



Department
of the
Treasury

Internal
Revenue
Service

Your Federal Income Tax

For Individuals

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For use in
preparing

2001
Returns

TAX GUIDE 2001



FOR INDIVIDUALS

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All material in this publication may be reprinted freely. A citation to Your Federal Income Tax (2001) would be appropriate.

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

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

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

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

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

Introduction

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

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

Throughout the publication are examples showing how the tax law applies in typical situations. Sam-

ple forms and schedules show you how to report certain items on your return. Also throughout the publication are flowcharts and tables that present tax information in an easy-to-understand manner.

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

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

- List of where to report certain items listed on information documents.
- List of mailing addresses for where to file returns.
- List of recorded tax information topics (TeleTax).

If you operate your own business or have other self-employment income, such as babysitting or sell-

ing crafts, see the following publications for more information.

- Publication 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*.
- Publication 533, *Self-Employment Tax*.
- Publication 535, *Business Expenses*.
- Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers)*.

For information on how you can get free IRS publications and forms, see *How To Get Tax Help* in the back of this publication.

Sending us comments and recommendations. We welcome your comments about this publication and your suggestions for future editions. You can write us at the following address.

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



Using a personal computer and modem, you can e-mail us while visiting our web site at www.irs.gov.

Important Changes for 2001

This section summarizes important tax changes that took effect in 2001. These changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 2001 Tax Changes*.

Tax relief for victims of terrorist attacks. At the time this publication was being prepared for print, Congress was considering legislation that would provide tax relief for individuals affected by terrorist attacks against the United States.

For more information, see Publication 3920.

Reduced tax rates. For tax years beginning in 2001, the income tax rates have been reduced. The following items highlight these changes.

10% tax rate. A portion of your income that would be subject to the 15% tax rate is subject to a reduced rate of 10%. For 2001, most individuals receive the benefits of the 10% rate through the rate reduction credit, discussed later. A person who can be claimed as a dependent on someone else's return is not eligible for the credit and will receive the benefits of the 10% rate by completing a worksheet in the form instructions.

Other tax rates. The other tax rates, 28%, 31%, 36%, and 39.6% are reduced to 27.5%, 30.5%, 35.5%, and 39.1%, respectively. These reduced rates should have been reflected in amounts withheld (such as backup withholding) on certain payments made after August 6, 2001.

Advance payment of income tax. If you received an advance payment of income tax in 2001, you do not have to report this payment as income on your federal income tax return. This payment reduces your rate reduction credit, discussed next.

Rate reduction credit. If you did not receive the maximum advance payment in 2001, you may qualify for the rate reduction credit. You can use the worksheet in your form instructions to determine whether you can claim the credit. See chapter 38.

Child tax credit. The maximum child tax credit for each child is increased to \$600. The qualifications for claiming the additional child tax credit have been changed to include a qualifying individual with fewer than 3 children. See chapter 35.

Interest on student loans. You may be able to deduct as an adjust-

ment to income interest paid on a qualified student loan. The maximum deduction is increased to \$2,500. See Publication 970, *Tax Benefits for Higher Education*.

Traditional IRA income limits. Generally, if you have a traditional individual retirement arrangement and are covered by an employer retirement plan, the amount of income you can have and not be affected by the deduction phaseout is increased. The amounts vary depending on filing status. See chapter 18.

Alternative minimum tax (AMT). The AMT exemption amounts are increased. See chapter 31.

Schedule D tax computation simplified. The tax computation on Schedule D is now easier for most taxpayers. For information on completing Schedule D, see chapter 17.

Lower capital gain tax rate. A new capital gain tax rate applies to gain that is "qualified 5-year gain." Qualified 5-year gain is long-term capital gain from the sale of property that you held for more than 5 years and that would otherwise be subject to the 10% capital gain rate. See chapter 17.

Election to recognize gain on property held on January 1,

2001. You can elect to treat certain assets held on January 1, 2001, as sold and then reacquired on the same date. The purpose of this election is to make any future gain on the property that would otherwise be subject to the 20% capital gain rate eligible for the 18% rate if the property is held for more than 5 years from the date reacquired. See Publication 553.

Foreign earned income exclusion. The amount of foreign earned income that you can exclude increased to \$78,000. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Standard mileage rate. The standard mileage rate for the cost of operating your car increased to 34½ cents a mile for all business miles driven. See chapter 28.

Minimum required distributions. Until final regulations are issued, proposed regulations can be relied on to determine the minimum required distribution from certain qualified plans and individual retirement arrangements (IRAs). These regulations simplify the rules for distributions during the life of the employee (or IRA owner) and for distributions after the death of that individual. In most cases, these

regulations reduce the minimum required distribution. For information on IRA distributions, see chapter 18. For information on distributions from certain qualified plans, see Publication 575, *Pension and Annuity Income*.

Certain amounts increased. Some tax items that are indexed for inflation increased for 2001.

Earned income credit. The maximum amount of income you can earn and still get the earned income credit has increased. You may be able to take the credit if you earned less than \$32,121 (\$10,710 if you do not have any qualifying children). The maximum amount of investment income you can have and still be eligible for the credit has increased to \$2,450. See chapter 37.

Standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) is higher in 2001 than it was in 2000. The amount depends on your filing status. See chapter 21.

Exemption amount. You are allowed a \$2,900 deduction for each exemption to which you are

entitled. However, your exemption amount could be phased out if you have high income. See chapter 3.

Limit on itemized deductions. Some of your itemized deductions may be limited if your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing separately). See chapter 22.

Social security and Medicare taxes. The maximum wages subject to social security tax (6.2%) is increased to \$80,400. All wages are subject to Medicare tax (1.45%).

New names for certain tax provisions. The names used to refer to certain tax provisions have been changed.

- Medical savings accounts (MSAs) are now **Archer MSAs**. For information on Archer MSAs, see Publication 969, *Medical Savings Accounts (MSAs)*.
- Education individual retirement accounts (education IRAs) are now **Coverdell education savings accounts** (Coverdell ESAs). For infor-

mation on Coverdell ESAs, see Publication 970, *Tax Benefits for Higher Education*.

Parent of a kidnapped child. The parent of a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a family member may be able to take the child into account in determining his or her eligibility for the following.

- Head of household or qualifying widow(er) with dependent child filing status.
- Exemption for dependents.
- Child tax credit.
- Earned income credit.

See Publication 501, *Exemptions, Standard Deduction, and Filing Information* and Publication 596, *Earned Income Credit (EIC)*.

Payments to Holocaust victims. Restitution payments received after 1999 (and certain interest earned on the payments) are not taxable and do not affect the taxability of certain benefits, such as social security benefits. You may

have to file Form 1040X if you included these amounts in income on your 2000 tax return or if you used the payments in any computation affecting your tax liability. For more details, see chapter 13.

Third party designee. Beginning with your tax return for 2001, you can check the "Yes" box in the "Third Party Designee" area of your return to authorize the IRS to discuss your return with a friend, family member, or any other person you choose. This allows the IRS to call the person you identified as your designee to answer any questions that may arise during the processing of your return. It also allows your designee to perform certain actions. See your income tax package for details.

Mailing your return. You may be mailing your return to a different address this year because the IRS has changed the filing location for several areas. If you received an envelope with your tax package, please use it. Otherwise, see your tax form instructions. ■

Important Changes for 2002

This section summarizes important tax changes that take effect in 2002 and that could affect your estimated tax payments for 2002. More information on these and other changes can be found in Publication 553.

Tax rates reduced. For tax years beginning in 2002, the income tax rates have been reduced. The following items highlight these changes.

10% tax rate. The 10% tax rate is reflected in the tax tables and tax schedules. You do not have to make a separate computation or figure a credit to get the benefits of this rate.

Other tax rates. The other tax rates, 27.5%, 30.5%, 35.5%, and 39.1% are reduced to 27%, 30%, 35%, and 38.6%, respectively. These reduced rates should be reflected in amounts withheld (such as backup withholding) on certain payments made after 2001.

Earned income credit (EIC). Significant changes to the EIC take effect in 2002.

- Earned income will no longer include nontaxable employee compensation.

- EIC will be based, in part, on adjusted gross income (AGI), **not** modified AGI.
- New rules will be used to determine which person can claim a qualifying child when two or more persons may be able to claim the same child.
- The definition of an eligible foster child will change. The child will have to live with you for more than half of the year, instead of the whole year.
- EIC will no longer be reduced by the amount of alternative minimum tax shown on your return.

Estimated tax safe harbor for higher income individuals. For estimated tax payments for tax years beginning in 2002, the estimated tax safe harbor for higher income individuals (other than farmers and fishermen) has been modified. If your 2001 adjusted gross income is more than \$150,000 (\$75,000 if you are married filing a separate return for 2002), you will have to pay the smaller of 90% of your expected tax for 2002 or **112%** of the tax shown on your 2001 return to avoid

an estimated tax penalty. See chapter 5.

Higher education expenses. You may be able to deduct as an adjustment to income up to \$3,000 of qualified tuition and related expenses you paid. The expenses can be for you, your spouse, or your dependent.

Interest on student loans. Two changes apply to the deduction for student loan interest.

- The provision that limited your deduction to interest paid during the first 60 months is repealed.
- The modified AGI phaseout amounts are increased.

For more information on the deduction for student loan interest, see Publication 970.

Coverdell education savings accounts. The following changes apply to Coverdell education savings accounts.

- Contribution limit increases to \$2,000 per beneficiary.
- The income phase out increases for joint filers.

• Qualified education expenses include elementary and secondary school expenses.

- Age limits do not apply to "special needs" beneficiaries.
- Contributions may be made until April 15 of the following year.
- Tax-free distributions can be used for special needs services.

