credit for two types of plug-in vehicles—certain low-speed electric vehicles and two- or three-wheeled vehicles.
- Conversion kits: The law also provides a tax credit for plug-in electric drive conversion kits.

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.

What is the Mortgage Interest Credit?

Taxpayers who hold qualified 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.

This topic is out of scope for the volunteer program and is included for informational purposes only. 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 that is input.

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.



IRA contributions made by the taxpayer are often overlooked. Be sure to ask taxpayers if they made traditional or Roth IRA contributions. IRA contributions may qualify the taxpayer for the retirement savings contributions credit.

Residential Energy Credits

Residential energy credits are available to taxpayers for making energy-saving improvements to their home. Part I, Form 5695, is used to claim the nonbusiness energy property credit. Remember that Part II, Form 5695, Residential Energy Efficient Property Credit is out of scope for the volunteer program. Be sure to refer to the Volunteer Resource Guide (Tab G) for key points on Energy Credits.

Credit for the Elderly or the Disabled

Elderly individuals, age 65 or older, and individuals under age 65 who retired on permanent and total disability, may be able to claim a special nonrefundable credit on their tax returns if they are U.S. citizens or resident aliens. Few taxpayers 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.

Other Energy Incentives

Topics of alternative motor vehicle credit, plug-in electric vehicle credit, and the credit for plug-in electric drive conversion kits are out of scope for the volunteer program. Taxpayers who may qualify for these credits should be referred to a professional tax preparer.

Mortgage Interest Credit

The mortgage interest credit is calculated on Form 8396. Refer taxpayers who choose to claim this credit to a professional tax preparer.



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 \$55,500, which is the threshold limit for Married Filing Jointly.

Answer 2: True. A taxpayer who is under age 65 at the end of 2010, retired on permanent and total disability, on January 1, 2010 had not reached normal retirement age, and who receives taxable disability income for 2010, 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 28: Other Taxes



Introduction

This lesson covers the Other Taxes section of the return. You will determine if the taxpayer owes additional taxes. When you conclude this lesson, your findings will be the taxpayer's total tax.

Other Taxes	55 Subtract line 54 from line 46. If line 55 is more than line 46, enter -0-	▶ 56 57 58 59 60 61	W-2 and 1099 Form 4137 Form 5329 Form 5405 Add lines 55 through 59. This is your total tax	56
	56 Self-employment tax. Attach Schedule SE			57
	57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919			58
	58 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			59
	59 a <input type="checkbox"/> Form(s) W-2, box 9 b <input type="checkbox"/> Schedule H, line 27 c <input type="checkbox"/> Form 5405, line 16			60
	60 Add lines 55 through 59. This is your total tax			

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 separate from the income tax figured from the tax tables or 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
- Advance earned income credit payments
- 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 of the tax return. This topic, however, 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?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 4137
- Form 5329 and Instructions
- Form 5405 and Instructions
- Form W-2
- Schedule SE

Optional:

- Publication 334
- Publication 531
- Form 1040 Instructions
- Form W-5



Social security and Medicare taxes on tip income and advanced earned income credit are 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. It is 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.

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.



Remember that the scope is expanding to include Schedule C with limits. The Schedule C criteria will be the same as Schedule C-EZ except it will include those taxpayers who have up to \$10,000 in expenses.



Self-employed taxpayers who receive tips should include the tips in gross receipts on Schedule C/C-EZ.

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. Then, if preparing a paper return, follow the Schedule SE instructions to calculate the self-employment tax. Finally, enter one-half of the self-employment tax as an adjustment to income on Form 1040, page 1. This is similar to the benefit that employees receive because their employers pay one-half 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 one-half of the self-employment tax.



What about taxes on unreported tip income?

All tip income is subject to federal income tax. However, tips of less than \$20 per month that are not reported to the employer are not subject to social security and Medicare taxes.

Individuals who receive \$20 or more per month in tips from any one job must report their tip income to their employer. The employer reports these tips as part of the wages on Form W-2, box 1. The employer withholds social security and Medicare taxes and federal income tax on that income.

What about allocated tips?

An employer may “allocate” tips to an employee if the employee worked in a restaurant, cocktail lounge, or similar business and reported tips that were less than the employee’s share of 8% of food and drink sales. If the employer allocates tips to employees, the amount is reported on Form W-2, box 8. This amount is to be included 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.

If a taxpayer is filing a paper return and only has unreported tips of less than \$20 per month, Form 4137 is not required since social security and Medicare taxes are not applicable.



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. Determine if that income was reported on Form 1040; if it wasn’t, enter it on the appropriate form.

To figure the tax on a paper return, use Form 4137 and follow the instructions on the form. Report the tax amount on the applicable line on the Form 1040.



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.



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.



EXERCISES

Answers follow the lesson summary.

Question 1: Jody 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 have to be added to income on Jody's Form 1040, line 7?

- A. \$1,418
- B. \$1,000
- C. \$418
- D. \$18

Question 2: What amount of unreported tips does Jody 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 money they contribute and on the 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 due 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
- Minimum distributions are not withdrawn when required
- Excess contributions are not removed by the due date of the return including extensions

The additional tax for each situation is outlined on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

NEW Beginning with the 2010 tax year, Form 5329, Part I, is in scope for the VITA/TCE program. Volunteers need to know the exceptions to the additional tax for early distributions.



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 do not meet any of the exceptions.

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.



Be sure to note that 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.

Taxpayers frequently use an early distribution for household expenses or bills that are not on the list of exceptions. This situation does not require completion of Form 5329.



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.

Refer to the approved intake and interview sheet, Part III—Income, for the question regarding pension or IRA distributions. If the answer is "yes," ask the taxpayer for any Form 1099-R that reports these payments. Ask the taxpayer that question to determine if the taxpayer is subject to the additional tax or qualifies for an exception.

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, John enters 10% of the taxable amount on the applicable line of Form 1040. John also enters "no" to the left of this line to indicate that Form 5329 is not required.

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.

TIP

Refer to the Publication 17 chapters Retirement Plans, Pensions, and Annuities or Individual Retirement Arrangements for the list of exceptions to the additional tax on qualified retirement plans.



What are Advance Earned Income Credit Payments?

When a taxpayer qualifies for the Earned Income Credit (EIC), the amount of the credit is reported in the Payments section of Form 1040. The EIC is a refundable tax credit. It reduces the taxpayer's total tax payment and could result in a tax refund for the taxpayer. The EIC will be discussed in Lesson 30.

Taxpayers can choose to get payments of EIC in advance, as part of their paychecks, instead of waiting to get it all at once when they file their tax return. The employer will include a portion of the earned income credit in the employee's regular pay. Farm workers are excluded. The amount of advance EIC is reported on the employee's Form W-2, box 9. If advance EIC is received, the taxpayer is required to file a tax return, even if the taxpayer's gross income is below the amount required to file.

example

Claire lives with her 2-year-old son and knows that she qualifies for EIC in 2010. She received advance EIC during 2010 in her paycheck. Her Form W-2 will reflect the advance EIC paid to her for the year.

NEW Effective for tax years after 2010, advance EIC is eliminated. The change was included in The Education Jobs and Medicaid Assistance Act signed by the President on August 10, 2010.

How does AEIC affect tax?

AEIC is EIC that was paid to the taxpayer during the tax year. The AEIC amount must be reported on Form 1040 in the Other Taxes section. On the same return, the EIC amount must be reported in the Payments section.

The AEIC is added to the total tax and EIC is subtracted from the total tax. Reporting the numbers in this way ensures that the taxpayers receive all the earned income credit to which they are entitled. If this is the case for a taxpayer you are helping, be sure to explain this and answer any questions. This usually results in the taxpayers receiving an additional amount of EIC when the tax return is filed. However, taxpayers may owe tax if their income changed during the year.

example

When the volunteer helped Claire prepare her tax return, the AEIC amount of \$550 was reported in the Other Taxes section. The \$1,776 in EIC for which she qualified was reported in the Payments section. As a result, her tax return reflected the advance payment of her EIC, and she is allowed the remaining \$1,226 as part of her 2010 refund.



Tax Software Hint: Be sure that Form W-2 is entered in its entirety. Information from box 9 will automatically display on the applicable line on Form 1040. The applicable box is checked to reflect that this entry is for advance earned income credit. Go to the Volunteer Resource Guide (Tab 2), Form W-2 Instructions, for software entries.

TIP

Effective after 2010, a recent tax law change eliminates advance EIC. Taxpayers can no longer request advance EIC using Form W-5. This form will be obsolete after 2010. Volunteers may see advance EIC on Form W-2 for tax year 2010 but should explain to these taxpayers that advance EIC for subsequent years is no longer available. Taxpayers eligible for EIC after 2010 will need to wait and claim EIC when that tax return is prepared.

**EXERCISES** (continued)

Question 3: Gloria had advance earned income credit (AEIC) paid to her during the year. The amount in her Form W-2, box 9, was \$700.

Gloria qualified for an EIC amount of \$1,025. Her income tax was \$200 and her withholding was \$1,000. There were no other payments, credits, or other taxes. What is the final amount on her tax return? Choose the best answer below.

- A. Gloria owes tax of \$1,125
- B. Gloria has an overpayment of \$2,025
- C. Gloria has an overpayment of \$1,125
- D. Gloria has an overpayment of \$1,825

Question 4: Ramon has two children and expects to qualify for EIC in 2010. He needed the cash as soon as possible. He arranged to receive advance EIC payments throughout 2010, rather than waiting to file his 2010 return to get the entire EIC amount. In what section of his tax return are the AEIC payments reported?

- A. Income
- B. Other Taxes
- C. Payments
- D. Adjustments to Income

What about repayment of the first-time homebuyer credit?

The first-time homebuyer credit is covered in Lesson 29, Payments. However, certain situations may require the credit to be repaid and reported in the Form 1040, Other Taxes section.

Review the Income section of the approved Intake and Interview Sheet to determine if the taxpayer sold a home in 2010. Be sure to probe during the interview with the taxpayer to determine if repayment of the homebuyer credit may be applicable as a result of the 2008 homebuyer credit, because of a sale or if the home ceased to be a principal residence.

If the taxpayer received the first-time homebuyer credit in 2009 and the home ceases to be the taxpayer's 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, the taxpayer generally must repay the credit over a 15-year period in 15 equal installments. The repayment period begins in 2010, and the taxpayer must include the first installment as additional tax on the 2010 tax return. 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.



Be sure to note that the rules for the 2008 homebuyer credit are different. This credit functions like a no-interest loan and must be paid back. The first year for payback is tax year 2010.

example

Joan received a first-time homebuyer's credit of \$7,500 in 2008. The credit for 2008 was like an interest-free loan with a pay back over 15 years, starting in 2010. Joan still lives in the home. Joan must start repaying the credit on her 2010 return and must complete Form 5405 that will reflect additional tax of \$500. The \$500 is carried over to the Form 1040, Other Taxes section.

The home ceases to be the taxpayer's main home in situations where 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 on Form 1040, page 2, Other Taxes section.

How do I figure total tax?

The Form 1040, Other Taxes section provides a total of the taxpayer's income tax plus the other taxes that may apply to the taxpayer. Adding the amounts on these lines together gives the total tax. This amount takes into account the tax on all income, adjustments to income, deductions, nonrefundable tax credits, and other taxes. The next step is entering the tax payments and finding 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 28.

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:

- Self-employment tax
- Social security and Medicare taxes on unreported tip income
- Additional taxes on IRAs and other qualified retirement plans
- Advance earned income credit payments
- Repayment of first-time homebuyer credit



Remember that, based on recent legislation, advance EIC has been eliminated for tax years after 2010.



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.



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. Jody'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. Jody 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.

Answer 3: C. Gloria has an overpayment of \$1,125.

Answer 4: B. Other Taxes

Notes



Lesson 29: Payments



Introduction

This lesson is one of several lessons that cover the Payments section of the return. This part of the return includes additional child tax credit, the refundable education credit, payments, 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	61	Federal income tax withheld from Forms W-2 and 1099	61
	62	2010 estimated tax payments and amount applied from 2009 return	62
	63	Making work pay credit. Attach Schedule M	63
	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 (see page 72)	68
	69	Excess social security and tier 1 RRTA tax withheld (see page 72)	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 61, 62, 63, 64a, and 65 through 71. These are your total payments	72

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
 - Making work pay credit
 - Homebuyer credit (first-time homebuyer and long-time resident)
 - Amount paid with a request for an extension to file
 - Excess social security and tier 1 RRTA tax withheld
- Report these payments and credits correctly on the taxpayer's return

The information you obtain from an approved intake and interview sheet will help you determine the payments and credits that should be reported on the taxpayer's return.