Employer-provided educational assistance. The following changes apply to employer-provided educational assistance.

- Exclusion made permanent.
- Exclusion applies to graduate level courses.

Qualified tuition programs. The qualified tuition program (formerly qualified state tuition program) includes programs established and maintained by one or more eligible educational institutions. Two other changes affect this program.

- Distributions from a state program that are used to pay qualified higher education expenses are tax free. Other

distributions are subject to 10% additional tax.

- Tax-free distributions can be used for special needs services.

Tax benefits for adoption.

Changes apply to the adoption credit and to the exclusion for benefits under an employer-provided adoption assistance program. These changes include the following.

- The credit for children without special needs is made permanent.
- The exclusion under an adoption assistance program is made permanent.
- The credit and exclusion amounts increased to a maximum of \$10,000.
- The modified AGI phaseout amounts increased.

Benefits for public safety officer's survivors.

For tax years beginning after 2001, a survivor annuity received by the spouse, former spouse, or child of a public safety officer killed in the line of

duty will generally be excluded from the recipient's income regardless of the date of the officer's death. Survivor benefits received before 2002 are excluded only if the officer died after 1996. See chapter 13.

Foreign earned income exclusion.

The amount of foreign earned income that you can exclude will increase to \$80,000. See Publication 54.

Self-employed health insurance deduction.

The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increases to 70%.

Retirement savings plans.

The following paragraphs highlight changes that affect individual retirement arrangements (IRAs) and pension plans.

Increased IRA contribution and deduction limit.

Your maximum contribution (and any allowable deduction) limit is increased. Previously, the limit was \$2,000. The new limit depends on your age at the end of the year.

- If you are under age 50, the most you can contribute is the smaller of \$3,000, or your taxable compensation.
- If you are age 50 or older, the most you can contribute is the smaller of \$3,500, or your taxable compensation.

Rollovers of IRAs into qualified plans.

For distributions after December 31, 2001, you may be able to roll over tax free, a distribution from your IRA into a qualified plan.

Rollovers of distributions from employer plans.

For distributions after December 31, 2001, you can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA.

Hardship exception to the 60-day rule.

For distributions after December 31, 2001, the IRS may waive the 60-day requirement to roll over distributions from your IRA or your employer's pension plan where the failure to do so would be against equity or good conscience, including casualty, disaster, or

other events beyond your reasonable control.

Limit on elective deferrals.

The maximum amount of elective deferrals under a salary reduction agreement that can be contributed to a qualified plan is increased to \$11,000 (\$12,000 if you are age 50 or over). However, for SIMPLE plans, the amount is increased to \$7,000 (\$7,500 if you are age 50 or over).

New credit for elective deferrals and IRA contributions.

You may be able to take a credit of up to \$1,000 for qualified retirement savings contributions.

Meal expenses when subject to "hours of service limits."

If you are subject to the Department of Transportation's "hours of service" limits, the percentage of your business-related meal expenses that you can deduct has increased. For 2002 and 2003, you can deduct 65% if the meals take place during or incident to the period subject to those limits. See chapter 28.

Important Reminders

Listed below are important reminders and other items that may help you file your 2001 tax return. Many of these items are explained in more detail later in this publication.

Write in your social security number.

To protect your privacy, social security numbers (SSNs) are not printed on the peel-off label that comes in the mail with your tax instruction booklet. This means you must enter your SSN in the space provided on your tax form. If you filed a joint return for 2000 and are filing a joint return for 2001 with the same spouse, enter your names and SSNs in the same order as on your 2000 return. See chapter 1.

Taxpayer identification numbers.

You must provide the taxpayer identification number for each person for whom you claim certain tax benefits. This applies even if the person was born in 2001. Generally, this number is the person's social security number (SSN). See chapter 1.

Lump-sum distributions.

The 5-year tax option for figuring the tax on a lump-sum distribution from a qualified retirement plan is re-

pealed. However, plan participants can continue to choose the 10-year tax option or capital gain treatment for a lump-sum distribution that qualifies for the special treatment. See chapter 11.

Tax from recapture of education credits.

You may owe this tax if you claimed an education credit in one year and in a later year you, your spouse if filing jointly, or your dependent received:

- A refund of qualified tuition and related expenses, or
- Tax-free educational assistance.

See chapter 36.

Advance earned income credit.

If a qualifying child lives with you and you expect to qualify for the earned income credit in 2002, you may be able to get part of the credit paid to you in advance throughout the year (by your employer) instead of waiting until you file your tax return. See chapter 37.

Sale of your home.

Generally, you will only need to report the sale of your home if your gain is more

than \$250,000 (\$500,000 if married filing a joint return). See chapter 16.

Individual retirement arrangements (IRAs).

The following paragraphs highlight important reminders that relate to IRAs. See chapter 18 for details.

Individual retirement arrangement (IRA) for spouse.

A married couple filing a joint return can contribute up to the maximum amount each to their IRAs, even if one spouse had little or no income.

Spouse covered by plan.

Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct contributions to your traditional IRA if you are not covered by an employer plan.

Roth IRA.

You may be able to establish a Roth IRA. In this type of IRA, contributions are not deductible but earnings grow tax free and qualified withdrawals are not taxable. You may also be able to convert a traditional IRA to a Roth IRA, but you must include all or part of the taxable converted amount in income.

Foreign source income.

If you are a U.S. citizen with income from

sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties).

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

Joint return responsibility.

Generally, both spouses are responsible for the tax and any interest or penalties on a joint tax return. In some cases, one spouse may be relieved of that responsibility for items of the other spouse that were incorrectly reported on the joint return. For details, see *Joint responsibility* in chapter 2.

Include your phone number on your return. To promptly resolve any questions we have in processing your tax return, we would like to be able to call you. Please enter your daytime telephone number on your tax form next to your signature.

Payment of taxes. Make your check or money order payable to "United States Treasury." You can pay your taxes by credit card or, if you file electronically, by electronic funds withdrawal (direct debit). See chapter 1.

Faster ways to file your return. The IRS offers fast, accurate ways to file your tax return information without filing a paper tax return.

You can use IRS *e-file* (electronic filing). For details, see chapter 1. For details on these fast filing methods, see chapter 1.

Private delivery services. You may be able to use a designated private delivery service to mail your tax returns and payments. See chapter 1 for more information.

Refund on a late filed return. If you were due a refund but you did not file a return, you generally must file within 3 years from the date the return was originally due to get that refund.


Privacy Act and paperwork reduction information. The IRS Restructuring and Reform Act of

1998, the Privacy Act of 1974, and the Paperwork Reduction Act of 1980 require that when we ask you for information we must first tell you what our legal right is to ask for the information, why we are asking for it, how it will be used, what could happen if we do not receive it, and whether your response is voluntary, required to obtain a benefit, or mandatory under the law. A complete statement on this subject can be found in your tax form instruction booklet.

Treasury Inspector General for Tax Administration. If you want to confidentially report misconduct, waste, fraud, or abuse by an IRS employee, you can call

1-800-366-4484 (1-800-877-8339 for TTY/TDD users). You can remain anonymous.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1 - 8 0 0 - T H E - L O S T (1-800-843-5678)** if you recognize a child.



Part One.

The Income Tax Return

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

1.

Filing Information

Important Changes

Who must file. Generally, the amount of income you can receive before you must file a return has been increased. See *Table 1–1*, *Table 1–2*, and *Table 1–3* for the specific amounts.

Third party designee. You can now allow the IRS to discuss your 2001 tax return with a friend, family member, or any other person you choose by checking the “Yes” box in the “third party designee” area of your return. See *Third Party Designee*.

Mailing your return. You may be mailing your return to a different address this year because the IRS has changed the filing location for several areas. If you received an envelope with your tax package, please use it. Otherwise, see your form instructions for where to file.

Sign your return electronically. Create your own personal identification number (PIN) and file a completely paperless tax return with IRS e-file. See *Does My Return Have To Be On Paper*.

Important Reminders

Alternative filing methods. Rather than filing a return on paper, you may be able to file electronically using IRS e-file. For more information, see *Does My Return Have To Be On Paper*, later.

Change of address. If you change your address, you should notify the IRS. See *Change of Address*, later, under *What Happens After I File*.

Write in your social security number. You must write your social security number (SSN) in the spaces provided on your tax return. If you file a joint return, please write the SSNs in the same order as the names.

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

Alternative payment methods. If you owe additional tax, you may be able to pay electronically. See *How To Pay*, later.

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

Service in combat zone. You are allowed extra time to take care of your tax matters if you are a member of the Armed Forces who served in a combat zone, or if you served in the combat zone in support of the Armed Forces. See *Individuals Serving in Combat Zone*, later, under *When Do I Have To File*.

Adoption taxpayer identification number. If a child has been placed in your home for purposes of legal adoption and you will not be able to get a social security number for the child in time to file your return, you may be able to get an adoption taxpayer identification number (ATIN). For more information, see *Social Security Number*, later.

Taxpayer identification number for aliens. If you or your dependent is a nonresident or resident alien who does not have and is not eligible to get a social security number, file **Form W–7** with the IRS to apply for an Individual Taxpayer Identification Number (ITIN). For more information, see *Social Security Number*, later.

1040PC format no longer accepted. The 1040PC format was a computer-generated paper tax return. The availability of electronic filing for home computer users has reduced the need for this format. The IRS no longer accepts tax returns in the 1040PC format. The IRS encourages all former 1040PC filers to use IRS e-file.

Introduction

This chapter discusses:

- Whether you have to file a return,
- Which form to use,
- How to file electronically,
- When, how, and where to file your return,
- What happens if you pay too little or too much tax,

- What records you should keep and how long you should keep them, and
- How you can change a return you have already filed.