Refer to the Volunteer Resource Guide (Tab 6), Other Taxes and Payments section, to identify and review the Payments section of the return.



The making work pay credit applies to tax years 2009 and 2010. Schedule M is used for the calculation of this credit.

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 current 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 federal income tax withheld is reflected in Form 1040, Payments section, page 2, on the line for federal income tax withheld.

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form W-2
- Form 1040
- Form 5405
- Schedule M
- Schedule M Instructions

Optional:

- Publication 505
- Publication 919
- Form 1040 Instructions
- Form 1040-ES
- Forms 1099
- Form 4868



For a household employee, an employer should withhold federal income tax only if the household employee asks the employer to withhold it and the employer agrees.



The withholding from all income documents is included on the return, but not all income statements are required to be attached. Refer to Form 1040, page 1, for the following guidance: “Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R 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 into the tax software, 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 by the taxpayer. Estimated tax payments are due on a quarterly basis. If estimated 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.

Where do I get this information?

This lesson covers where to find the information on the approved intake and interview sheet and where these payments are entered on the tax form. Lessons 31 and 33 will provide more details on estimated taxes. On the approved intake and interview sheet, determine if there is income from sources such as self-employment or investment income for which taxes may not have been withheld. When interviewing the taxpayer ask, “Did you pay estimated taxes to the IRS for the 2010 tax year?” If the answer is “yes,” ask to see the taxpayer’s record of payments, such as Form 1040-ES, Estimated Tax for Individuals. Look for the taxpayer’s response to this question on the approved intake and interview sheet.

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.

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 tax by indicating the amount they want to apply to the next year’s estimated taxes.

Where do I get this information?

Ask 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 2009 tax return to document the amount of tax applied to 2010. Add this amount to the estimated tax payments and enter the total on the applicable line. You will be confirming information provided by the taxpayer that should be included on the approved intake and interview sheet.



Tax Software Hint: For software entries to record 2010 estimated tax payments, go to the Volunteer Resource Guide (Tab 6), Form ACH 1040/ES, and refer to the hint in the margin.

TIP

Estimated tax includes the taxpayer’s income tax and self-employment tax. Self-employment tax is the social security and Medicare taxes owed by self-employed workers.

TIP

See Lessons 31 and 33 for more information on estimated taxes.

TIP

Suggest the taxpayer obtain Form 1040-ES for details about estimated taxes. Forms can be obtained by downloading from www.irs.gov or 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.

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...	ERNIE RESPONDS...
<i>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?</i>	Yes, I did.
<i>Do you have a record of your payments, perhaps on a Form 1040-ES?</i>	Yeah, here it is.
<i>Good, you paid each quarter. We'll enter those payments. While we're here, did last year's return show an overpayment?</i>	Yes, here it is: \$150.
<i>Did you apply any of that to your 2010 taxes?</i>	Yes, all of it.
<i>Okay, we'll enter that too. Now we show the total of the withholding from your W-2s, your estimated tax paid and the refund amount from last year's return applied to this year.</i>	Good!

What is the making work pay credit?

Making work pay is a credit that is part of the ARRA legislation. It is available for tax years 2009 and 2010 and cuts taxes for working families. The making work pay provision provides a refundable tax credit of up to \$400 for working individuals and \$800 for married taxpayers filing joint returns.

The credit is fully refundable, meaning that once it is applied against any tax owed, the remainder is refunded to the taxpayer, unlike many other tax credits.



Some taxpayers may not be entitled to the entire credit. For example: If earned income is less than \$6,451 (\$12,903 for Married Filing Jointly) the amount of the making work pay credit will be less than \$400 (or \$800 for joint filers). The calculation is made on Schedule M.

The credit is calculated at a rate of 6.2% of earned income and will phase out for taxpayers with modified adjusted gross income (MAGI) in excess of \$75,000 or \$150,000 for married couples filing jointly.

For taxpayers who receive a paycheck and are subject to income tax withholding, the credit was handled by employers through automatically reduced withholding based on the withholding tables issued for 2010.

Though all eligible taxpayers will need to claim the credit when they file their 2010 income tax return, the benefit is reflected in reduced income tax withholding in taxpayers' paychecks.

Self-employed taxpayers can claim the credit when they file their return.

For most taxpayers who are employees, the reduced withholding should equal the credit taken on the tax return.



Refer to the Volunteer Resource Guide, front section (before Tab A), for a quick reference on the making work pay credit.

Who is not eligible for the making work pay credit?

Taxpayers must have earned income to qualify for the making work pay credit. Therefore, those who have pension income without earned income are not eligible for this credit. In addition, the following are not eligible for the making work pay credit:

- Individuals who can be claimed as a dependent on someone else's tax return.
- Individuals who are nonresident aliens.
- Individuals who do not have a valid social security number. A social security number does not include an identification number issued by the IRS.

An exception is made for taxpayers who do not have a social security number and file a joint return, as long as their spouse has a valid social security number.

TIP

If the taxpayer is married and claims the making work pay credit on a 2010 joint return, neither the taxpayer nor the spouse can be claimed as a dependent on someone else's 2010 return.

How does the \$250 economic recovery payment affect the making work pay credit?

In some cases, taxpayers may have received the \$250 economic recovery payment that was scheduled for summer of 2009 in 2010. In these cases, taxpayers must reduce their making work pay credit in 2010 by the \$250 economic recovery payment they received in 2010. The situation may not arise often, but volunteers need to be aware that some taxpayers may receive the \$250 economic recovery payment in 2010 instead of 2009.

One of the provisions of ARRA is the \$250 payment made to certain recipients of social security benefits, supplemental security income (SSI), railroad retirement benefits, or veterans disability compensation or pension benefits. On a joint return, the amount may be \$500 if both spouses received the \$250 payment. This payment is made directly from the payer of the benefit, not from IRS.

This \$250 economic recovery payment is not taxable income. However, taxpayers who have received this payment and who also have earned income must reduce the making work pay credit by the amount of the \$250 economic recovery payment. The calculation is made on the Schedule M.

TIP

The Internet lookup tool will continue to be available for the 2011 filing season. If taxpayers are unsure if they received this payment in 2010, they can check at www.irs.gov, by entering "economic recovery payment" in the search box and clicking "Search." Then, they select "Did I receive an Economic Recovery Payment?"

example

Barry is retired and started receiving social security in January 2007. He works part time at the local hardware store. He received an economic recovery payment of \$250 in February 2010. The payment should have been received in June 2009, but there was a delay in issuing his payment. When Barry completes his return for 2010, he must reduce the making work pay credit on Schedule M by the \$250 economic recovery payment that was received in 2010.



What changes were made to the First-Time Homebuyer Credit

NEW The Worker, Homeownership and Business Assistance Act of 2009, extended the first-time homebuyer credit and expanded who qualifies for the credit. The Homebuyer Assistance and Improvement Act of 2010 was signed into law on July 2, 2010.

The new laws:

- Extend deadlines for purchasing and closing on a home
- Authorize the credit for long-time homeowners buying a replacement principal residence
- Raise the income limitations for homeowners claiming the credit
- Add documentation requirements for claiming the credit



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?

The Worker, Homeownership, and Business Assistance Act of 2009 extended the deadline for qualifying home purchases from November 30, 2009, to April 30, 2010. The Homebuyer Assistance and Improvement Act of 2010 provided an extension to the settlement date. If a buyer enters into a binding contract by April 30, 2010, the buyer has until September 30, 2010, to settle on the purchase. There were no other changes in the homebuyer credit made by the new law passed in July 2010. The new law addresses concerns that many homebuyers might be unable to meet the original June 30 closing deadline under prior law.

To be considered a first-time homebuyer, taxpayers cannot have owned a home in the last 3 years, and, once they buy the home, they must live in it for 3 years to avoid repayment of 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 at \$8,000 for a first-time homebuyer.

The law also provides a "long-time resident" credit of up to \$6,500 (married individuals filing separately are limited to \$3,250) to taxpayers who do not qualify as "first-time homebuyers." 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.



The new legislation added the "long-time resident" credit that has not previously been available.

For all qualifying home purchases in 2010, taxpayers have the option of claiming the credit on either their 2009 or 2010 tax returns.

Form 5405, First-Time Homebuyer Credit and Repayment of Credit is used to claim the credit and has been updated to reflect the tax law changes. Taxpayers who purchase a home after November 6, 2009, must use the most current version of the form to claim the credit. Likewise, taxpayers claiming the credit on their 2009 returns, no matter when the house was purchased, must also use the most current version of Form 5405. Taxpayers who claim the credit on their 2010 tax return will not be able to file electronically but instead will need to file a paper return.



Be aware of the taxpayer's option to claim the credit on 2009 or 2010 for qualifying purchases in 2010.

What are the new income limits?

The law raises the income limits for people who purchase homes after November 6, 2009. The full credit will be available to taxpayers with Modified Adjusted Gross Incomes (MAGI) up to \$125,000, or \$225,000 for joint filers. The phaseout of the credit begins when your MAGI exceeds \$125,000 (\$225,000 if married filing jointly). The credit is eliminated completely when your MAGI reaches \$145,000 (\$245,000 if married filing jointly).

For homes purchased prior to November 7, 2009, existing MAGI limits remain in place. The full credit is available to taxpayers with MAGI up to \$75,000, or \$150,000 for joint filers. The phaseout of the credit begins when your MAGI exceeds \$75,000 (\$150,000 if married filing jointly). The credit is eliminated completely when your MAGI reaches \$95,000 (\$170,000 if married filing jointly).

Are there other requirements?

Several new restrictions apply to homes purchased after November 6, 2009:

- No credit is available if the purchase price of the home exceeds \$800,000.
- The purchaser must be at least 18 years old on the date of purchase. For a married couple, only one spouse must meet this age requirement.
- A dependent is not eligible for the credit.

In addition, there are some provisions in the Act to enhance the administration of the first-time homebuyer credit:

- The new law requires taxpayers to attach a properly executed copy of the settlement statement to the return for tax years ending after November 6, 2009. For most individual taxpayers, this would be for the tax years 2009 and 2010.
- The new law gives the IRS broader authority to deny first-time homebuyer credit claims, without having to first audit a taxpayer's return. Known as math error authority, it applies, retroactively, to credits claimed on original and amended 2008 returns, as well as to claims yet to be filed.



While the Form 5405 Instructions indicate that a properly executed settlement statement should show the signatures of all parties, the IRS recognizes that the elements of the settlement document, often a Form HUD-1, may vary from jurisdiction to jurisdiction and may not reflect the signatures of the buyer and seller. The settlement statement that must be attached to the return is considered to be properly executed if it is complete and valid according to local law. In locations where signatures are not required, the IRS encourages the buyer to sign the settlement statement prior to attaching it to the tax return even in cases where the settlement form does not include a signature line.

Who Cannot Claim the Credit?

Taxpayers cannot claim the credit if any of the following apply:

1. The purchase price of the home is more than \$800,000. This rule applies to homes purchased after November 6, 2009.
2. The taxpayer's modified adjusted gross income is:
 - \$95,000 or more (\$170,000 or more if Married Filing Jointly) and taxpayer purchased the home before November 7, 2009, or
 - \$145,000 or more (\$245,000 or more if Married Filing Jointly) and taxpayer purchased the home after November 6, 2009. (See Form 5405 Instructions.)
3. Taxpayers cannot claim the credit for any year for which they can be claimed as a dependent on another person's tax return. This rule applies to homes purchased after November 6, 2009.

4. Taxpayer (and spouse if married) are under age 18 on the date of purchase. This rule applies to homes purchased after November 6, 2009. For a married couple, only one spouse must meet this age requirement.
5. The taxpayer is a nonresident alien.
6. The taxpayer's home is located outside the United States.
7. The taxpayer sells the home, or it ceases to be the taxpayer's main home before the end of the year in which the taxpayer purchased it. (See exception for military and certain other taxpayers below.)
8. The taxpayer acquired the home by gift or inheritance.
9. The taxpayer acquired the home from a related person. This includes:
 - a. Taxpayer's spouse, ancestors (e.g., parents, grandparents), or lineal descendants (e.g., children, grandchildren).
 - b. A corporation in which the taxpayer directly or indirectly owns more than 50% in value of the outstanding stock of the corporation.
 - c. A partnership in which the taxpayer directly or indirectly owns more than 50% of the capital interest or profits interest. (For more details about related persons see Publication 544, Sales and Other Disposition of Assets, Chapter 2.)
10. The taxpayer acquired the home after November 6, 2009, from a person related to the taxpayer's spouse. This includes taxpayer spouse's ancestors or lineal descendants (e.g., parents-in-law or taxpayer's stepchildren), and any relationships described in 9b or 9c above that taxpayer's spouse has.

Are there special rules for members of the military?

Additionally, there are new benefits for members of the military and certain other federal employees:

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. Thus, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2011. If a binding contract is entered into by that date, the taxpayer has 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.

In many cases, the credit repayment (recapture) requirement is waived for members of the uniformed services, members of the Foreign Service, and employees of the intelligence community. This relief applies where a home is sold or is no longer the taxpayer's principal residence after December 31, 2008, in connection with government orders received by the individual (or the individual's spouse) for qualified official extended duty service. The credit is still allowable even if this happens during the year of purchase. Qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence (whether inside or outside the U.S.), or while residing under government orders in government quarters. Extended duty is defined as any period of duty pursuant to a call or an order to such duty for a period in excess of 90 days or for an indefinite period.



Note the extended time frames for members of military and other federal employees serving outside the U.S.



Repayment relief is granted for members of uniformed services, Foreign Service, employees of the intelligence community in certain situations when home is sold or is no longer a principal residence.

For more details on the credit, visit the First-Time Homebuyer Credit page on www.irs.gov.

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.



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.

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.

Refer to Lesson 28, Other Taxes, and Form 5405 and Instructions for the procedures for 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 due by April 15, they will owe interest and may be charged penalties.



If the April 15 deadline falls on a Saturday, Sunday, or legal holiday, the deadline is the next business day.

Later, when taxpayers file their return, they report the payment made with Form 4868 on the applicable line in Form 1040, Payments section.

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 on paper or electronically. The extension must be mailed or transmitted by the due date of the return.

You can help taxpayers file for an extension using the tax software.



Tax Software Hint: For software entries, 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 are other payments?

What other types of payments are there?

You will notice that the Payments section of Form 1040 also lists these 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



Form 8839 includes a new refundable credit for claiming adoption expenses. This information is provided for awareness only. This topic is out of scope for the VITA/TCE program. Refer taxpayers with adoption expenses to a professional tax preparer.

Refer taxpayers who choose to claim any of these credits to a professional tax preparer. These topics are out of scope for the volunteer program.

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. The Form 1040 Instructions include a worksheet to calculate the excess amount. 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, it is important to accurately enter all the information from each Form W-2 into the software.

How do I find the total payments?

Figuring the total tax payments is easy. Add the lines in the Payments section. 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 29. Return to this lesson after you have reviewed this information.

Summary

The Payments section of the tax return is critical to an accurate return. It lists all the tax 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.



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<.

Notes:



Lesson 30: 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 approved 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?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 596
- Publication 4491-W
- Form 1040
- Form 1040 Instructions
- 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 of 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 2010, the earned income credit expands to allow families to claim credit for three or more children, up to a maximum of \$5,666. The EIC amounts are adjusted for inflation every year.



NEW Effective after 2010, a recent tax law change eliminates advance EIC. Taxpayers can no longer request advance EIC using Form W-5. This form will be obsolete after 2010. Volunteers may see advance EIC on Form W-2 for tax year 2010 but should explain to these taxpayers that advance EIC for subsequent years is no longer available. Taxpayers eligible for EIC after tax year 2010 will need to wait and claim EIC when that tax return is prepared.

Taxpayers with at least one qualifying child may choose to receive part of their earned income credit in advance in their paychecks during the year. This is referred to as the advance earned income credit.

This amount is reported on Form W-2, box 9. Turn to the Volunteer Resource Guide (Tab 2), Form W-2 Instructions. Locate box 9 on the sample Form W-2 in the box marked "Advance EIC payment."

If the taxpayer received advance EIC as shown in box 9 on Form W-2, a return must be filed to report the advanced payment and claim any additional EIC.

You can learn more about advance EIC in the Other Taxes lesson.

The EIC is entered in the Payments section of the tax return. In the Volunteer Resource Guide (Tab 6), turn to the page titled Other Taxes and Payments. Find the lines on Form 1040 where the AEIC and the EIC are entered on the return.

How does a taxpayer qualify for the EIC?

There are general sets of rules for claiming the earned income credit:

- Rules for everyone
- Rules for taxpayers with a qualifying child
- Rules for taxpayers who do not have a qualifying child

What rules apply to everyone?

The taxpayer must meet all the rules to qualify for the earned income credit. Turn to the chart titled Summary of EIC Eligibility Requirements in the Volunteer Resource Guide (Tab 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 the company 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 company 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 a picture of Form 1099-R. A distribution code of “3” in box 7 indicates this is a disability pension.

Ask if the taxpayer is still under the plan’s minimum retirement age. If they are, report this income on line 7 of Form 1040 or Form 1040A. If they are at or above the company’s minimum retirement age, report this as you would a regular pension. Sometimes the company never changes the code 3 in box 7 to indicate that this is now regular pension income.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 2), 1099-R Pension and Annuity Income.



There is a limit to the amount of investment income a person can receive and still qualify for the EIC. For 2010, the amount is \$3,100. Investment income includes such items as taxable interest and dividends, tax-exempt interest, capital gain net income, and income from residential rental property.



Nontaxable combat pay is shown in box 12 of Form W-2, designated with code Q.

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.



Volunteers preparing paper returns should be sure to use the EIC worksheets (in the Form 1040 Instructions) and compare which method would provide the taxpayer with the most beneficial credit.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 6), Schedule EIC - Worksheet.

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 deduction for one-half of 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 deduction for one-half 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 maids 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 and Form 1040A and line 1 of Form 1040EZ. If there is no Form W-2, you should write HSH next to the amount on the corresponding line. This income should also be included in the computation of 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). When preparing a paper return, refer to the Volunteer Resource Guide (Tab H) to find this listed in the Earned Income Table. Enter the initials **PRI** and the amount on the dotted line next to Form 1040 line 7.



Tax Software Hint: 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. Can 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 must file Form 1040 or Form 1040A 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

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.

example

Jane who is 31 years old and Todd who is 33 years old, have one daughter, Amanda, who is 8 years old. Jane and Todd have never been married. Jane and her daughter 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 the cost of Jane's apartment for rent and utilities. He also gave Jane extra money for groceries.

Todd does not pay any expenses or support for any other family member. All are U.S. citizens and have valid SSNs. Todd did provide over half the cost of providing a home for Jane and Amanda, but he cannot file Head of Household since Amanda did not live with him over half the year. Jane does not qualify to claim him 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. Todd cannot since Amanda did not live with him for over half the year. Review the Earned Income Credit rules in the Volunteer Resource Guide (Tab H).

What are the rules for a qualifying child of more than one person?

Only one taxpayer can claim a child that meets the conditions to be a qualifying child of more than one person. Review the Qualifying Child of More than One Person rules in the Volunteer Resource Guide (Tab H).



If the child meets the conditions to be the qualifying child of more than one person, only one person can claim the child as a qualifying child.



For EIC purposes, a qualifying child does not have to be the taxpayer's dependent unless the child is married. For example, the custodial parent (the parent the child lived with for more than half the year) can qualify for the EIC. The noncustodial parent cannot qualify for EIC because the child did not live with that parent for more than half of the year. It does not matter that the custodial parent does not claim the dependency exemption for the child in the case of divorced or separated parents.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide (Tab 1), Main Information Screen.



List the children from youngest to oldest in the software.

What are the rules for taxpayers without qualifying children?

Taxpayers can file Form 1040EZ, Form 1040A, or Form 1040 to claim the EIC without a qualifying child. Review the rules in the Volunteer Resource Guide (Tab H), under Part C, Rules If You Do Not Have a Qualifying Child.



Review the question on the approved intake and interview sheet: Can your parents or someone else claim you or your spouse on their tax return? Did the taxpayer check yes or no?



For a couple filing a joint return, only one taxpayer has to meet the age requirement.

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.



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

The approved intake and interview sheet asks a volunteer if the taxpayer was previously disallowed the EIC. The volunteer would answer the question based on their explanation of the question during their conversation.

How do I answer the question, "Based on the interview, is the taxpayer qualified for the EIC?"

You answer this question after you have collected all the facts using the interview tips in the Volunteer Resource Guide (Tab H).

TIP

Special rules apply if the taxpayer was previously denied EIC. See the Volunteer Resource Guide (Tab H), Disallowance of the Earned Income Credit.

Optional Class Exercise

Mark and Evelyn Bell are married and file a joint return. They have an 8-year-old child, Jennifer Bell, who lived with them the entire year and whom they claim as a dependent. The Bells have adjusted gross income of \$21,250, which consists of wages of \$21,211 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 is the correct Earned Income Credit amount calculated?

The credit is determined using worksheets and the Earned Income Credit tables.

You will already have determined if your taxpayer qualifies for the EIC from the information you gathered to answer questions on the approved intake and interview sheet.

The EIC worksheets can be found in Form 1040, 1040A or 1040EZ Instructions. Every tax preparer or their site should have at least one set of instruction booklets.

Combat Pay Election

If a taxpayer has combat pay listed in box 12 of Form W-2 marked with code Q, and you are preparing a paper return, you may need to prepare two EIC worksheets to determine if the combat pay should or should not be added to your taxpayer's income.

If this election is chosen, write the combat pay amount by the EIC line of the payment section of the tax return. You can see this entry in the Volunteer Resource Guide (Tab 6), Form 1040 – Other Taxes and Payments.

Where are the EIC tables and how do I use them?

The EIC tables are located in the appendix of Publication 4491-W. Additional tables are in Publication 596, Form 1040 and Form 1040A. The Form 1040EZ Instructions only contain information for taxpayers with no children.

Let's look at those tables now. Turn to the first page of the EIC tables.

Class Exercise

A taxpayer is filing Head of Household and has one qualifying child. The earned income and AGI is \$19,000. How much is the EIC this person is entitled to?

Notice at the top of the table you find your amount in the "At least - But less than" column. Then go across and find the correct filing status column: Single, Head of Household and Qualifying Widow(er), or in a separate column, Married Filing Jointly. Subcolumns break it down to "No children, One child, Two children, Three children." The EIC should be \$2,638. If you didn't get this answer, try again.

You would enter the amount 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.

Tax software will print Schedule EIC to be attached to the taxpayer's copy of the return. If you are not using a software program, be sure to attach Schedule EIC to the taxpayer's return and give them a copy also.

Do not attach the worksheets to the return. Give them to the taxpayer with his/her copy of the return.



Double-check that the heading on your page says "Earned Income Credit (EIC) Table." It is common to mistake the Tax Tables for the Earned Income Credit tables.

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. You will also find an optional exercise of completing her EIC worksheet.

Summary

The earned income credit computation is based on filing status, number of qualifying children (1–3), earned income, and adjusted gross income. Certain individuals with no children may also qualify.

By using the approved 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.

Taxpayers who received advance EIC payments will have the amount entered in box 9 of their Form W-2. They are required to file a tax return.

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 \$3,100 for 2010.*

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.*

Answer 7: No. *With just one qualifying child, the married couple's income would be more than the limit of \$40,545 for 2010, 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. If you are filing a paper return, be sure to write Dawn's information on Schedule EIC.*

Optional Class Exercise Answer: Yes, *Mark and Evelyn Bell both meet the general eligibility requirements and, their daughter meets all the qualifying child tests.*



Lesson 31: 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 13).

72	Add lines 61, 62, 63, 64a, and 65 through 71. These are your total payments .	►
Refund	73 If line 72 is more than line 60, subtract line 60 from line 72. This is the amount you overpaid	73
Direct deposit?	74a Amount of line 73 you want refunded to you . If Form 8888 is attached, check here ► <input type="checkbox"/>	74a
See page 73 and fill in 74b, 74c, and 74d, or Form 8888.	► b Routing number <input type="text"/> ► c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	► d Account number <input type="text"/>	
	75 Amount of line 73 you want applied to your 2011 estimated tax ► 75	75
Amount You Owe	76 Amount you owe . Subtract line 72 from line 60. For details on how to pay, see page 74.	76
	77 Estimated tax penalty (see page 74) 77	77

Do another form? Complete this return with the IPB (see page 75)? Yes Complete the following No

To complete these sections of the taxpayer's return, you will need to confirm answers provided during your initial interview in the Life Events section of the approved intake and interview sheet, regarding direct deposit and direct debit. Also, review the Volunteer Resource Guide (Tab 6) and (Tab 13) which provide guidance on refunds and balance due returns.