Do I Have To File a Return?

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

- 1) Individuals in general. (There are special rules for surviving spouses, executors, administrators, legal representatives, U.S. citizens living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
- 2) Dependents.
- 3) Child under age 14.
- 4) Self-employed persons.
- 5) Aliens.

The filing requirements for each category are explained in this chapter.

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



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

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

Individuals—In General

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

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

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

Table 1–1. 2001 Filing Requirements for Most Taxpayers

To use this table, first find your marital status at the end of 2001. Then, read across the line that shows your filing status and age at the end of 2001. You must file a return if your gross income was at least the amount shown in the last column.

Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States (even if you may exclude part or all of it).

When using this table, do not include social security benefits as gross income unless you are married filing a separate return and lived with your spouse at any time in 2001. (If you must include the benefits, see chapter 12 for the amount to include.)

Also, see *Table 1–2* and *Table 1–3* for other situations when you must file a return.

Marital Status	Filing Status	Age*	Gross Income	
Single (including divorced and legally separated)	Single	under 65 65 or older	\$7,450 \$8,550	
	Head of household	under 65 65 or older	\$9,550 \$10,650	
Married, with a child, living apart from your spouse during the last 6 months of 2001	Head of household	under 65 65 or older	\$9,550 \$10,650	
		Married, joint return	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)	\$13,400 \$14,300 \$15,200
Married, living with your spouse at the end of 2001 (or on the date your spouse died)	Married, separate return	any age	\$2,900	
		Married, joint or separate return	any age	\$2,900
Married, not living with your spouse at end of 2001 (or on the date your spouse died)	Single	under 65 65 or older	\$7,450 \$8,550	
		Head of household	under 65 65 or older	\$9,550 \$10,650
			Qualifying widow(er) with dependent child	under 65 65 or older	$10,500 $11,400

*If you turned age 65 on January 1, 2002, you are considered to be age 65 at the end of 2001.

Gross income. This includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. It also includes income from sources outside the United States (even if you may exclude all or part of it). Common types of income are discussed in the chapters in *Part Two* of this publication.

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

Self-employed individuals. If you are self-employed, your gross income includes the

amount on line 7 of Schedule C (Form 1040), *Profit or Loss From Business*, or line 1 of Schedule C–EZ (Form 1040), *Net Profit From Business*. See *Self-Employed Persons*, later, for more information about your filing requirements.



If you do not report all of your self-employment income, you could cause your social security benefits to be lower when you retire.

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

Age. If you are 65 or older at the end of the year, you generally can have a higher amount of

gross income than other taxpayers before you must file. See *Table 1–1*. You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 2002, you are considered 65 for 2001.

Surviving Spouses, Executors, Administrators, and Legal Representatives

You must file a final return for a decedent (a person who died) if both of the following are true.

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

For more information on rules for filing a decedent's final return, see chapter 4.

U.S. Citizens Living Outside the United States

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements. For information on special tax rules that may apply to you, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. It is available at most U.S. embassies and consulates. Also see *How To Get Tax Help* in the back of this publication.

Residents of Puerto Rico

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

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

Individuals With Income From U.S. Possessions

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

Table 1–2. 2001 Filing Requirements for Dependents

See chapter 3 to find out if someone can claim you as a dependent.

If your parents (or someone else) can claim you as a dependent, and any of the situations below apply to you, you must file a return. (See *Table 1–3* for other situations when you must file.)

In this table, **earned income** includes salaries, wages, tips, and professional fees. It also includes taxable scholarship and fellowship grants. (See *Scholarship and Fellowship Grants* in chapter 13.) **Unearned income** includes investment-type income such as interest, dividends, and capital gains. It also includes unemployment compensation, taxable social security benefits, pensions, annuities, and distributions of unearned income from a trust. **Gross income** is the total of your earned and unearned income.

Caution: If your gross income was \$2,900 or more, you generally cannot be claimed as a dependent unless you were under age 19 or a full-time student under age 24. For details, see *Gross Income Test* in chapter 3.

Single dependents— Were you either age 65 or older or blind?

- No.** You must file a return if any of the following apply.
- Your unearned income was more than \$750.
 - Your earned income was more than \$4,550.
 - Your gross income was more than the larger of:
 - 1) \$750, or
 - 2) Your earned income (up to \$4,300) plus \$250.
- Yes.** You must file a return if any of the following apply.
- Your earned income was more than \$5,650 (\$6,750 if 65 or older **and** blind).
 - Your unearned income was more than \$1,850 (\$2,950 if 65 or older **and** blind).
 - Your gross income was more than:
 - 1) The larger of \$750, or your earned income (up to \$4,300) plus \$250, plus
 - 2) \$1,100 (\$2,200 if 65 or older **and** blind).

Married dependents—Were you either age 65 or older or blind?

- No.** You must file a return if any of the following apply.
- Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.
 - Your earned income was more than \$3,800.
 - Your unearned income was more than \$750.
 - Your gross income was more than the larger of:
 - 1) \$750, or
 - 2) Your earned income (up to \$3,550) plus \$250.
- Yes.** You must file a return if any of the following apply.
- Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.
 - Your earned income was more than \$4,700 (\$5,600 if 65 or older **and** blind).
 - Your unearned income was more than \$1,650 (\$2,550 if 65 or older **and** blind).
 - Your gross income was more than:
 - 1) The larger of \$750 or your earned income (up to \$3,550) plus \$250, plus
 - 2) \$900 (\$1,800 if 65 or older **and** blind).

Child Under Age 14

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

Self-Employed Persons

You are self-employed if you:

- Carry on a trade or business as a sole proprietor,
- Are an independent contractor,
- Are a member of a partnership, or
- Are in business for yourself in any other way.

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

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

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

Use Schedule SE (Form 1040) to figure your self-employment tax. Self-employment tax is comparable to the social security and Medicare tax withheld from an employee's wages. For more information about this tax, get Publication 533, *Self-Employment Tax*.

Foreign governments or international organizations. If you are a U.S. citizen who works in the United States for an international organization, a foreign government, or a wholly owned instrumentality of a foreign government, and your employer does not deduct social security and Medicare taxes from your income, you must include your earnings from services performed in the United States when figuring your net earnings from self-employment.

Ministers. You must include income from services you performed as a minister when figuring your net earnings from self-employment, unless you have an exemption from self-employment tax. This also applies to Christian Science practitioners and members of a religious order who have not taken a vow of poverty. For more information, get Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Aliens

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

Dependents

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

Responsibility of parent. Generally, a child is responsible for filing his or her own tax return and for paying any tax on the return. But if a dependent child who must file an income tax return cannot file it for any reason, such as age,

a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the parent or guardian must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

Child's earnings. Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them. If the child does not pay the tax due on this income, the parent is liable for the tax.

Table 1–3. Other Situations When You Must File a 2001 Return

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

1. You owe any special taxes, such as:
 - Social security or Medicare tax on tips you did not report to your employer. (See chapter 7.)
 - Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See chapter 7.)
 - Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance.
 - Alternative minimum tax. (See chapter 31.)
 - Tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See chapter 18.)
 - Tax on an Archer MSA. (See Publication 969, *Medical Savings Accounts (MSAs)*.)
 - Recapture of an investment credit or a low-income housing credit. (See the instructions for Form 4255, *Recapture of Investment Credit*, or Form 8611, *Recapture of Low-Income Housing Credit*.)
 - Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See chapter 16.)
 - Recapture of the qualified electric vehicle credit. (See chapter 38.)
 - Recapture of an education credit. (See chapter 36.)
 - Recapture of the Indian employment credit.
2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W–2. (See chapter 37.)
3. You had net earnings from self-employment of at least \$400. (See *Self-Employed Persons* in this chapter.)
4. You had wages of \$108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes. (See Publication 533.)

- 2) You (and your spouse if married filing a joint return) were under age 65 on January 1, 2002, and not blind at the end of 2001.
- 3) You do not claim any dependents.
- 4) Your taxable income is less than \$50,000.
- 5) Your income is **only** from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, qualified state tuition program earnings, and taxable interest of \$400 or less.
- 6) You did not receive any advance earned income credit (EIC) payments.
- 7) You do not claim any adjustments to income, such as a deduction for IRA contributions or student loan interest.
- 8) You do not claim any credits other than the earned income credit or the rate reduction credit.

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

Figuring tax. On Form 1040EZ, you can only use the tax table to figure your tax. You cannot use Form 1040EZ to report any other tax.

Form 1040A

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

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

- 1) Your income is **only** from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, ordinary dividends (including Alaska Permanent Fund dividends), capital gain distributions, qualified state tuition program earnings, and unemployment compensation.
- 2) Your taxable income is less than \$50,000.
- 3) Your adjustments to income are for only the following items.
 - a) The deduction for contributions to an IRA.
 - b) The student loan interest deduction.
- 4) You do not itemize your deductions.
- 5) Your taxes are from only the following items.
 - a) Tax Table.
 - b) Alternative minimum tax. (See chapter 31.)
 - c) Advance earned income credit (EIC) payments, if you received any. (See chapter 37.)
 - d) Recapture of an education credit.
 - e) Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500*.
 - f) Capital Gain Tax Worksheet.

The rules used to determine your alien status are discussed in Publication 519, *U.S. Tax Guide for Aliens*.

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

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

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

Who Should File

Even if you do not have to file, you should file a federal income tax return to get money back if any of the following conditions apply.

- 1) You had income tax withheld from your pay.

- 2) You qualify for the earned income credit. See chapter 37 for more information.
- 3) You qualify for the additional child tax credit. See chapter 35 for more information.

Which Form Should I Use?

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

Form 1040EZ

Form 1040EZ is the simplest form to use.