If available, use the new bookmark product titled, Balance Due Payment Options, Pub 4853 and Pub 4853(SP), that summarizes payment options. It is a useful item 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 Third Party Designee portion of the tax return and determine its purpose

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 17
- Publication 4491-W
- Form 1040
- Form 8888
- Form 9465
- Form W-4
- Form W-4P

Optional:

- Publication 594
- Publication 4541
- Publication 4542
- Form 2210 and Instructions
- Publication 4853
- Publication 4853(SP)

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.



Tax Software Hint: The tax software shows the entire refund amount on the amount to be refunded line.

Refund checks are usually mailed within 6 to 8 weeks after the return is filed. However, instead of getting a paper check, taxpayers may choose to have their refund deposited directly into their account at a bank, credit union, or other financial institution. 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.

For the 2011 filing season, taxpayers will have more options related to purchasing savings bonds with their refunds. Additional details will be covered later in the lesson.

Encourage taxpayers to use direct deposit, which is much faster, safer, and more efficient. With an e-filed return, a direct deposit is usually received within 10 to 14 days.

How do I enter the information for direct deposit?



Tax Software Hint: 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. For software entries, go to the Volunteer Resource Guide (Tab 1), Main Information Screen on Direct Deposit.

Go the Volunteer Resource Guide (Tab 13), Pointers for Direct Deposit of Refunds, which includes a diagram showing where to find the Routing Transit Number (RTN) and Depositor Account Number (DAN) information on a check.



Tax Software Hint: Go to the Volunteer Resource Guide (Tab 1), Main Information Screen, for software entries related to direct deposit. 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.



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.

Can the refund be deposited into more than one account?

Taxpayers can choose to divide their direct deposit refund among up to three accounts. For example, a person expecting a refund of \$500 could choose to deposit \$200 into a checking account, \$200 into a savings account, and \$100 into an IRA account.



Tax Software Hint: Use Form 8888, *Allocation of Refund (Including 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.



If the routing and account numbers are not valid, the refund will be delayed 4–6 weeks. If the direct deposit is rejected, a paper check will automatically be mailed to the address on the return.

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.



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, Financial Management Service (FMS) will reduce the payment designated for the account that appears next.



Publications 4541 and 4542 provide information on split refunds and are available electronically on www.irs.gov.

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 disallow 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: Although direct deposit saves postage, it is no faster than receiving a refund through the mail. True False

Question 2: When entering an account number for direct deposit, make sure to include all spaces and hyphens. True False

What is the new information about U.S. savings bonds for the 2011 filing season?

IRS will provide taxpayers with an opportunity to purchase U.S. savings bonds with their tax refunds. The 2011 filing season is the second year for this option. Volunteers should review these guidelines to promote this asset-building opportunity as part of the 2011 filing season.

For the 2010 filing season, bonds could only be issued in the name of the taxpayer (and spouse, if joint return). In the 2011 filing season, taxpayers will 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 new 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?

For the 2011 filing season, taxpayers can choose to save part or all of their refunds by requesting savings bonds on Form 8888, Allocation of Refund (Including Bond Purchases). The taxpayer will not need another account for the remainder of the refund. Taxpayers can designate on Form 8888 the amount of the refund they want in a paper check. Form 8888 has been revised to reflect the specific details on how to purchase savings bonds with a federal tax refund.

In addition to the three direct deposits, taxpayers can now allocate their refund to purchase up to three U.S. Series I Savings Bonds and receive a paper 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 now (a) make bond purchases and add beneficiaries or co-owners, and (b) make bond purchases for someone other than themselves. Taxpayers will no longer have to enter the prespecified RTN number and the word "Bond" for account number. Programming will be in place that will automatically assign the RTN and account number when lines 4 through 6 are completed.
- Part III: If taxpayers wish to receive part of their refund by paper check, they can now do this on Form 8888.
- Part IV: Total allocation of refund. Add the amounts for each part together, which must equal the total refund amount.

The 2010 Form 8888 Instructions provide directions for the specific information to include on the form for the purchase of savings bonds.

example

Mary's 2010 tax return shows she is due a refund of \$548.00. Mary chooses to buy a savings bond in the amount of \$500. Mary can elect to deposit the remaining \$48 into her checking account or she can receive a paper check for the \$48. Mary's Form 8888 will include the specific information for the \$500 savings bond purchase and if she chooses the checking account deposit of the remaining \$48.

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 in Pittsburgh at 1-800-245-2804 to inquire about the status of the savings bonds.

For additional information refer to 2010 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.



Explain to taxpayers who have an amount owed that the return must be filed by the due date even if the full amount cannot be paid. A separate penalty for filing a return after the due date may be applied.



This is the best course of action for the taxpayer. If the taxpayer cannot fully pay by the due date, explain other options.

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 13), 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. 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, you should 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 the applicable line in Form 1040, Amount You Owe section, may request the following:

- Pay in full within 60 or 120 days with no fee; interest and penalties charged on payments after April 15
- Make monthly installment payments by filing Form 9465, *Installment Agreement Request*



CAUTION
Question the taxpayers on their ability to pay. If they cannot pay, they should choose the option that is the least costly. For example, the 60-to-120 day pay-in-full option has no user fee. Any amount of tax owed that is not paid by the April due date is subject to penalty and interest charges.



If paying the tax would cause the taxpayer an undue hardship, the taxpayer can ask for an extension of time to pay by filing Form 1127 by April 15. For more information, see Form 1127.



If the taxpayers pay their income tax (including estimated tax) by credit or debit card, they can deduct the convenience fee charged by the card processor as a miscellaneous itemized deduction (subject to the 2% AGI floor).



The paper Form 1040-V includes instructions and a table of IRS Service Center addresses.



CAUTION
Taxpayers should not mail cash with their returns.

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 in 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, click "Set Up a Payment Plan."



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 refer to 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?

- A. Direct deposit of a refund
- B. Electronic funds withdrawal of a tax payment
- C. Using a credit card to make a tax payment
- D. Using a personal check to make a tax payment

Taxpayer Interview and Tax Law Application

Seymour's paper 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 2010 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 15. I would just need to see proof of account to verify your bank account information so I can include the routing and account numbers in your electronic return.

SEYMOUR RESPONDS...

Hmm. How does electronic funds withdrawal work? Does it come out of my account right away?

And there's no charge?

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

Right. And it saves you the trouble of mailing in the voucher with your payment.

SEYMOUR RESPONDS...

Sounds good to me. But I don't have my checking account information with me. Maybe I should just mail in my payment.

You can do that too. Here's Form 1040-V, which has been completed for you. Make your check or money order payable to "United States Treasury." If it's not already printed on the check, make sure it shows your name, address and daytime phone number. Also, print your social security number and "2010 Form 1040" on the front of your check. Then mail the payment with the voucher. I'll get the mailing address for you.

That doesn't seem too hard.

Just make sure it gets postmarked no later than April 18. 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.

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 to 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 2010. His withholding is \$417. He owes \$1,240. His 2009 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 2010 tax or 100% of his 2009 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. If necessary, the taxpayer can complete the Form 2210 that will be included with the notice.



Tax Software Hint: For 2010, Form 2210 will be defaulted in the software and \$0 will be reflected on line 9. This will prevent volunteer preparers from calculating the estimated tax penalty. Volunteer preparers need to inform taxpayers with a balance due who are meeting the estimated penalty requirements that they may receive a notice from the IRS.



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.

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



Refer to Form W-4 instructions to see the applicable lines a taxpayer must complete to revise Form W-4.

Publication 919, *How Do I Adjust My Income 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)



It is very important to help taxpayers who need assistance revising their withholding. If taxpayers did not have enough tax withheld in 2010, advise them to submit a revised withholding form to increase the amount of income tax withheld.



Refer to the Volunteer Resource Guide (Tab 13), Balance Due Returns, on how to avoid a balance due. Remember to advise taxpayers to use the withholding calculator on www.irs.gov as a way to check their withholding for next year.

What is the Third Party Designee?

For taxpayers who want to allow a friend, a family member, or another person to discuss their 2010 tax return with the IRS, the “Yes” box of the Third Party Designee area of the return can be checked. You may see this situation in the case of an individual going overseas, or elderly parents who wish to have their adult child handle their affairs. You will also need to enter the name, phone number, and any five numbers the 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.

You Owe	77	Estimated tax penalty (see page 14)	77	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see page 75)?			<input type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No
	Designee's name ►	Phone no. ►	Personal identification number (PIN) ►	_____

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 to their check or account card. If an error is made in the bank information, the 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 31.

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 page 2 of Form 1040. 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.

For the 2011 filing season, taxpayers can use their 2010 tax refund to buy U.S. savings bonds, even without a bank account or an existing account with Treasury. For the 2011 filing season, taxpayers will have additional options. They will be able to buy bonds as co-owners with children and grandchildren.

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 due no later than April 15. They can pay with a check or money order, with Form 1040-V, electronic funds withdrawal, or a credit card.

If taxpayers are unable to pay, they may request an installment agreement by submitting Form 9465. This can be done with the return, whether filed electronically or on paper. Taxpayers can also use 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

If it appears the taxpayer owes an estimated tax penalty, advise the taxpayer that the IRS will calculate the penalty and send a bill.

Adjusting Tax Withholding

Help taxpayers who need assistance revising their withholding. If taxpayers did not have enough tax withheld in 2010, advise them to submit a revised Form W-4 (to their employer) or Form W-4P (to a pension payer). Available resources include the withholding calculator on www.irs.gov and Publication 919.

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.



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. Taxpayers will receive their refund faster if they use direct deposit.

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.

Notes:



Lesson 32: Quality Review of the Tax Return



Introduction

This lesson covers the final steps in the return preparation process that 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 an IRS-approved quality review sheet
- 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 preferred method is to review a print copy of the tax return, a completed intake sheet, along with all source documents, even if the return was prepared electronically. The taxpayer should be present for and engaged in the quality review.

To perform a quality review of a tax return, use Form 13614-C, Intake/Interview & Quality Review Sheet; Form 8158, Quality Review Sheet; or an approved alternative quality review sheet, and the tools in the Volunteer Resource Guide. Depending on the site, one of three methods of quality review 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 can not be present)

What do I need?

- Approved Intake and Interview Sheet, or Form 13614-C
 - Approved Quality Review Sheet or Form 8158
 - Volunteer Resource Guide
 - Publication 17
 - Publication 4491-W
 - Form 8879
- Optional:**
- Form 8332
 - Form 8453



Volunteers should always review their work, even if it is to be reviewed by another party.

The approved quality review sheet is a list of items that must be verified when reviewing tax forms. Reviewing these items prevents common errors from occurring.

How do I conduct a quality review of a return?

First, make sure you fully understand the taxpayer's tax situation. If the intake sheet is not complete, the quality reviewer should either complete it with the assistance of the taxpayer or return it to the preparer to be completed with the taxpayer. All IRS-approved, partner-created quality review sheets should have a similar checklist.



Corrections must be marked on the intake sheet by the preparer or quality reviewer.

The taxpayer's section of the intake sheet should be validated prior to the return preparation and 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 return preparer.

A quality review must be conducted with the taxpayer after completing the return and before the taxpayer signs the return. Confirm each item on the approved quality review sheet. Verify that the tax return reflects the correct tax law application to the information and source documents the taxpayer provided.

Use the Volunteer Resource Guide (Tab 13), Finishing the Return: Check Your Work—The Quality Review and 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.



Always include the taxpayer in the quality review process.

When should the taxpayer sign the return?

Taxpayers should sign their tax return after the quality review is completed. Taxpayers who e-file must sign and date Form 8879, IRS e-file Signature Authorization, or use an electronic PIN. Taxpayers who file paper returns must sign and date the return in the Sign Here section. **A return is not considered to be valid, and refunds are not issued, unless the return is signed.**

The Volunteer Resource Guide has complete instructions on signature procedures for different types of situations. Please review the Volunteer Resource Guide (Tab 13), Finishing the Return. Return Signature and PIN Guidelines provides detailed guidelines for obtaining taxpayer signatures.

Publication 17 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.



Members of the Armed Forces may have different rules for signing joint returns. See Publication 3.



Returns prepared by volunteer tax preparers should be signed by the taxpayer after the quality review is complete.

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. Therefore, it is important that all returns be identified with the site identification number.

At sites using tax preparation software, this information is usually programmed to print automatically on each return. If the correct SIDN is not in the Paid Preparer's Use Only Section, immediately inform the Site Coordinator.

You must ensure that the correct site's identification number (SIDN) has been entered in the box "Preparer's SSN or PTIN." **Do not complete any other information in the Paid Preparer's Use Only section.**

records.					
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ►			Firm's EIN ►	S15011111
	Firm's address ►			Phone no.	

Form 1040 (2010)

Some VITA/TCE tax preparation sites provide you with paper return forms that are preprinted with the site's identification number (SIDN), which is an nine-character alphanumeric starting with the letter "S," in the Paid Preparer Section of the return. Some sites may provide labels or stamps with the SIDN. Your Site Coordinator provides this number along with other necessary guidelines for completing the return.

If your site does not use forms with the preprinted SIDN, you must print your site's entire identification number in the Preparer's SSN or PTIN field.

Once you have obtained the taxpayer's signature or PIN and entered the SIDN, you are ready to assemble the return. Refer to Lesson 33, Concluding the Interview, 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 are the form numbers of the IRS quality review sheet used by most 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, print two copies of Form 8879 and obtain the taxpayer's signatures on both copies. If the return is a joint return, make sure both signatures are included on the forms, otherwise the return will not be electronically transmitted. Review the Volunteer Resource Guide (Tab 13), 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: Sandra, who is 17, is eligible to use a Self-Select PIN to sign her return using tax software. She did not file a tax return for the previous year. Can she still file an electronic tax return for the 2010 tax year? Yes No

Question 4: 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 the sample interview with Vanessa related to the quality review and e-filing. Return to this lesson after you have reviewed the sample interview.

Summary

This lesson explained the steps involved in the quality review process for paper and electronic tax returns. To perform a quality review of a tax return, use Form 13614-C, Intake/Interview & Quality Review Sheet; Form 8158, Quality Review Sheet; or an IRS-approved alternative. If necessary, use the tools in the Volunteer Resource Guide.

It may help to think of these sections of Form 13614-C in terms of how they relate to sections of the tax return:

- *Sections A and B:* Verify that Form 13614-C, Sections A and B, are complete.
- *Taxpayer Identity section:* Verify taxpayer's identity using photo ID. Verify taxpayer's name and SSN using Social Security card. Verify with the taxpayer that date of birth and address are correct.
- *Spouse and Dependent Identity section:* Verify spouse's and dependent's identities. Verify the name and SSN using Social Security cards. Verify with the taxpayer that date of birth is correct.
- *Filing Status:* Have you asked all the questions to determine the correct filing status?
- *Exemptions:* Verify that the dependents claimed meet the tests to qualify and are entered correctly on the return.
- *Income:* Verify that all income shown on source documents and noted in Section A, part III, is included on the tax return.
- *Adjustments to Income:* Verify that any adjustments to income are reported correctly and are supported by the taxpayer's documentation.
- *Standard, Additional, or Itemized Deductions:* Verify that all information is correct and that support forms or documentation is present.
- *Credits:* Verify that all appropriate credits have been reported correctly and that support forms or documentation is present.
- *Withholding and Estimated Tax Payments:* Verify that any withholding shown on Form(s) W-2 and other source documents have been included and are reported correctly.
- *Direct Deposit or Debit:* Verify that checking or savings account and routing information match the supporting documents.
- *Site Identification Number (SIDN):* Verify that the correct SIDN is shown on the return.

In addition, for electronic filing, you and/or the designated quality reviewer should make sure that Forms 8879 are signed when the Practitioner PIN signature option is used. Use of the Self-Select PIN signature option does not require Forms 8879.



EXERCISE ANSWERS

Answer 1: B. Both spouses must sign a joint return, even if only one spouse had income.

Answer 2: Form 13614-C or Form 8158, Quality Review Sheet.

Answer 3: Yes. Sandra will need to enter zero ("0") for her prior year's AGI in order to use the Self-Select PIN, or she may sign Form 8879 in order to file her 2010 tax return electronically.

Answer 4: Designated quality reviewer (the preferred method), peer review, and self-review, only allowed if a second qualified person can not be present.



Lesson 33: 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/documentation they should keep and why
- What documentation about them is maintained at the site—why, how long, etc.
- What they need to know and do if they overpaid their taxes (e.g., refund due 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 dates and estimated tax payments, reducing the number of exemptions on Form W-4 to avoid additional payments)

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 e-file Refund Cycle Chart when refunds will be paid to the taxpayer
- Explain to taxpayers what they should do when they owe money and what they can do to avoid owing taxes in the future
- 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?

- 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?

Most volunteer tax assistance sites use tax software to create and e-file tax returns. Even so, taxpayers must retain paper copies of their returns. Follow the steps in the Volunteer Resource Guide (Tab 13) 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(s) name(s) and social security number(s) 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 taxpayer(s) the printed copy of the tax return, verifying once more the personal information and discussing each section down through the final tax refund or balance due.

Who keeps the records?

What forms should the taxpayer keep?

The taxpayers must keep records to prove their income and expenses. If they own a home or investments, their basic records should contain documents related to those items including all tax-related documents.

Advise the taxpayer 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 Form(s) W-2 and Form(s) 1099.
- If applicable:
 - Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (or similar statement)
 - Original Power of Attorney
- For e-file returns, the taxpayer 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.



Advise taxpayers to bring the envelope to the site with them next year.

If Publication 730, Important Tax Records Envelope, or an alternative is available, place the taxpayer's tax return and supporting documents into that envelope.

What tax return data will the site keep?

If a paper return is filed, the volunteer site will **not** keep copies of taxpayers' returns or any other taxpayer-related documentation. Taxpayers should keep copies of their records.

For e-file returns, 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
- One signed Form 8879 (which will be held for 3 years) for each return transmitted (unless Self-Select PIN procedures were followed)
- One copy of Form(s) W-2 and/or Form(s) 1099-R
- A copy of the IRS Acknowledgment Report for transmitted federal returns
- A copy of the Declaration Control Report (DCR) for transmitted returns may be kept



If your site does not have storage capability or will not be open after April 15th, make storage arrangements with your local IRS SPEC contact.

What should I tell the taxpayer about refunds or balances due?

For taxpayers who are due a refund:

- Review the 2011 IRS e-file Refund Cycle Chart in the Volunteer Resource Guide (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 an account. This may be set up using tax software and e-filed with the return; see the Volunteer Resource Guide (Tab 6).
- Advise taxpayers to send Form 1040-V to the appropriate address if they wish to mail a payment; for e-file returns, Form 1040-V, Payment Voucher, 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 April 18 to avoid penalties and interest.
- If taxpayers are unable to pay, see the Volunteer Resource Guide (Tab 13) for the various payment options available.
- If taxpayers can pay a portion of the amount owed by the 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 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, the IRS Web site provides a helpful withholding calculator at www.irs.gov—keyword: 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 29, 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. Her tax last year, while she was still working full time, was \$2,760. When you complete her return this year, her tax totals \$1,300. Maria should make estimated payments, since her tax after withholding and credits will be more than \$1,000, and her withholding is less than \$1,170 (90% of this year's tax). 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 of the taxpayers you will assist 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 taxpayer's checking or savings account, by credit card, or by check or money order with Form 1040-ES, payment voucher. 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 their social security number and "2010 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 the taxpayer off, show as much concern and interest as you did at the start of your time together:

- Ask the taxpayer, "Do you have any questions before you leave?"
- Advise the taxpayer 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 the taxpayer in case there are any problems with the e-filing of the return.
- Thank the taxpayer for using the service.

Does the taxpayer have to do anything else?

If the return will be e-filed, give the taxpayer a brief explanation of how the process works:

- The Site Coordinator or designee will transmit all the e-file returns.
- The next day, the Site Coordinator or designee will receive 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 may need to contact the taxpayer to resolve the problem.
- If the return is not being e-filed, the taxpayer must mail the signed copy of the tax return, along with copy B of all Form(s) W-2, and Form 1099-R. The taxpayer may need another copy of the return and Form(s) W-2 if filing a state return. Make sure the taxpayer knows the correct address for mailing the return(s). Advise the taxpayer that the return must be postmarked by the filing deadline of April 18.

Summary

Concluding the interview properly ensures that each taxpayer has 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 34: 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

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 paper-filed federal returns to the service center for where they currently live.

What do I need?

- Approved Intake and Interview Sheet
- Volunteer Resource Guide
- Publication 3
- Publication 17
- Publication 525
- Publication 4491-W
- Form 1040
- Form 4868
- Form 8822

Optional:

- Form 1040 Instructions



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.

If the military member is stationed overseas and has an APO or FPO address, file the paper tax return with the IRS Service Center in Austin, Texas, 73301-0215 USA.



Tip: If April 15 falls on a weekend or holiday, then the due date is the next business day.

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 **April 15** of the following year.

Taxpayers who have a balance due can pay by check, money order, electronic funds withdrawal, or credit card.



If the postal service does not deliver to the taxpayer's street address and the taxpayer has a post office box, enter the post office box number on the line for the present home address.

What 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.

Form 8822
(Rev. December 2008)
Department of the Treasury
Internal Revenue Service

Change of Address

► 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.

2 Gift, estate, or generation-skipping transfer tax returns (Forms 706, 709, etc.)
► For Forms 706 and 706-NA, enter the decedent's name and social security number below.

► Dece... ► Social security number...



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 31, 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.



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.

Form 4868		Application for Automatic Extension of Time To File U.S. Individual Income Tax Return		OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)		For calendar year 2010, or other tax year beginning		2010
Part I Identification		Part II Individual Income Tax		
1 Your name(s) (see instructions) Address (see instructions)		4 Estimate of total tax liability for 2010 . . . \$ _____ 5 Total 2010 payments . . . 6 Balance due. Subtract line 5 from line 4 (see instructions) . . . 7 Amount you are paying (see instructions) ► 8 Check here if you are "out of the country" and a U.S. citizen or resident (see instructions) ► <input type="checkbox"/> 9 Check here if you file Form 1040NR or 1040NR-EZ and did not receive wages as an employee subject to U.S. income tax withholding. ► <input type="checkbox"/>		
City, town, or post office State ZIP Code				Cat. No. 13141W Form 4868 (2010)
2 Your social security number		3 Spouse's social security number		
For Privacy Act and Paperwork Reduction Act Notice, see your 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

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.



EXERCISES (continued)

Question 2: True or False? Interest is charged on the balance due paid after the regular due date of the return. True False

If Form 4868 is filed late, the request for an extension will be denied, and the IRS will inform the taxpayer that the request was denied.



For more details on penalties,
refer to filing information in
Publication 17.



EXERCISES (continued)

Question 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.

On Form 1040EZ or Form 1040A, add the amount paid with an extension to the total payments; and to the left of the line, enter "Form 4868" and show the amount paid to receive credit for the payment.

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 and 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 15 due date to the date the tax is paid. Form 4868 is not required to obtain this automatic two-month extension to file.



Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic two-month extension.

What must taxpayers attach to their return?

Taxpayers using the automatic two-month extension must attach a statement to their return stating that they meet the requirements.

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, 2010, through January 31, 2011.
- D. None of the above.

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 15
- B. June 15
- C. June 16

How should the IRS be notified about combat zone service?

The IRS works with the Department of Defense to identify taxpayers who are serving in a combat zone, 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.



Operation Unified Response is a contingency operation that gives designated persons providing earthquake relief in Haiti the same extensions that are available to military and support personnel serving in Iraq, Afghanistan, and other combat zone localities. Members of the military and certain civilians providing earthquake relief in Haiti have additional time to take care of various tax matters. For more information see www.irs.gov.

example

Captain Kristina Jones entered a combat zone on December 1, 2008. She remained there through March 31, 2010, when she departed for the U.S. She was not injured and did not return to the combat zone. Her deadlines for filing 2008, 2009, and 2010 returns are:

- 2008 tax return deadline is January 10, 2011. 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, 2009).
- 2009 tax return deadline is January 10, 2011; the deadline is extended by 285 days (180 plus 105).
- 2010 tax return deadline is not extended because the 180-day extension period after March 31, 2010, ends on September 27, 2010 (which is before the start of the next filing period, January 1–April 15, 2011).

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, 2008 through May 31, 2010, and was not injured, the deadline for filing a 2008 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

When can taxes be deferred?

Reservists called to active duty or regular Armed Forces members not in a combat zone may still qualify to defer the payment of back taxes by:

- Serving their initial period of service (the period of active duty following recall to active duty from an inactive reserve or national guard unit or for regular military, the period following induction or first enlistment) or
- Showing that the ability to pay back taxes has been materially impaired because income has dropped as a result of going into military service

What are rules for deferment?

Armed Forces members who have a current payment agreement or receive a notice requesting payment must make a written request for deferment to the IRS. The IRS will review each request and advise the taxpayer in writing of its decision.

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 form shows the 'Third Party Designee' section. It includes fields for the designee's name, phone number, and a five-digit personal identification number (PIN). There are also checkboxes for 'Yes' and 'No' regarding whether to allow another person to discuss the return with the IRS. A declaration statement at the bottom states that the information provided is true to the best of the taxpayer's knowledge.