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

- 1) Your filing status is single or married filing jointly. If you were a nonresident alien at any time in 2001, your filing status must be married filing jointly.

- 6) You claim only the following credits.
 - a) The credit for child and dependent care expenses. (See chapter 33.)
 - b) The credit for the elderly or the disabled. (See chapter 34.)
 - c) The child tax credit. (See chapter 35.)
 - d) The additional child tax credit. (See chapter 35.)
 - e) The education credits. (See chapter 36.)
 - f) The earned income credit. (See chapter 37.)
 - g) The adoption credit. (See chapter 38.)
 - h) The rate reduction credit. (See chapter 38.)

You must meet all of the above requirements to use Form 1040A. If you do not, you must use Form 1040.

If you meet the above requirements, you can use Form 1040A even if you received employer-provided adoption benefits or dependent care benefits.



If you receive a capital gain distribution that includes 28% rate gain, qualified 5-year gain, unrecaptured section 1250 gain, or section 1202 gain, you cannot use Form 1040A. You must use Form 1040.

Form 1040

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

You may have received Form 1040A or Form 1040EZ in the mail because of the return you filed last year. If your situation has changed this

year, it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions and some adjustments to income and credits you cannot take on Form 1040A or Form 1040EZ.

You must use Form 1040 if any of the following apply.

- 1) Your taxable income is \$50,000 or more.
- 2) You itemize your deductions.
- 3) You received or paid interest on securities transferred between interest payment dates.
- 4) You received nontaxable distributions required to be reported as capital gains.
- 5) You received capital gain distributions that included 28% rate gain, qualified 5-year gain, unrecaptured section 1250 gain, or section 1202 gain.
- 6) You have to complete Part III of Schedule B (Form 1040) because:
 - a) You received a distribution from a foreign trust, or
 - b) You had a bank, securities, or other financial account in a foreign country at any time during the year.

Note. If the combined value of the foreign account(s) was \$10,000 or less during all of 2001, or if the account(s) was with a U.S. military banking facility operated by a U.S. financial institution, you may be able to use Form 1040A or Form 1040EZ.

- 7) You had income that cannot be reported on Form 1040EZ or Form 1040A. This includes gain from the sale of property, barter income, alimony income, taxable

refunds of state and local income taxes, self-employment income (including farm income), and income received as a partner in a partnership, a shareholder in an S corporation, or a beneficiary of an estate or trust.

- 8) You are reporting original issue discount in an amount more or less than the amount shown on Form 1099–OID.
- 9) You sold or exchanged capital assets or business property.
- 10) You claim adjustments to gross income for other than contributions to an IRA or the student loan interest deduction. If these are your only adjustments to gross income, you may be able to file Form 1040A.
- 11) Your Form W–2 shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance in box 12. (See chapter 7.)
- 12) You received \$20 or more in tips in any one month and did not report all of them to your employer. (See chapter 7.)
- 13) You must pay tax on self-employment income. (See Schedule SE (Form 1040), *Self-Employment Tax*.)
- 14) You must pay household employment taxes. (See Schedule H (Form 1040).)
- 15) You have to recapture an investment credit, a low-income housing credit, a qualified electric vehicle credit, or an Indian employment credit.
- 16) You have to recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See chapter 16.)
- 17) You have to pay tax on an excess golden parachute payment.
- 18) You claim any credits other than the credits listed earlier under *Form 1040A*.
- 19) You have to file other forms with your return to report certain exclusions, taxes, or transactions. This includes the following forms.
 - a) Form 2555, *Foreign Earned Income*.
 - b) Form 2555–EZ, *Foreign Earned Income Exclusion*.
 - c) Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*.
 - d) Form 4970, *Tax on Accumulation Distribution of Trusts*.
 - e) Form 4972, *Tax on Lump-Sum Distributions*. (See chapter 11.)
 - f) Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

Note. Do not file Form 1040 only because you have to file Form 5329. File Form 5329 by itself. (See chapters 11 and 18.)
 - g) Form 8271, *Investor Reporting of Tax Shelter Registration Number*.

Table 1–4. **Benefits of IRS e-file**

Accuracy	<ul style="list-style-type: none"> • Your chance of getting an error notice from the IRS is significantly reduced.
Security	<ul style="list-style-type: none"> • Your privacy and security are assured.
Electronic Signatures	<ul style="list-style-type: none"> • Create your own Personal Identification Number (PIN) and file a completely paperless return through your tax preparation software or tax professional. There is nothing to mail!
Proof of Acceptance	<ul style="list-style-type: none"> • You receive an electronic acknowledgement within 48 hours confirming that the IRS has accepted your return for processing.
Fast Refunds	<ul style="list-style-type: none"> • You get your refund in half the time, even faster with Direct Deposit—in as few as 10 days.
FREE/Low Cost Filing	<ul style="list-style-type: none"> • Check out the IRS Web Site at www.irs.gov for IRS e-file partners offering free or low cost filing options to taxpayers who qualify.
Electronic Payment Options	<ul style="list-style-type: none"> • Convenient, safe and secure electronic payment options are available. e-file and pay in a single step. Schedule an electronic funds withdrawal from your bank account (up to and including April 15, 2002) or pay by credit card.
Federal/State Filing	<ul style="list-style-type: none"> • Prepare and file your federal and state tax returns together and double the benefits you get from e-file.

- h) Form 8814, *Parents' Election To Report Child's Interest and Dividends*.
- i) Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*.

Deposit, you can receive your refund in as few as 10 days.

Offset against debts. As with a paper return, you may not get all of your refund if you owe certain past-due amounts, such as federal tax, state tax, a student loan, or child support. See *Offset Against Debts* under *Refunds*, later.

Refund inquiries. If you do not receive your refund within 4 weeks after your return was accepted by IRS, you can call TeleTax Refund Information. See *What is TeleTax* in your tax forms package for information on how to use this service.

If TeleTax has no information about your return, contact your tax professional or electronic return transmitter for the date IRS accepted your return. If your return was accepted more than 6 weeks ago, contact the IRS. Explain that you filed your return electronically and that TeleTax has no information on it. Also, provide the first social security number shown on your return and the date the IRS accepted your return.

Balance due. If you owe tax, you must pay it by April 15, 2002, to avoid late-payment penalties and interest. You can make your payment electronically by scheduling an electronic funds withdrawal from your checking or savings account or by credit card.

See *How To Pay*, later, for information on how to pay the balance due.

VITA or TCE. The IRS Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs may be able to help you file your return electronically. For information on these programs, call the IRS.

Personal identification number (PIN). If you *e-file* your return, you can sign your return electronically by creating your own Personal Identification Number (PIN). This PIN serves as your signature and can only be used if you file electronically using tax preparation software or through a tax professional. (It can even be used by first-time filers who were 16 or older on December 31, 2001.) To create a PIN, you must know your adjusted gross income and total tax from your 2000 tax return (prior to any adjustment). These amounts, along with your name, social security number, and date of birth, will be used to verify your identity.

If you are not eligible or choose not to use a PIN to sign your return electronically, you must complete Form 8453 or Form 8453-OL, whichever applies.

Using a Tax Professional

Many tax professionals file returns electronically for their clients. You can prepare your own return and have a professional electronically transmit it, or you can have your return prepared and transmitted by a tax professional. In either situation, you can sign your return using your PIN.

Depending on the tax professional, and the specific services requested, a fee may be charged. Look for the "Authorized IRS *e-file* Provider" sign or search for a provider near you on the IRS web site at www.irs.gov (click on Electronic Services).

Form 8453. Your tax professional may ask you to sign Form 8453, *U.S. Individual Income Tax Declaration for an IRS e-file Return*. Both spouses must sign if a joint return is being filed. Your tax professional will file the Form 8453 with the IRS. Your tax professional is required to give you the preparer-signed copy of your return, including a copy of the completed Form 8453. This material is for your records. Do not mail this copy to the IRS.

Using a Personal Computer

A computer with a modem and/or Internet access is all you need to file your tax return using IRS *e-file*. You can buy tax preparation software at various electronic stores or computer and office supply stores. You can download software from the Internet or prepare and file your tax return completely on-line by using a tax preparation software package on the Internet (nothing to buy or install). Best of all, you can *e-file* your tax return from the comfort of your home any time of day or night. Sign your return electronically using your PIN to complete the process. To find a list of software companies that participate in the IRS *e-file* program, visit our web site at www.irs.gov.

Form 8453-OL. After the IRS has accepted your return, you may have to send the IRS Form 8453-OL, *U.S. Individual Income Tax Declaration for an IRS efile On-line Return*. Form 8453-OL is available through your electronic return transmitter.

Using a Telephone (TeleFile)

If you receive a TeleFile tax package, you may be able to file your Form 1040EZ information over the phone. If you are eligible to use TeleFile, IRS will send you the TeleFile tax package automatically. You can use TeleFile only if you receive the package. You cannot order it.

To file using TeleFile, follow the instructions in the TeleFile tax package. The call takes about 10 minutes and is free. You must use a touch-tone phone.

When Do I Have To File?

April 15, 2002, is the due date for filing your 2001 income tax return if you use the calendar year. For a quick view of due dates for filing a

Does My Return Have To Be On Paper?

IRS *e-file* (electronic filing) is the preferred method of filing. It's so easy, 40 million people use it. You may be able to file a paperless return, or a return with less paper. This section explains IRS *e-file*:

- Using a tax professional,
- Using your personal computer, or
- Using a telephone (TeleFile).

IRS e-file



Table 1-4 lists the benefits of IRS *e-file*. IRS *e-file* uses automation to replace most of the manual steps needed to process paper returns. As a result, the processing of *e-file* returns is faster and more accurate than the processing of paper returns. However, errors on the return or problems with its transmission can delay processing.

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

Using *e-file* does not affect your chances of an IRS examination of your return.

State returns. In most states, you can file an electronic state return simultaneously with your federal return. For more information, check with your local IRS office, state tax agency, tax professional, or the IRS web site at www.irs.gov.

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

With *e-file*, your refund will be issued in half the time as when filing on paper. Most refunds are issued within 3 weeks. If you choose Direct

Table 1-5. When To File Your 2001 Return

(For U.S. citizens and residents who file returns on a calendar year)

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
No extension requested	April 15, 2002	June 17, 2002
Automatic extension Form 4868 filed, or credit card payment made	August 15, 2002	August 15, 2002
2nd extension Form 2688 filed after getting automatic extension	October 15, 2002	October 15, 2002

return with or without an extension of time to file (discussed later), see *Table 1–5*.

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

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

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

Private delivery services. If you use a private delivery service designated by the IRS to send your return, the postmark date generally is the date the private delivery service records in its database or marks on the mailing label. The private delivery service can tell you how to get written proof of this date.

The following are designated private delivery services.

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service.
- DHL Worldwide Express (DHL): DHL “Same Day” Service and DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.



Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.

Electronically filed returns. If you use IRS *e-file*, your return is considered filed on time if the authorized electronic return transmitter postmarks the transmission by the due date. An authorized electronic return transmitter is a participant in the IRS *e-file* program that transmits electronic tax return information directly to the IRS.

The electronic postmark is a record of when the authorized electronic return transmitter received the transmission of your electronically filed return on its host system. The date and time in your time zone controls whether your electronically filed return is timely.

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

If you were due a refund but you did not file a return, you generally must file within 3 years from the date the return was originally due to get that refund.

Nonresident alien. If you are a nonresident alien and earn wages subject to U.S. income tax withholding, your 2001 U.S. income tax return (Form 1040NR or Form 1040NR–EZ) is due by:

- April 15, 2002, if you use a calendar year, or
- The 15th day of the 4th month after the end of your fiscal year if you use a fiscal year.

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

- June 17, 2002, if you use a calendar year, or
- The 15th day of the 6th month after the end of your fiscal year, if you use a fiscal year.

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

Filing for a decedent. If you must file a final income tax return for a taxpayer who died during the year (a decedent), the return is due by the 15th day of the 4th month after the end of the decedent’s normal tax year. In most cases, for a 2001 return, this will be April 15, 2002. See *Final Return for the Decedent* in chapter 4.

Extensions of Time To File

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

- Outside the United States, or
- Serving in a combat zone.

These rules are discussed separately.

Automatic extension. If you cannot file your 2001 return by the due date, you may be able to get an automatic 4-month extension of time to file.

Example. If your return is due on April 15, 2002, you will have until August 15, 2002, to file.

How to get the automatic extension. You can get the automatic extension by:

- 1) Using IRS *e-file* (electronic filing), or
- 2) Filing a paper form.

E-file options. There are three options for using *e-file* to get an extension of time to file. If you *e-file*, you will get a confirmation number when you complete the transaction. Keep the number with your records.

Complete **Form 4868**, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, to use as a worksheet. If you think you may owe tax when you file your return, use *Part III* of the form to estimate your balance due. Do not send Form 4868 to the IRS.

E-file by phone. You can file Form 4868 by phone any time from March 1 through April 15, 2002. You will need to provide certain information from your tax return for 2000. If you wish to make a payment by electronic funds withdrawal,

see *Electronic payment by electronic filer*, under *How To Pay*, later in this chapter.

E-file using your personal computer or a tax professional. You can use a tax software package with your personal computer or a tax professional to file Form 4868 electronically. You will need to provide certain information from your tax return for 2000. If you wish to make a payment by electronic funds withdrawal, see *Electronic payment by electronic filer*, under *How To Pay*, later in this chapter.

E-file and pay by credit card. You can get an extension by paying part or all of your estimate of tax due by using a credit card. You can do this by phone or over the Internet. You do not file Form 4868. See *Payment by credit card*, under *How To Pay*, later in this chapter.

Filing a paper Form 4868. You can get an extension of time to file by filing a paper Form 4868. Mail it to the address shown in the form instructions.

If you want to make a payment with the form, make your check or money order payable to the “United States Treasury.” Write your social security number, daytime phone number, and “2001 Form 4868” on your check or money order.

When to file. You must request the automatic extension by the due date for your return. You can file your return any time before the 4-month extension period ends.

When you file your return. Enter any payment you made related to the extension of time to file on line 64, Form 1040. If you file Form 1040EZ or Form 1040A, include that payment in your total payments on line 10 of Form 1040EZ or line 41 of Form 1040A. Also print “Form 4868” and the amount paid in the space to the left of line 10 or line 41.

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

You can apply for an extension beyond the 4-month extension either by writing a letter to the IRS or by filing **Form 2688**, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return*. You should ask for the extension early so that, if it is not approved, you still will be able to file on time. Except in cases of undue hardship, a request for additional time will not be approved unless you have first used the automatic 4-month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

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

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

You must sign the request for this extension, or it may be signed by your attorney, CPA, enrolled

agent, or a person with a power of attorney. If you are unable to sign the request because of illness or for another good reason, a person with a close personal or business relationship to you can sign for you, stating why you could not sign the request.

E-file. Refer to your tax software package or tax preparer for ways to file Form 2688 electronically. You will need to provide certain information from your tax return for 2000. Do not mail the Form 2688 if you file electronically.

Extension approved. If your application for this extension is approved, you will be notified by the IRS.

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

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

No further extensions. An extension of more than 6 months will not be approved if you are in the United States.

Individuals Outside the United States

You are allowed an automatic 2-month extension (until June 15, 2001, if you use the calendar year) to file your 2001 return and pay any federal income tax due if:

- 1) You are a U.S. citizen or resident, and
- 2) On the due date of your return:
 - a) You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, **or**
 - b) You are in military or naval service on duty outside the United States and Puerto Rico.

However, if you pay the tax due after the due date (generally, April 15), interest will be charged from that date until the date the tax is paid.

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

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

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

How to get the extension. To use this special automatic extension, you must attach a statement to your return explaining what situation

qualified you for the extension. (See the situations listed under (2), earlier.)

Extensions beyond 2 months. If you cannot file your return within the automatic 2-month extension period, you may be able to get an additional 2-month extension, for a total of 4 months. Generally, you must file a paper Form 4868 by the end of the automatic extension period (usually June 15) to get this additional 2-month extension.

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

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

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

Individuals Serving in Combat Zone

The deadline for filing your tax return, paying any tax you may owe, and filing a claim for refund is automatically extended if you serve in a combat zone. This applies to members of the Armed Forces, as well as Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces.

Combat zone. For purposes of the automatic extension, the term "combat zone" includes the following areas.

- 1) The Persian Gulf Area, effective August 2, 1990.
- 2) The qualified hazardous duty area of Bosnia and Herzegovina, Croatia, and Macedonia, effective November 21, 1995.
- 3) The qualified hazardous duty area of the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel, effective March 24, 1999.

See Publication 3, *Armed Forces' Tax Guide*, for information about other tax benefits available to military personnel serving in a combat zone.

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

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

In addition to the 180 days, your deadline is also extended by the number of days you had left to take action with the IRS when you entered

the combat zone. For example, you have 3½ months (January 1 – April 15) to file your tax return. Any days left in this period when you entered the combat zone (or the entire 3½ months if you entered it before the beginning of the year) are added to the 180 days. See *Extension of Deadline* in Publication 3 for more information.

How Do I Prepare My Return?

This section explains how to get ready to fill in your tax return and when to report your income and expenses. It also explains how to complete certain sections of the form. You may find *Table 1–6* helpful when you prepare your return.

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

If you do not receive a tax return package in the mail, or if you need other forms, you can order them. See *How To Get Tax Help* in the back of this publication.

Table 1–6. Six Steps for Preparing Your Return

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|--|
| <ol style="list-style-type: none">1—Get your records together for income and expenses.2—Get the forms, schedules, and publications you need.3—Fill in your return.4—Check your return to make sure it is correct.5—Sign and date your return.6—Attach all required forms and schedules. |
|--|

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

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

If you do not receive Form W–2 by January 31, 2002, contact your employer. If you still do not get the form by February 15, the IRS can help you by requesting the form from your employer. For more information, see *Form W–2 under Credit for Withholding and Estimated Tax* in chapter 5.

Form 1099. If you received certain types of income, you may receive a Form 1099. For example, if you received taxable interest of \$10 or more, the payer generally must give you a Form 1099–INT. If you have not received it by January 31, 2002, contact the payer. If you still

do not get the form by February 15, call the IRS for help.

When Do I Report My Income and Expenses?

You must figure your taxable income on the basis of a tax year. A "tax year" is an annual accounting period used for keeping records and reporting income and expenses. You must account for your income and expenses in a way that clearly shows your taxable income. The way you do this is called an accounting method. This section explains which accounting periods and methods you can use.

Accounting Periods

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

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

More information. For more information on accounting periods, including how to change your accounting period, see Publication 538, *Accounting Periods and Methods*.

Accounting Methods

Your accounting method is the way you account for your income and expenses. Most taxpayers use either the cash method or an accrual method. You choose a method when you file your first income tax return. If you want to change your accounting method after that, you generally must get IRS approval.

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

Constructive receipt. You constructively receive income when it is credited to your account or set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, interest credited to your bank account on December 31, 2001, is taxable income to you in 2001 if you could have withdrawn it in 2001 (even if the amount is not entered in your passbook or withdrawn until 2002).

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

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

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

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

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

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

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

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

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

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

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

Additional information. For more information on accounting methods, including how to change your accounting method, get Publication 538.