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. A copy must be attached to the return.

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 the 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 the combat zone. The statement must be signed by the spouse who is not serving in the 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



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 ending on or after the first day the member served in a combat zone in active service.

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 2010 as a result of injuries he suffered during a terrorist attack in 2008. What years are Mr. Morris' income liabilities forgiven?

- A. 2008 through 2009
- B. 2008 through 2010
- C. 2007 through 2010

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:

- Form 1040EZ, Form 1040A, or Form 1040 for each year an income 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 2010. His 2009 tax return—due on April 15, 2010—is not the final tax return. The final tax return would be the 2010 Form 1040, filed in 2011.

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 pages (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.
- 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 31, 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. 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 15.

Answer 6: The deadline for filing the 2008 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 2008 is extended 285 days (180 plus 105) after leaving the combat zone, to March 12, 2011. 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, 2009).

Answer 7: C. 2007, 2008, 2009, 2010.



Lesson 35: Amended and Prior Year Returns



Introduction

This lesson will help you determine how to amend a 2010 return that was originally prepared at the same VITA/TCE site. In addition, this lesson provides guidance on preparing prior year returns (last three prior years).

If a taxpayer requests your help in filing an amended return, first review the original return that corresponds to the scope of VITA/TCE regarding amendments. Examine the return carefully, looking for obvious errors. Then ask the taxpayer to identify and explain the errors. Try to determine if the original return is, in fact, in error. To amend a federal income tax return, use the latest revision of Form 1040X.

Ask probing questions, using 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:

- Identify when it is appropriate to prepare an amended return, Form 1040X, Amended U.S. Individual Income Tax Return
- 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 file prior year return

What do I need?

- Approved Intake and Interview Sheet
- 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 to correct any errors or omissions on a return they have already filed. Use Form 1040X to prepare an amended return.

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 the taxpayer receives a notice from the Internal Revenue Service, refer the taxpayers 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

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.



If the federal return has to be amended, often the state return must also be amended.

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 injured spouse Form 8379 with their original return. This form can be e-filed. 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 that the change requested by the taxpayer is correct. Review the approved 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.
- 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 the taxpayer has amended the return for another issue. You will need this information to properly amend the return. 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.

Look at the format of a Form 1040X, Amended U.S. Individual Income Tax Return.

What is Form 1040X?

Form 1040X is not year-specific. You must specify the year for which the amended return is being prepared. When preparing a paper Form 1040X, be sure you are using the latest version of the form. The revision date is in the upper left corner. When this training material was printed, the latest revision date of Form 1040X is the draft dated August 24, 2010. Note that this form is returning to a 3-column format.



The starting point in the column is the corrected amounts with the updates if another amended return was previously filed or if the IRS changed something on the original return.

Department of the Treasury—Internal Revenue Service
Amended U.S. Individual Income Tax Return

► See separate instructions.

This return is for calendar year 2010 2009 2008 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.		

The sentence under the Form 1040X header says, "This return is for calendar year (checked box) ____, or Other year (fill in) or fiscal year (month and year ended):" The taxpayers served by the VITA/TCE program are calendar-year taxpayers. That is, they report income received from January 1 through December 31. They claim allowable deductions paid from January 1 through December 31. If you were preparing a paper return, you would insert the appropriate tax year after "calendar year." If you are using the tax software and the original return is on the computer, the tax software will enter the year for you.

Form 1040X has 3 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 corrected figures
- The differences between the figures in columns A and C are shown in column B

Form 1040X, Part I, Exemptions, (on page 2) is filled out only if you are adding or taking away personal or dependency exemptions.

Form 1040X, Part II, Presidential Election Campaign Fund (on page 2) is used to make a \$3 donation for the Presidential Election Campaign Fund for you (or your spouse) if you did not do so on your original return. This election has been on the form in the past; it is only now being called Part II.

Form 1040X, Part III, Explanation of Changes, (on page 2) 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."

Lines 23–31, Exemptions, are used only if the taxpayer is increasing or decreasing the:

- Number of exemptions claimed on line 6d of the return being amended or
- Exemption amount of housing individuals displaced by Hurricane Katrina or a Midwestern Disaster Area



You can prepare an amended, a current year, and a prior year return using tax software. However, the amended and prior year returns cannot be filed electronically. They must be mailed to the IRS.



Be sure to take note of the instructions under Part III, Explanation of Changes. It reminds the taxpayer filing Form 1040X to include his or her name and social security number on any attachments filed with the form.

What are the time frames related to 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 from 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 2007 tax return was due April 16, 2008. He filed it on March 20, 2008. He amends the 2007 return, expecting the correction to result in a refund. If he gets it postmarked on or before April 15, 2011, it will be within the three-year limit, and the return will be accepted. But if the amended 2007 return is postmarked after April 15, 2011, 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 rule. For example, a taxpayer may be able to claim a loss on a debt or securities that became worthless in a prior year, an injured spouse claim may be filed for up to seven prior years, and certain military issues may go beyond the three-year limit. If you think the taxpayer may qualify for an exception to the three-year time limit rule, refer the taxpayer to a professional tax preparer.

What if taxpayers are due a refund on their amended return?

If the amended return indicates that the taxpayer is due a refund, be sure to advise the taxpayer that:

- The taxpayer must wait until the original return is processed (up to 8 weeks after filing the original return).
- 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 of the original return or the date the original return was filed, whichever is later, to the date the amended return is filed. (This interest will be taxable on the tax return for the year in which it is received.)
- Generally, it takes 8–12 weeks to process an amended tax return.



Guidance issued on Form 1040X dated July 2010 stated that the current processing time for amended returns is 12–16 weeks. Since this may change, check with your instructor or Site Coordinator for the latest information.

What if the taxpayer owes money on the amended return?

If the amended return indicates that the taxpayer owes money, file Form 1040X and instruct the taxpayer to pay any tax due by the April due date to avoid any interest and penalties.

Even if the taxpayers are filing Form 1040X and cannot pay the balance in full by the April due date, be sure to have them file the return anyway. The IRS will calculate interest on the balance due and send the taxpayers a bill.

Interest is calculated based on the amount of tax owed. Interest rates can change every 3 months. The interest is calculated for each day the balance due is not paid in full. Encourage the taxpayers to pay as much as possible to reduce interest and penalties. Refer to Form 1040X Instructions for more information on payment options.



Refer the taxpayer to the Form 1040X Instructions for how to include all the correct information on the check or money order.



EXERCISES

Answers are after the lesson summary.

Question 1: John e-filed his 2008 Form 1040 on March 29, 2009. The next year, while preparing his 2009 return, John discovered an error in his 2008 return that resulted in a higher refund. John mailed an amended 2008 return on April 19, 2010. Is this too late to qualify for the refund?

Yes No

Question 2: On May 6, 2012, Brenda discovers an error on her timely filed 2008 tax return. Correction of this error would result in a refund. She mails an amended return on May 6, 2012. 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.



Tax Software Hint: For software entries, go to Volunteer Resource Guide (Tab 13), Amended Returns, to review the step-by-step procedures for preparing Form 1040X.

Remember to follow the interview process and use the research tools to prepare an accurate return.



The Refund or Amount You Owe section on Form 1040X must be filled out carefully. Look at line 17, "Overpayment, if any, shown on original return." The original refund is entered here. 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 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 in.
2. Have the taxpayers (and spouse if Married Filing Jointly) sign and date the bottom of the second page of Form 1040X. Check the state return for where to sign and where to mail 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.
4. Attach any additional forms or schedules needed to explain the changes. Document the explanations for amending the return in Form 1040X, Section C.



Remember to attach required documentation if the taxpayer is claiming first-time home-buyer credit on an amended return.

Explain that normal processing time for an amended return is generally 8–12 weeks. Also tell the taxpayers that, if they owe money and they 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. If taxpayers indicate they are unable to pay the total amount due, encourage them to pay as much as possible. Refer to the Form 1040X Instructions for more information on payment options.



Tax Software Hint: Refer to the white tabs in the Volunteer Resource Guide for software entries and more information on amended returns (Tab 13).

Who can prepare prior year returns?

VITA/TCE volunteers may prepare tax returns for the current and the last three prior years. Seasoned volunteers (at least two years of experience) preparing prior year returns must be certified at the Intermediate or Advanced level.

Taxpayers seeking assistance outside the scope of the volunteers' certification should seek assistance from a tax professional. If your site does not have the necessary tools to prepare a prior year return, seek guidance from your site coordinator. The taxpayer should be referred to an IRS Taxpayer Assistance Center. A poster, Publication 4750 and brochure, Publication 4742, titled, Haven't Filed Your Federal Tax Returns in a While?, are now available to promote the filing of prior year returns. Your Site Coordinator may order these for outreach efforts from your local IRS SPEC office. Publications 4742 and 4750 can also be viewed on the Forms and Publications web page on www.irs.gov.



The preparation of prior year returns is not a requirement for participation in the VITA/TCE program.



If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, please research www.irs.gov to secure the address of the closest IRS TAC office that will prepare prior year returns.

What technical resources are required?

Each site coordinator should be aware of the requirements for preparing prior year returns (if prior year returns are prepared at the site). The SPEC relationship managers and www.irs.gov (keyword search: prior year returns) are critical resources for administrative and technical requirements.

At a minimum, the following tools are required:

- Tax preparation software for the return year; Publication 17, Your Federal Income Tax for Individuals; Publication 4012, Volunteer Resource Guide; and Volunteer Quality Alerts must be available for the prior years.
- The tax software includes both Publication 17 and Publication 4012. Prior year quality alerts are located at www.irs.gov (keyword search: volunteer quality alerts).



Direct partners and volunteers to the Partner and Volunteer Resource Page (Keyword Search: Community Network) on www.irs.gov. This includes all hot topics for partners and volunteers.



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.

Is the Intake/Interview Sheet and Quality Review Checklist required?

Yes, an approved, prior year Form 13614-C, Intake/Interview & Quality Review Sheet, and Form 8158, Quality Review Checklist, must be completed for every prior year tax return. The prior year forms are available on www.irs.gov (Keyword search: "prior year returns").

How do I file a prior year return?

Prior year returns cannot be electronically filed. Also see the information about balance due prior year returns in Tab 13.



Taxpayers can also visit the local Field Assistance Tax Assistance Centers (TAC) for delivering the completed return and/or full payment for balance due returns.



Prior year returns cannot be filed electronically (e-filed).

Summary

You can help taxpayers file an amended tax return for the *current year* using tax software. In the VITA/TCE program, you can assist taxpayers if they filed the original return at the same volunteer site. Amended returns should be filed if any of the following were reported incorrectly:

- Filing status
- Total income
- Deductions or credits

Remember to use the interview process and research tools to prepare an accurate amended return.

An amended return must be mailed; it cannot be filed electronically.

A refund check on an amended return cannot be direct deposited; a paper check is mailed to the taxpayer.

If you are amending the federal return, you usually have to amend the state return. VITA/TCE volunteers may prepare tax returns for the current and the last three prior years. Seasoned volunteers (at least two years of experience) preparing prior year returns must be certified at the Intermediate or Advanced level.

If a taxpayer requests return preparation assistance for returns older than three years or if the site is unable to prepare prior year returns, please research www.irs.gov to secure the address of the closest IRS TAC office that will prepare prior year returns.

Prior year returns cannot be filed electronically (e-filed).



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 before April 15, 2011. That is 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.

Notes



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 has completed pages one and two of her intake and interview sheet. Using your Volunteer Resource Guide, the Form 13614-C Job Aid, your tax law knowledge, and your screening and interview skills, you are ready to begin.

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 approved intake and interview sheet.

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. Phone Primary: 303-555-5555	Other: n/a		E-mail n/a				
5. Your Date of Birth 11/12/1972	6. Your Occupation Retail Sales		7. Are you Legally Blind <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No				
9. Spouse's Date of Birth 07/14/1969	10. Spouse's Occupation Cook		8. Totally and Permanently Disabled <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No				
11. Is Spouse 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 your parents or someone else claim you or your spouse on their tax return? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Unsure							
Part II. Family and Dependent Information							
1. As of December 31, 2010, your marital status was:							
<input type="checkbox"/> Single							
<input checked="" type="checkbox"/> Married: Did you live with your spouse during any part of the last six months of 2010? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No							
<input type="checkbox"/> Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____							
<input type="checkbox"/> Widowed: Year of spouse's death: _____							
2. List the name of everyone below who lived in your home and outside your home that you supported during 2010. If additional space is needed please check here and use page 4 for additional information. <input type="checkbox"/>							
Name (first, last) Do not enter your name or Spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/10	daughter	8	yes	yes	no	no
Zachary Franklin	09/07/00	son	12	yes	yes	yes	no
Zoe Franklin	12/12/06	daughter	12	yes	yes	no	no
Annabelle Johnson	11/15/36	mother	12	yes	yes	no	no

Vanessa's possible filing statuses

On her approved intake and interview sheet, 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 your Volunteer Resource Guide, 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 approved intake and interview sheet.