Social Security Number

You must enter your social security number (SSN) in the space provided on your return. Be sure the SSN on your return is the same as the SSN on your social security card. If you are married, enter the SSNs for both you and your spouse, whether you file jointly or separately.

If you are filing a joint return, write the SSNs in the same order as the names. Please use this same order in submitting other forms and documents to the IRS.

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

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

Exception. If your child was born and died in 2001 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter "DIED" in column 2 of line 6c.

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

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

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

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

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

Adoption taxpayer identification number (ATIN). If you are in the process of adopting a child who is a U.S. citizen or resident and cannot get an SSN for the child until the adoption is final, you can apply for an ATIN to use instead of an SSN.

File **Form W-7A** with the IRS to get an ATIN if all of the following are true.

- You have a child living with you who was placed in your home for legal adoption by an authorized placement agency.
- You cannot get the child's existing SSN even though you have made a reasonable attempt to get it from the birth parents, the placement agency, and other persons.
- You cannot get an SSN for the child from the SSA because, for example, the adoption is not final.
- You cannot get an Individual Taxpayer Identification Number (ITIN) (discussed later) for the child.
- You are eligible to claim the child as a dependent on your tax return.

After the adoption is final, you must apply for an SSN for the child. You cannot continue using the ATIN.

See **Form W-7A** for more information.

Nonresident alien spouse. If your spouse is a nonresident alien and you file a joint or separate return, your spouse must have either an SSN or an ITIN. If your spouse is not eligible for an SSN, see the next discussion.

Individual taxpayer identification number (ITIN). The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file **Form W-7** with the IRS. It usually takes about 4 to 6 weeks to get an ITIN. Enter this number on your tax return wherever your SSN is requested.

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



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

Penalty for not providing social security number. If you do not include your SSN or the SSN of your spouse or dependent as required, you may have to pay a penalty. See the discussion on *Penalties*, later, for more information.

SSN on correspondence. If you write to the IRS about your tax account, be sure to include your SSN (and the name and SSN of your spouse, if you filed a joint return) in your correspondence. Because your SSN is used to identify your account, this helps the IRS respond to your correspondence promptly.

Presidential Election Campaign Fund

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

Computations

The following information on entering numbers on your tax return may be useful in making the return easier to complete.

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

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

Example. You receive two **W-2** forms: one showing wages of \$5,000.55 and one showing wages of \$18,500.73. On **Form 1040**, line 7, you

would enter \$23,501 (\$5,000.55 + \$18,500.73 = \$23,501.28), not \$23,502 (\$5,001 + \$18,501).

Equal amounts. If you are asked to enter the smaller or larger of two equal amounts, enter that amount.

Example. Line 1 is \$500. Line 3 is \$500. Line 5 asks you to enter the smaller of line 1 or 3. Enter \$500 on line 5.

Negative amounts. If you need to enter a negative amount, put the amount in parentheses rather than using a minus sign. To combine positive and negative amounts, add all the positive amounts together and then subtract the negative amounts.

Attachments

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



*IRS e-file is paperless. There's nothing to sign, attach, or mail, not even your **Forms W-2**.*

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

If you received a **Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**, showing federal income tax withheld, attach a copy of that form in the place indicated on the front page of your return.

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

Form 1040A. Attach the additional schedules and forms that you had to complete behind the **Form 1040A** in order by number. If you are filing **Schedule EIC**, put it last. Do not attach items unless required to do so.

Form 1040. Attach any forms and schedules behind **Form 1040** in order of the "Attachment Sequence Number" shown in the upper right corner of the form or schedule. Put forms without an attachment sequence number next. Then arrange all other statements or attachments in the same order as the forms and schedules they relate to and attach them last. Do not attach items unless required to do so.

Third Party Designee

You can authorize the IRS to discuss your return with a friend, family member, or any other person you choose. If you check the "Yes" box in the third party designee area of your 2001 tax return and provide the information required, you are authorizing:

- 1) The IRS to call the designee to answer any questions that arise during the processing of your return, and

2) The designee to:

- a) Give information that is missing from your return to the IRS,
- b) Call the IRS for information about the processing of your return or the status of your refund or payments, and
- c) Respond to certain IRS notices that you have shown the designee. These notices about math errors, offsets (see *Refunds*, later), and return preparation will be sent to you, not the designee.

The authorization cannot be revoked. However, it will automatically end no later than the due date (without any extensions) for filing your 2002 tax return. This is April 15, 2003, for most people.

See your form instructions for more information.



If you want to allow the paid preparer who signed your return to discuss it with the IRS, just enter "Preparer" in the space for the designee's name.

Signatures

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



If you file a joint return, both spouses are generally liable for the tax, and the entire tax liability may be assessed against either spouse. See chapter 2.

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

Enter your occupation in the space provided in the signature section. If you file a joint return, enter both your occupation and your spouse's occupation. Entering your daytime telephone number may help speed the processing of your return.

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

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

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

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

If the taxpayer is mentally competent but physically unable to sign the return or POA, a valid "signature" is defined under state law. It can be anything that clearly indicates the

taxpayer's intent to sign. For example, the taxpayer's "X" with the signatures of two witnesses might be considered a valid signature under a state's law.

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

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

Paid Preparer

Generally, anyone you pay to prepare, assist in preparing, or review your tax return must sign it and fill in the other blanks in the paid preparer's area of your return. Signature stamps and labels are not acceptable.

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

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

If you prepare your own return, leave this area blank. If another person prepares your return and does not charge you, that person should not sign your return.

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

Refunds

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (2002) estimated tax. You cannot have your overpayment applied to your 2002 estimated tax if you file Form 1040EZ.



If you choose to have a 2001 overpayment applied to your 2002 estimated tax, you cannot change your mind and have any of it refunded to you after the due date of your 2001 return.

Follow the form instructions to complete the entries to claim your refund and/or to apply your overpayment to your 2002 estimated tax.



If your refund for 2001 is large, you may want to decrease the amount of income tax withheld from your pay in 2002. See chapter 5 for more information.

Direct Deposit. Instead of getting a paper check, you may be able to have your refund deposited directly into your account at a bank or other financial institution. Follow the form instructions to request Direct Deposit.

If the Direct Deposit cannot be done, the IRS will send a check instead.

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

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

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

Refund more or less than expected. If you receive a check for a refund you are not entitled to, or for an overpayment that should have been credited to estimated tax, do not cash the check. Call the IRS.

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

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

If you did not receive a notice and you have any questions about the amount of your refund, you should wait 2 weeks. If you still have not received a notice, call the IRS.

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

Joint return and injured spouse. When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an **injured spouse**. An injured spouse can get a refund for his or her share of the overpayment that would otherwise be used to pay the past-due amount.

To be considered an injured spouse, you must:

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

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

Amount You Owe

When you complete your return, you will determine if you have paid the full amount of tax that you owe. If you owe additional tax, you should pay it with your return.

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



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



If the amount you owe for 2001 is large, you may want to increase the amount of income tax withheld from your pay or make estimated tax payments for 2002. See chapter 5 for more information.

How To Pay

If you have an amount due on your tax return, you can pay by check, money order, or credit card. If you filed electronically, you also may be able to make your payment by electronic funds withdrawal.



You do not have to pay if the amount you owe is less than \$1.

Payment by check or money order. If you pay by check or money order, make it out to the "United States Treasury." Please show your correct name, address, social security number, daytime telephone number, and the tax year and form number on the front of your check or money order.

For example, if you file Form 1040 for 2001 and you owe additional tax, show your name, address, social security number, daytime telephone number, and "2001 Form 1040" on the front of your check or money order. If you file an amended return (Form 1040X) for 2000 and you owe tax, show your name, address, social security number, daytime telephone number, and "2000 Form 1040X" on the front of your check or money order.

Enclose your payment with your return, but do not attach it to the form. If you filed Form 1040, please complete **Form 1040-V, Payment Voucher**, and enclose it with your payment and return. Form 1040-V will help us process your payment more accurately and efficiently. Follow the instructions that come with the form.

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

Payment not honored. If your check or money order is not honored by your bank (or other financial institution) and the IRS does not receive the funds, you still owe the tax. In addition, you may be subject to a dishonored check penalty.

Payment by credit card. You can use your American Express®, Discover®, or MasterCard® credit card.

To pay by credit card, call a service provider and follow the recorded instructions. You can also pay by credit card over the Internet using a service provider's web site.

The service providers charge a convenience fee based on the amount you are paying. Fees may vary between the providers. You will be told what the fee is during the transaction and will have the option to continue or end the transaction. You may also obtain the convenience fee by calling the service provider's automated customer service telephone number or visiting their respective web site.



Do not add the convenience fee to your tax payment.

If you pay by credit card, write the confirmation number you were given at the end of the transaction and the tax payment amount in the upper left corner of page 1 of your tax return.

Service Providers

PhoneCharge Inc.

To make a payment,
call 1-888-ALL-TAXX
or 1-888-255-8299
For Customer Service . . . 1-877-851-9964
Web
Address . . www.1888ALLTAXX.com

Official Payments Corporation

To make a payment,
call 1-800-2PAY-TAX
or 1-800-272-9829
For Customer Service . . . 1-877-754-4413
Web
Address . . www.officialpayments.com

Electronic payment by electronic filer. If you file your tax return electronically, you can make your payment electronically.

You can file and pay in a single step by authorizing an electronic funds withdrawal from your checking or savings account. This option is available through tax software packages, tax professionals, and TeleFile. If you select this payment option, you will need to have your account number, your financial institution's routing transit number, and account type (checking or savings). You can schedule the payment for any future date up to and including the return due date (April 15, 2002).



Be sure to check with your financial institution to make sure that an electronic funds withdrawal is allowed and to get the correct routing and account numbers.