2. List the name of everyone below who lived in your home and outside your home that you supported during 2010. If additional space is needed please check here and use page 4 for additional information. <input type="checkbox"/>							
Name (first, last) Do not enter your name or Spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/10	daughter	8	yes	yes	no	no
Zachary Franklin	09/07/00	son	12	yes	yes	yes	no
Zoe Franklin	12/12/06	daughter	12	yes	yes	no	no
Annabelle Johnson	11/15/36	mother	12	yes	yes	no	no

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've reviewed your intake sheet and, to start off with, 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?	Yes.
Okay, that makes you 38. I see that you checked "Married" but answered "No" to living with your spouse during the past six months.	Yes, Harvey moved out in February 2010.
But you were still married on December 31st of last year, correct?	Yes, that's right.
Do you and your husband plan to file jointly?	I think I want to file Married Filing Separately, but I'm not sure.
And you have three children you may be claiming as dependents, and possibly your mother as a fourth dependent?	Yes, that's right.
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'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 the Volunteer Resource Guide (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 approved intake and interview sheet to determine her income for the tax year. Vanessa's W-2 indicates she has wages of \$31,000.

a Employee's social security number 111-11-5555	Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile
OMB No. 1545-0008			
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 \$1,984.00	
	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 Advance EIC payment	10 Dependent care benefits	
e Employee's first name and initial Vanessa L. Franklin	Suff. 3344 Cleveland Drive	11 Nonqualified plans	12a See instructions for box 12 D \$1,000.00
		13 Statutory employee	12b
		Retirement plan	
		Third-party sick pay	
	14 Other		12c

Section A. To be completed by Taxpayer (continued)

Part III. Income – In 2010, did you (or your spouse) receive: (Check Yes, No or Unsure to all questions below)

Yes No Unsure

- 1. Wages or Salary? (Form(s) 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, 1099-OID)
- 5. Refund of state/local income taxes previously used as a deduction on 1040 Sch A? (Form(s) 1099-G)
- 6. Alimony Income?
- 7. Self-Employment Income/Loss (such as earnings from contract labor, small business)? (Form(s) 1099-MISC)
- 8. Income (gain or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Form(s) 1099-B)
- 9. Disability Income (such as payments from SSA, VA, insurance, etc)? (Forms 1099-R, W-2)
- 10. Distributions from Pensions, Annuities, and/or IRA? (Form(s) 1099-R)
- 11. Unemployment Compensation? (Form(s) 1099-G)
- 12. Social Security or Railroad Retirement Benefits? (Form(s) SSA-1099)
- 13. Income (profit or loss) from Rental Property?
- 14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

On her approved intake and interview sheet, Vanessa also indicated that she had self-employment income. You next confirm and clarify this and any other income sources. Refer to the Income section of the Volunteer Resource Guide (Tab D) for other income sources you should consider.

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.</i> <i>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 intake and interview sheet 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

Consult Chart A—2010 Filing Requirement Chart For Most People Who File in the Volunteer Resource Guide (Tab A). 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 intake sheet.



Sample interview to verify identity

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<p><i>By the way, thanks for taking the time to complete our intake sheet. 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.</i></p>	<p>No problem! Here's my driver's license. I wrote everyone's name on the intake sheet, just as they appear on the cards.</p>
<p><i>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.</i></p>	<p>Yeah, I haven't moved since getting that license.</p>
<p><i>Okay. Then, let's continue reviewing the intake sheet.</i></p>	<p>Sounds good.</p>

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 intake sheet. After reviewing Parts I and II of her approved intake and interview sheet, 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 2010. 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 the Volunteer Resource Guide (Tab B), Filing Status Interview Tips. You should also complete 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 Part I, Your Personal Information, on her intake and interview sheet to see if Vanessa can be claimed as a dependent on someone else's tax return.

13. Can your parents or someone else claim you or your spouse on their tax return? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Unsure
Part II. Family and Dependent Information
1. As of December 31, 2010, your marital status was:
<input type="checkbox"/> Single <input checked="" type="checkbox"/> Married: Did you live with your spouse during any part of the last six months of 2010? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____ <input type="checkbox"/> Widowed: Year of spouse's death: _____
list the names below who lived in your home and outside your home that you supported during 2010

Refer to the Volunteer Resource Guide (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 Part II, Family and Dependent Information, item 2, on Vanessa's intake and interview sheet. She listed four potential dependents.

2. List the name of everyone below who lived in your home and outside your home that you supported during 2010.
If additional space is needed please check here and use page 4 for additional information.

Name (first, last) Do not enter your name or Spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/10	daughter	8	yes	yes	no	no
Zachary Franklin	09/07/00	son	12	yes	yes	yes	no
Zoe Franklin	12/12/06	daughter	12	yes	yes	no	no
Annabelle Johnson	11/15/36	mother	12	yes	yes	no	no

You see that her children are under 11 years of age and her mother is 74 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 the Volunteer Resource Guide (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.

Sample Interview Clarifying Dependency Exemptions

The special rules of divorced, separated, or never married parents may apply in this situation. They are listed in Publication 17, Personal Exemptions and Dependents chapter.



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

VOLUNTEER SAYS...

VANESSA RESPONDS...

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?

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 the Volunteer Resource Guide (Tab C), Interview Tips for Children of Divorced, Separated, or Never Married Parents.

After completing the interview using the interview tips in the Volunteer Resource Guide, 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 the Volunteer Resource Guide (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 (\$3,650 for 2010). Therefore, Vanessa's mother meets the gross income test (step 5).

To answer step 6 in the interview tips, 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 17, Personal Exemptions and Dependents chapter provides 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 in Section B: To Be Completed by Certified Volunteer Only, on her intake and interview sheet.

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.

The children are the grandmother's qualifying children, but the grandmother does not pass the Qualifying Child of More Than One Person rule because her Adjusted Gross Income (AGI) is less than Vanessa's.

Based on the 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 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 divorce decree or written agreement in effect that would allow him to claim the children.

A copy of the completed Section B of Vanessa's approved intake and interview sheet 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.

Section B. To be Completed by Certified Volunteer Only

Remember: You are the link between the taxpayer's information and a correct tax return. Verify the taxpayer's information on pages 1 & 2 is complete. Any question marked "Unsure" must be discussed with the taxpayer and changed to "Yes" or "No".

Must be completed ONLY 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 half 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 no, which ones:

Annabelle

- 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



Return to lesson 6.

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 Part III, Income, of Vanessa's intake and interview sheet. Before beginning the interview, review the Income section in the Volunteer Resource Guide (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.

Part III. Income – In 2010, did you (or your spouse) receive: (Check Yes, No or Unsure to all questions below)		
Yes	No	Unsure
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
1. Wages or Salary? (Form(s) 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, 1099-OID)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
5. Refund of state/local income taxes previously used as a deduction on 1040 Sch A? (Form(s) 1099-G)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
6. Alimony Income? <i>Child support income, not alimony</i>		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
7. Self-Employment Income/Loss (such as earnings from contract labor, small business)? (Form(s) 1099-MISC)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
8. Income (gain or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Form(s) 1099-B)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
9. Disability Income (such as payments from SSA, VA, insurance, etc)? (Forms 1099-R, W-2)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
10. Distributions from Pensions, Annuities, and/or IRA? (Form(s) 1099-R)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
11. Unemployment Compensation? (Form(s) 1099-G)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
12. Social Security or Railroad Retirement Benefits? (Form(s) SSA-1099)		
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
13. Income (profit 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 Wage and Interest Income

Because the intake and interview sheet does not list detailed information about wages and taxable interest, you ask some probing questions to learn more about her wage and interest 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>	Just myself.
<i>Great! I wish I could work for myself! So, Bob's was your only source of wages?</i>	Yes.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

VANESSA RESPONDS...

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 2010?

No.

We've identified your total wages as \$31,000.

What about my cosmetics business?

We will account for those earnings later.

The volunteer and Vanessa continued reviewing the entries on Vanessa's intake and interview sheet, as well as the Volunteer Resource Guide (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. She earned no taxable interest from bank accounts. 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?

In Part III, Income, of Vanessa's intake and interview sheet, she answered "Yes" to self-employment income. You learned that this came from her cosmetics business.

Refer to the Volunteer Resource Guide (Tab 2) to see a facsimile of Schedule C-EZ. You should familiarize yourself with the requirements for filing this schedule 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 to determine if she can report it on Schedule C-EZ. If she cannot, you will need to refer her to a professional tax preparer.

Sample interview on the use of Schedule C-EZ

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Let's talk about your income from your personal cosmetics business.</i>	OK, I have all my stuff right here.
<i>You may be able to file Schedule C-EZ. If you can't, then I'll have to refer you to a professional tax preparer. First, during 2010, what was the total of your business expenses?</i>	\$590. I made a summary of all my income and expenses from my business bank account. This account is purely for my business.
<i>Okay. And it's obvious that you use the cash method of accounting. Did you carry any inventory during the year?</i>	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.
<i>Am I correct that the bank statement shows you did not have a loss on the business in 2010?</i>	That's right. I sold \$2,990 last year and my expenses were \$590.
<i>Did you have any employees?</i>	No, I did it all myself.
<i>And you aren't taking any kind of depreciation or amortization on equipment or property owned by the business?</i>	No, I don't have anything like that!
<i>Do you intend to deduct expenses for using your home as your office?</i>	No, not at all.
<i>Have you always been the only person involved in this business?</i>	Yes.
<i>Good. Then we can prepare Schedule C-EZ for you!</i>	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...	
<i>Do you have any Forms 1099-MISC for income from your cosmetics business?</i>	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!	
<i>Good! Does this year-end summary for your business account list all the deposits and expenses for your business?</i>	Yes, it does.	
<i>That makes it easy. By the way, do you use your vehicle to conduct your business?</i>	Yes, for parties and deliveries; that sort of thing.	
<i>Did you keep track of the mileage that went only for your business?</i>	No.	
<i>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>	I sure will!	

Before you continue the interview, be sure to indicate Vanessa's responses to these questions on page 2 of the intake and interview sheet. In the margins of Part III, item 7, enter "Total income \$2,990, expenses \$590."

Part III. Income – In 2010, did you (or your spouse) receive: (Check Yes, No or Unsure to all questions below)

Yes No Unsure

- | | | | |
|-------------------------------------|-------------------------------------|-------------------------------------|--|
| <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 1. Wages or Salary? (Form(s) 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, 1099-OID) |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | 5. Refund of state/local income taxes previously used as a deduction on 1040 Sch A? (Form(s) 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 Income/Loss (such as earnings from contract labor, small business)? (Form(s) 1099-MISC) <i>Total income \$2,990, expenses \$590</i> |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | 8. Income (gain or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? |

What “other income” must Vanessa report?

Recall that Vanessa only checked "Yes" to wages and self-employment in the Income section of her intake and interview sheet. 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 the Volunteer Resource Guide (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...

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 2010. Here is a list of things that are considered income. Did you receive any of these in 2010? [Volunteer shows Vanessa Table A, Examples of Income, in the Volunteer Resource Guide (Tab D).]

I don't think so. No, I'm sure I didn't.

Okay, that finishes up the Income section. Next, we'll discuss any adjustments to your income.

After such an interview, be sure to record any additional information you gained from the taxpayer's responses, on Form 13614-C, page 2 or 4, or other IRS-approved intake and interview sheet.



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 the Volunteer Resource Guide (Tab E), Adjustments section.

Also, review Vanessa’s intake and interview sheet, particularly in Part III (Income), items 4 and 7, and in Part IV (Expenses), items 1 and 2.

In Part III, Vanessa indicates that she had self-employment income. She can deduct one-half 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 28, Other Taxes.)

Because the intake and interview sheet 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 the responses she gave on her intake and interview sheet.

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 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 intake and interview sheet, 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 27, 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 Volunteer Resource Guide (Tab F), Deductions section, 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 \$8,400.</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 real estate 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 the Volunteer Resource Guide.

Since 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 \$8,400 for the tax year.

Vanessa stated that she paid medical and/or dental expenses and donations, so you decided to probe further using the Volunteer Resource Guide (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. Each round trip was 20 miles, and I have receipts for the five trips I took during the year for a total of 100 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, the reimbursement rate for qualified medical travel for the months you traveled in 2010 was 16.5 cents per mile. So, that's another \$17.</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 \$2,102. However, to claim medical expenses, you will need to have paid more than \$2,447 in expenses, which is 7.5% of your adjusted gross income. 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.

Employee's address:						
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
CO	39-0000000	\$31,000.12	\$257.00			

W-2 Wage and Tax Statement **2010** 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...

You can itemize 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.

Excellent!

Sample Interview Clarifying Interest Deductions

SAMPLE INTERVIEW

VOLUNTEER SAYS...

VANESSA RESPONDS...

Did you pay any interest?

Just the interest on my credit card. Is that deductible?

I'm sorry, but it isn't.

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 itemize this deduction.

Based on your findings during the interview, you make the following notes on Vanessa's intake and interview sheet. In Part IV, Item 5, you write \$2,102 and by Item 8, you write \$200.

<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	4. Unreimbursed employee business expenses (such as mileage)?	\$2,102
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	5. Medical expenses?	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Home mortgage interest?	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Real estate taxes for your home or personal property taxes?	
<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 that allowed you and your spouse, to work or to look for work?	

Vanessa's Miscellaneous Expense Deductions

You refer to Publication 17 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 of \$32,630, 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 \$8,400. Vanessa will take the standard deduction.



Return to Lesson 20.

Lesson 23: Credit for Child and Dependent Care

Does Vanessa qualify for the child and dependent care credit?

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 Can You Claim the Credit for Child and Dependent Care Expenses? decision tree in the Volunteer Resource Guide (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 dependent children are under 13, so they qualify.</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 intake and interview sheet. In Part IV, Item 9, you write \$1,500. . .

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	3. Educational expenses paid for your child, spouse or dependent?	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4. Unreimbursed employee business expenses (such as mileage)?	
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	5. Medical expenses? \$2,102	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	6. Home mortgage interest?	
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	7. Real estate taxes for your home or personal property taxes?	
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	8. Charitable contributions? \$200	\$1,500
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	9. Child/dependent care expenses that allowed you and your spouse, to work or to look for work?	

* V. Life Events 2010 Did you (or your spouse) check Yes, No or Unsure to all questions below?



Return to Lesson 23.

Lesson 24: 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 (Hope credit expanded) or lifetime learning education credits. Review the information in the Volunteer Resource Guide (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 on page 4 of Vanessa's intake and interview sheet with your findings.



Return to Lesson 24.

Lesson 26: Child Tax Credit

Is Vanessa eligible for the full child tax credit?

Vanessa's responses in the Family and Dependent Information of the intake and interview sheet 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 Volunteer Resource Guide (Tab G), Credits section, you can 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 your 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 the Volunteer Resource Guide (Tab G), Credits section.



Return to Lesson 26.

Lesson 27: 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. In Part IV, Expenses, of her intake and interview sheet, 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 her intake and interview sheet, as shown here.

Part IV. Expenses – In 2010 Did you (or your spouse) pay: (Check Yes, No or Unsure to all questions below)

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 | \$600 IRA,
\$1,000 on Form W-2 |
| <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | 2. Contributions to a retirement account? <input checked="" type="checkbox"/> IRA <input type="checkbox"/> Roth IRA <input checked="" 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 tuition, books, fees, etc.) | |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | 4. Unreimbursed employee business expenses (such as mileage)? | |

Vanessa's retirement savings may qualify her for the credit for retirement savings contributions. Review the Volunteer Resource Guide (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...

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, 1992.

Yes, that's right.

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.

That's correct.

During 2008, 2009, or the current tax year, 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?

No. I try to forget all about them.
Once you start taking it out, it's too hard to put it back.

You're so right about that. Well, based on your information, you may also be eligible for the saver's credit.

More good news.



Return to Lesson 27.

Lesson 28: 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 28.

Lesson 29: 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 intake and interview sheet that may affect a potential credit or payment she is entitled to receive.

Refer to the Volunteer Resource Guide (Tab 6), Other Taxes and Payments section, to identify and review the Payments section of the return.

Vanessa checked "No" on Part V, item 9, of her intake and interview sheet 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 2010.</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 and you meet all the requirements for the making work pay credit, which is \$400.</i>	Wow! I'm doing pretty good.
<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>	Even better!



Return to Lesson 29.

Lesson 30: 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 the Volunteer Resource Guide (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 \$43,352, 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 Volunteer Resource Guide (Tab H), Interview Tips for EIC with a Qualifying Child,

Sample Interview Clarifying EIC with Qualifying Child Credit

SAMPLE INTERVIEW	
VOLUNTEER SAYS...	VANESSA RESPONDS...
<i>Lets see, we already know the kids have valid social security numbers, they are your children and they are under the age of 19.</i>	Yes, that's correct.
<i>And your intake and interview sheet shows that they're single.</i>	Yeah, they're not even dating yet.
<i>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.</i>	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 30.

Lesson 31: 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 Volunteer Resource Guide (Tab 13), Pointers for Direct Deposit of Refunds and Balance Due Returns.

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>What's great about this year is 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. The Volunteer Resource Guide (Tab 13), Balance Due Returns, outlines the options.



Return to Lesson 31.

Intake/Interview & Quality Review Sheet**Section A. Page 1 and Page 2 to be completed by Taxpayer**

Thank you for allowing us to prepare your tax return. It is very important for you to provide the information on this form to help our certified volunteer preparer in completing your return. If you have any questions, please ask.

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 drivers license or other 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. Phone Primary: 303-555-5555	Other: n/a		E-mail n/a	
5. Your Date of Birth 11/12/1972	6. Your Occupation Retail Sales		7. Are you 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 Occupation Cook		11. Is Spouse 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 your parents or someone else claim you or your spouse on their tax return? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Unsure				

Part II. Family and Dependent Information

1. As of December 31, 2010, your marital status was:

- Single
 Married: Did you live with your spouse during any part of the last six months of 2010? Yes No
 Divorced or Legally Separated: Date of final decree or separate maintenance agreement: _____
 Widowed: Year of spouse's death: _____

2. List the name of everyone below who lived in your home and outside your home that you supported during 2010.

If additional space is needed please check here and use page 4 for additional information.

Name (first, last) Do not enter your name or Spouse's name below.	Date of Birth (mm/dd/yy)	Relationship to you (e.g. son, mother, sister)	Number of months lived in your home	US Citizen or resident of the US, Canada or Mexico (yes/no)	Single as of 12/31/10 (yes/no)	Full- time student (yes/no)	Received more than \$3650 in income (yes/no)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Bella Franklin	04/20/10	daughter	8	yes	yes	no	no
Zachary Franklin	09/07/00	son	12	yes	yes	yes	no
Zoe Franklin	12/12/06	daughter	12	yes	yes	no	no
Annabelle Johnson	11/15/36	mother	12	yes	yes	no	no

- Volunteers assisting with preparing your return are trained to provide high quality service and uphold the highest ethical standards.
- To report any concerns to IRS on site operating issues please call **Toll Free 1-877-330-1205** or email us at **WI.Voltax@irs.gov**.

Section A. To be completed by Taxpayer (continued)

Part III. Income – In 2010, did you (or your spouse) receive: (Check Yes, No or Unsure to all questions below)

Yes No Unsure

1. Wages or Salary? (Form(s) 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, 1099-OID)
 5. Refund of state/local income taxes previously used as a deduction on 1040 Sch A? (Form(s) 1099-G)
 6. Alimony Income? *Child support income, not alimony*
 7. Self-Employment Income/Loss (such as earnings from contract labor, small business)? (Form(s) 1099-MISC) *Total income \$2,990, expenses \$590*
 8. Income (gain or loss) from the sale of Stocks, Bonds or Real Estate (including your home)? (Form(s) 1099-B)
 9. Disability Income (such as payments from SSA, VA, insurance, etc.)? (Forms 1099-R, W-2)
 10. Distributions from Pensions, Annuities, and/or IRA? (Form(s) 1099-R)
 11. Unemployment Compensation? (Form(s) 1099-G)
 12. Social Security or Railroad Retirement Benefits? (Form(s) SSA-1099)
 13. Income (profit or loss) from Rental Property?
 14. Other Income: (gambling, lottery, prizes, awards, jury duty, etc.) Specify: _____ (Forms W-2 G, 1099-MISC)

Part IV. Expenses – In 2010 Did you (or your spouse) pay: (Check Yes, No or Unsure to all questions below)

Yes No Unsure

1. Alimony: If yes, do you have the recipient's SSN? Yes No *\$600 IRA, \$1,000 on Form W-2*
 2. Contributions to a retirement account? IRA Roth IRA 401K Other
 3. Educational expenses paid for yourself, spouse or dependents? (such as tuition, books, fees, etc.)
 4. Unreimbursed employee business expenses (such as mileage)?
 5. Medical expenses? *\$2,102*
 6. Home mortgage interest?
 7. Real estate taxes for your home or personal property taxes?
 8. Charitable contributions? *\$200*
 9. Child/dependent care expenses that allowed you and your spouse, to work or to look for work? *\$1,500*

Part V. Life Events – In 2010 Did you (or your spouse): Check Yes, No or Unsure to all questions below)

Yes No Unsure

1. Have a Health Savings Account? (Forms 5498-SA, 1099-SA)
 2. Have debt from a mortgage or credit card canceled/forgiven by a commercial lender? (Form(s) 1099-C)
 3. Buy a home? If yes, closing date _____
 4. Have Earned Income Credit (EIC) disallowed in a prior year? If yes, for which tax year? _____
 5. Purchase and install energy efficient home items? (such as windows, furnace, insulation, etc.)
 6. Live in an area that was affected by a natural disaster? If yes, where? _____
 7. Receive the First Time Homebuyers Credit in previous years?
 8. Pay any student loan interest?
 9. Make estimated tax payments or apply last year's refund to your 2010 tax?
If so how much? _____
 10. If you are due a refund, would you like a direct deposit or split your refund?
 11. If you are due a refund, would you like information on how to purchase U.S. Savings Bonds?
 12. If you have a balance due, would you like information about all of your payment options? (such as payment directly from your bank account, check, money order, credit/debit card or payment plan)

TAXPAYER STOP HERE!

Thank you for completing this form.

Section B. To be Completed by Certified Volunteer Only

Remember: You are the link between the taxpayer's information and a correct tax return. Verify the taxpayer's information on pages 1 & 2 is complete. Any question marked "Unsure" must be discussed with the taxpayer and changed to "Yes" or "No".

Must be completed ONLY 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 half 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 no, which ones:

Annabelle _____

- 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 _____

Reminder

Use Publication 17, *Your Federal Income Tax For Individuals* and Publication 4012, *Volunteer Resource Guide* in making tax law determinations.

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Section C. To be completed by a Certified Quality Reviewer

After reviewing the tax return and verifying that it reflects correct tax law application to the information provided by the taxpayer, check the final item.

1. **Sections A & B** of this form are complete.
2. **Taxpayer's Identity, Address and Phone Number** 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 **Income** 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.
11. If **Direct Deposit or Debit** was elected, checking/saving account and routing information match the supporting documents.
12. Correct SIDN is shown on the return.

- Check if the items above have been verified to validate accuracy based on your interview with the taxpayer and a second review of their source documents.

Form 13614-C (Rev. 9-2010)

Additional Taxpayer Notes:

Although we assisted Mrs. Franklin last year with her return, I conducted a probing interview to make sure her tax situation had not changed. I confirmed all her entries on this form; see notes in the margins.

Highlights are shown below:

Part I: no changes

Part II: Mrs. Franklin had a baby girl this year which increased her dependents.

She cannot claim her mother as a dependent. Her mother provided more than half of her own support.

Her husband did not live with her during the last 6 months of the year.

She does not want to file with her husband and qualifies for Head of Household (HOH) filing status.

HOH is more advantageous for Mrs. Franklin than Married Filing Separately.

Part III: Mrs. Franklin had checked "Unsure" for Alimony but after discussing it with her, we determined that it was child support.

She has income from wages and self-employment.

Part IV: Mrs. Franklin made contributions to an IRA and a 401K. She qualifies for the Retirement Saver's Credit.

She qualifies for the Lifetime Learning Credit, the Child and Dependent Care Credit and the Child Tax Credit.

Her medical expenses and charitable contributions were considered but it is more advantageous for her to take the standard deduction.

Part V: She would like direct deposit and to split her refund - checking account, IRA and savings bond.

Additional Tax Preparer Notes:

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.

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