To pay by electronic funds withdrawal from your checking or savings account when you file by TeleFile, fill in lines E, F, G, and H on the TeleFile Tax Record.

You can also file and pay in a single step by authorizing a credit card payment. This option is available through some tax software packages and tax professionals.

Estimated tax payments. Do not include any 2002 estimated tax payment in the payment for your 2001 income tax return. See chapter 5 for information on how to pay estimated tax.

Interest

Interest is charged on tax you do not pay by the due date of your return. Interest is charged even if you get an extension of time for filing.



If the IRS figures your tax for you, interest cannot start earlier than the 31st day after the IRS sends you a bill. For information, see Tax Figured by IRS in chapter 31.

Interest on penalties. Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return (including extensions) to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 21 calendar days from the date of the notice (or within 10 business days if the notice is for \$100,000 or more).

Interest due to IRS error or delay. All or part of any interest you were charged can be forgiven if the interest is due to an unreasonable error or delay by an officer or employee of the IRS in performing a ministerial or managerial act.

A ministerial act is a procedural or mechanical act that occurs during the processing of your case. A managerial act includes personnel transfers and extended personnel training. A decision concerning the proper application of federal tax law is not a ministerial or managerial act.

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

Interest and certain penalties may also be suspended for a limited period if you filed your return by the due date (including extensions) and the IRS does not provide you with a notice specifically stating your liability and the basis for it before the close of the 18-month period beginning on the later of:

- The date the return is filed, or
- The due date of the return without regard to extensions.

For more information, get Publication 556.

Installment Agreement

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by April 15, 2002, even if your request to pay in installments is granted. If your request is granted, you must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465, Installment Agreement Request**. You should receive a response to your request within 30 days. But if you file your return after March 31, it may take longer for a reply.

Guaranteed availability of installment agreement. The IRS must agree to accept the payment of your tax liability in installments if, as of the date you offer to enter into the agreement:

- 1) Your total taxes (not counting interest, penalties, additions to the tax, or additional amounts) do not exceed \$10,000,
- 2) In the last 5 years, you (and your spouse if the liability relates to a joint return) have not:
 - a) Failed to file any required income tax return,
 - b) Failed to pay any tax shown on any such return, or
 - c) Entered into an installment agreement for the payment of any income tax,
- 3) You show you cannot pay your income tax in full when due,
- 4) The tax will be paid in full in 3 years or less, and
- 5) You agree to comply with the tax laws while your agreement is in effect.

Gift To Reduce the Public Debt



You can make a contribution (gift) to reduce the public debt. If you wish to do so, make a **separate** check payable to "Bureau of the Public Debt." You can send it to:

Bureau of the Public Debt
Department G
P.O. Box 2188
Parkersburg, WV 26106-2188.

Or, you can enclose the check in the envelope with your income tax return. Please do not add this gift to any tax you owe.

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

Peel-Off Address Label

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

If you file electronically (and Form 8453 is required), use your label on Form 8453. (More information on electronic filing is found earlier in this chapter.)

The label helps the IRS to correctly identify your account. It also saves processing costs and speeds up processing so that refunds can be issued sooner.



You must write your SSN in the spaces provided on your tax return.

Correcting the label. Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If you changed your name, see the discussion under *Social Security Number*, earlier.

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

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

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

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

- 1) City,
- 2) Province or state, and
- 3) Name of foreign country. (**Do not** abbreviate the name of the country.)

Follow the country's practice for entering the postal code.

Where Do I File?

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

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

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

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

What Happens After I File?

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

What Records Should I Keep?



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

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

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

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

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

You may need to keep records relating to the basis of property longer than the period of limitations. Keep those records as long as they are important in figuring the basis of the original or replacement property. Generally, this means for as long as you own the property and, after you dispose of it, for the period of limitations that applies to you. See chapter 14 for information on basis.

Note. If you receive a Form W-2, keep Copy C until you begin receiving social security benefits. This will help protect those benefits, just in case there is a question about your work record or earnings in a particular year. The Social Security Administration suggests that you confirm your work record with them from time to time.

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

If you need a copy of a prior year tax return, you can get it from the IRS. Use **Form 4506, Request for Copy or Transcript of Tax Form**. There is a charge for a copy of a return, which you must pay with Form 4506.

Transcript. You can also use Form 4506 to ask for a transcript of your return filed this year or during the 3 preceding years. It will show most lines from your original return, including accompanying forms and schedules.

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

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

- Type of return filed,

- Filing status,
- Federal income tax withheld,
- Tax shown on return,
- Adjusted gross income,
- Taxable income,
- Self-employment tax,
- Number of exemptions,
- Refund,
- Earned income credit, and
- Mortgage interest deduction or real estate tax deduction.

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

Interest on Refunds

If you are due a refund, you may get interest on it. The interest rates are adjusted quarterly.

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

Accepting a refund check does not change your right to claim an additional refund and interest. File your claim within the period of time that applies. See *Amended Returns and Claims for Refund*, later. If you do not accept a refund check, no more interest will be paid on the overpayment included in the check.

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

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

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

Past-Due Refund

If you do not get your refund within 4 weeks after filing your return, you can call TeleTax. For details on how to use this telephone service, see *What Is TeleTax?* in your tax forms package. Please wait at least 4 weeks after filing your 2001 tax return before using this service. In some cases, TeleTax may not have refund information until 6 weeks after you file.

See *IRS e-file*, earlier, for information about refund inquiries when you file an electronic return.

Change of Address

If you have moved, file your return using your new address.

If you move after you filed your return, you should give the IRS clear and concise written notification of your change of address. The notification should be sent to the Internal Revenue Service Center serving your old address or to the Customer Service Division in the local area office. You can use **Form 8822, Change of Address**. If you are expecting a refund, also notify the post office serving your old address. This will help in forwarding your check to your new address (unless you chose Direct Deposit of your refund).

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

What If I Made a Mistake?

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

Amended Returns and Claims for Refund

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

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

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

Form 1040X. Use Form 1040X, *Amended U.S. Individual Income Tax Return*, to correct the return you have already filed. An amended tax return cannot be filed electronically under the e-file system.

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

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

If you cannot pay the full amount due with your return, you can ask to make monthly install-

ment payments. See *Installment Agreement*, earlier.

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

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

File a separate form for each tax year involved.

Time for filing a claim for refund. Generally, you must file your claim for a credit or refund within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. Returns filed before the due date (without regard to extensions) are considered filed on the due date (even if the due date was a Saturday, Sunday, or legal holiday). These time periods are suspended while you are financially disabled, discussed later.

If the last day for claiming a credit or refund is a Saturday, Sunday, or legal holiday, you can file the claim on the next business day.

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

Late-filed return. If you were due a refund but you did not file a return, you generally must file within 3 years from the date the return was originally due to get that refund.

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

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

Example 1. You made estimated tax payments of \$500 and got an automatic extension of time to August 16, 1999, to file your 1998 income tax return. When you filed your return on that date, you paid an additional \$200 tax. On August 15, 2002, you filed an amended return and claimed a refund of \$700. Because you filed your claim within 3 years after you filed your original return, you can get a refund of up to \$700, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim.

Example 2. The situation is the same as in Example 1, except you filed your return on October 29, 1999, 2½ months after the extension period ended. You paid an additional \$200 on that date. On October 29, 2002, you filed an amended return and claimed a refund of \$700. Although you filed your claim within 3 years from

the date you filed your original return, the refund was limited to \$200, the tax paid within the 3 years plus the 4-month extension period immediately before you filed the claim. The estimated tax of \$500 paid before that period cannot be refunded or credited.

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

Example. You filed your 1998 tax return on April 15, 1999. You paid taxes of \$500. On November 1, 2000, after an examination of your 1998 return, you had to pay an additional tax of \$200. On May 13, 2002, you file a claim for a refund of \$300. However, because you filed your claim more than 3 years after you filed your return, your refund will be limited to the \$200 you paid during the 2 years immediately before you filed your claim.

Financially disabled. The time periods are suspended for the period in which you are financially disabled. You are financially disabled if you are unable to manage your financial affairs because of a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. However, you are not treated as financially disabled during any period your spouse or any other person is authorized to act on your behalf in financial matters.

To claim that you are financially disabled, you must send in the following written statements with your claim for refund.

- 1) A statement from your qualified physician that includes:
 - a) The name and a description of your physical or mental impairment,
 - b) The physician's medical opinion that the impairment prevented you from managing your financial affairs,
 - c) The physician's medical opinion that the impairment was or can be expected to result in death, or that its duration has lasted, or can be expected to last, at least 12 months,
 - d) The specific time period (to the best of the physician's knowledge), and
 - e) The following certification signed by the physician: "I hereby certify that, to the best of my knowledge and belief, the above representations are true, correct, and complete."
- 2) A statement made by the person signing the claim for credit or refund that no person, including your spouse, was authorized to act on your behalf in financial matters during the period of disability (or the exact dates that a person was authorized to act for you).

Exceptions for special types of refunds. If you file a claim for one of the items listed below, the dates and limits discussed earlier may not apply. These items, and where to get more information, are as follows.

- A bad debt. (See *Nonbusiness Bad Debts* in chapter 15.)
- A worthless security. (See *Worthless securities* in chapter 15.)
- Foreign tax paid or accrued. (See Publication 514, *Foreign Tax Credit for Individuals*.)
- Net operating loss carryback. (See Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.)
- Carryback of certain business tax credits. (See Form 3800, *General Business Credit*.)
- A claim based on an agreement with the IRS extending the period for assessment of tax.
- An injured spouse claim. (See *Offset against debts*, earlier.)

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

If your claim is disallowed, you will receive an explanation of why it was disallowed.

Taking your claim to court. You can sue for a refund in court, but you must first file a timely claim with the IRS. If the IRS disallows your claim or does not act on your claim within 6 months after you file it, you can then take your claim to court. For information on the burden of proof in a court proceeding, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

The IRS provides a fast method to move your claim to court if:

- You are filing a claim for a credit or refund based solely on contested income tax or on estate tax or gift tax issues considered in your previously examined returns, and
- You want to take your case to court instead of appealing it within the IRS.

When you file your claim with the IRS, you get the fast method by requesting in writing that your claim be immediately rejected. A notice of claim disallowance will then be promptly sent to you.

You have 2 years from the date of mailing of the notice of disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Court of Federal Claims.

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

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

Also, your refund may be reduced by amounts you owe for past-due child support,

debts to another federal agency, or for state tax. The refund procedures discussed in this chapter will not be available to you to get back the reduction. See *Offset against debts*, earlier.

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

Penalties

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

Civil Penalties

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

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

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

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

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

Paying tax late. You will have to pay a **failure-to-pay** penalty of $\frac{1}{2}$ of 1% (.50%) of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the automatic 4-month extension of time to file period, if you paid at least 90% of your actual tax liability on or before the due date of your return and pay the balance when you file the return.

The monthly rate of the failure-to-pay penalty is half the usual rate (.25% instead of .50%) if an installment agreement is in effect for that month. You must have filed your return by the due date (including extensions) to qualify for this reduced penalty.

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

This penalty cannot be more than 25% of your unpaid tax. You will not have to pay the

penalty if you can show that you had a good reason for not paying your tax on time.

Combined penalties. If both the failure-to-file penalty and the failure-to-pay penalty (discussed earlier) apply in any month, the 5% (or 15%) failure-to-file penalty is reduced by the failure-to-pay penalty. However, if you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$100 or 100% of the unpaid tax.

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

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

The penalty is equal to 20% of the underpayment. The penalty will not be figured on any part of an underpayment on which the fraud penalty (discussed later) is charged.

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

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

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

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

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

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

Disclosure statement. To adequately disclose the relevant facts about your tax treatment of an item, use **Form 8275, Disclosure Statement**. You must also have a reasonable basis for treating the item the way you did.

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 2001-11 (or later update) are considered adequately disclosed on your return without filing Form 8275.

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

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

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

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

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

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

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

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

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

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

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

Failure to furnish tax shelter registration number. A person who sells (or otherwise

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

Criminal Penalties

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

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

2.

Filing Status

Introduction

This chapter discusses which filing status you should use. There are five filing statuses. They are:

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



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

You use your filing status in determining your filing requirements (chapter 1), standard deduction (chapter 21), and correct tax (chapter 31). You also use your filing status in determining whether you are eligible to claim certain deductions and credits.

Useful Items

You may want to see:

Publication

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

Marital Status

In general, your filing status depends on whether you are considered unmarried or married. A marriage means only a legal union between a man and a woman as husband and wife.

Unmarried persons. You are considered unmarried for the whole year if, on the last day of your tax year, you are unmarried or legally separated from your spouse under a divorce or a separate maintenance decree. State law governs whether you are married or legally separated under a divorce or separate maintenance decree.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

Divorce and remarriage. If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry

each other in the next tax year, you and your spouse must file as married individuals.

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

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

Married persons. If you are considered married for the whole year, you and your spouse can file a joint return, or you can file separate returns.

Considered married. You are considered married for the whole year if on the last day of your tax year you and your spouse meet any one of the following tests.

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

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

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

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

Married persons living apart. If you live apart from your spouse and meet certain tests, you may be **considered unmarried**. If this applies to you, you can file as head of household even though you are not divorced or legally separated. If you qualify to file as head of household instead of as married filing separately, your standard deduction will be higher. Also, your tax may be lower, and you may be able to claim the earned income credit. See *Head of Household*, later.

Single

Your filing status is **single** if, on the last day of the year, you are unmarried or legally separated from your spouse under a divorce or separate maintenance decree, and you do not qualify for another filing status. To determine your marital status on the last day of the year, see *Marital Status*, earlier.

Your filing status may be single if you were widowed before January 1, 2001, and did not remarry in 2001. However, you might be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

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

Married Filing Jointly

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

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses. You can file a joint return even if one of you had no income or deductions.



If you and your spouse each have income, you may want to figure your tax both on a joint return and on separate returns (using the filing status of married filing separately). Choose the method that gives the two of you the lower combined tax.

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

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year and can choose married filing jointly as your filing status. See *Spouse died*, earlier, for more information.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year and you cannot choose married filing jointly as your filing status.

Filing a Joint Return

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

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

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

Divorced taxpayer. You may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before your divorce. This responsibility may apply even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

Relief from joint liability. In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. You can ask for relief no matter how small the liability.

There are three types of relief available.

- 1) Innocent spouse relief, which applies to all joint filers.
- 2) Separation of liability, which applies to joint filers who are divorced, widowed, legally separated, or have not lived together for the past 12 months.
- 3) Equitable relief, which applies to all joint filers who do not qualify for innocent spouse relief or separation of liability and to married couples filing separate returns in community property states.

You must file Form 8857, *Request for Innocent Spouse Relief*, to request any of these kinds of relief. Publication 971, *Innocent Spouse Relief*, explains these kinds of relief and who may qualify for them.

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

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

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

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

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

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

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

Married Filing Separately

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

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



Unless you are required to file separately, you should figure your tax both ways (on a joint return and on separate returns). This way you can make sure you are using the method that results in the lowest combined tax. However, you will generally pay more combined tax on separate returns than you

would on a joint return because the tax rate is higher for married persons filing separately.

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

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

Special Rules

Special rules apply if your filing status is married filing separately.

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

Deductions, credits, and certain income. If your filing status is married filing separately:

- 1) You should itemize deductions if your spouse itemizes deductions, because you cannot claim the standard deduction.
- 2) You cannot deduct interest paid on a qualified student loan.
- 3) You cannot take the credit for child and dependent care expenses in most instances, and the amount that you can exclude from income under an employer's dependent care assistance program is limited to \$2,500 (instead of \$5,000 if you filed a joint return).
- 4) You cannot take the earned income credit.
- 5) You cannot exclude any interest income from qualified U.S. savings bonds that you used for higher education expenses.
- 6) You cannot take the credit for the elderly or the disabled unless you lived apart from your spouse for the entire year.
- 7) You cannot take the education credits (the Hope credit and the lifetime learning credit).
- 8) You cannot take the exclusion or credit for adoption expenses in most instances.
- 9) You will become subject to the limit on the child tax credit, the limit on itemized deductions, and the phaseout of the deduction for personal exemptions at income levels that are half of those for a joint return.
- 10) You may have to include in income more of your social security benefits (or equivalent railroad retirement benefits) than you would on a joint return. For information on social security and railroad re-

Table 2–1. **Who Is a Qualifying Person for Filing as Head of Household?**¹

IF the person is your . . .	AND . . .	THEN that person is . . .
Parent, Grandparent, Brother, Sister, Stepbrother, Stepsister, Stepmother, Stepfather, Mother-in-law, Father-in-law, Half brother, Half sister, Brother-in-law, Sister-in-law, Son-in-law, or Daughter-in-law	You can claim an exemption for him or her ²	A qualifying person.
	You cannot claim an exemption for him or her	NOT a qualifying person.
Uncle, Aunt, Nephew, or Niece	He or she is related to you by blood <u>and</u> you can claim an exemption for him or her ^{2, 3}	A qualifying person.
	He or she is not related to you by blood ³	NOT a qualifying person.
	You cannot claim an exemption for him or her	
Child, Grandchild, Stepchild, or Adopted child	He or she is single	A qualifying person. ⁴
	He or she is married, <u>and</u> you can claim an exemption for him or her ²	A qualifying person
	He or she is married, <u>and</u> you cannot claim an exemption for him or her	NOT a qualifying person. ⁵
Foster child ⁶	The child lived with you all year, <u>and</u> you can claim an exemption for him or her ²	A qualifying person.
	The child lived with you all year, <u>and</u> you cannot claim an exemption for him or her	NOT a qualifying person.

¹A person cannot qualify more than one taxpayer to use the head of household filing status for the year.

²If you can claim an exemption for a person only because of a multiple support agreement, that person cannot be a qualifying person. See *Multiple Support Agreement*.

³You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father. You are related by blood to a nephew or niece if he or she is the child or your brother or sister.

⁴This child is a qualifying person even if you cannot claim an exemption for the child.

⁵This child is a qualifying person if you could claim an exemption for the child except that the child's other parent claims the exemption under the special rules for a noncustodial parent discussed under *Support Test for Divorced or Separated Parents* in chapter 3.

⁶The term "foster child" is defined under *Exemptions for Dependents* in chapter 3.

irement benefits, see Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

- 11) You cannot roll over amounts from a traditional IRA into a Roth IRA during the year, unless you did not live with your spouse at any time during the year.
- 12) Your capital loss deduction limit is \$1,500 (instead of \$3,000 if you filed a joint return).

Individual retirement arrangements (IRAs). You may not be able to deduct all or part of your contributions to a traditional IRA if you or your spouse were covered by an employee retirement plan at work during the year. Your deduction is reduced or eliminated if your income is more than a certain amount. This amount is lower for married individuals who file separately and lived together at any time during the year. For more information, see *How Much Can I Deduct?* in Publication 590, *Individual Retirement Arrangements (IRAs)*.

Rental activity losses. If you actively participated in a passive rental real estate activity that

produced a loss, you generally can deduct the loss from your nonpassive income, up to \$25,000. This is called a special allowance. However, married persons filing separate returns who lived together at any time during the year cannot claim this special allowance. Married persons filing separate returns who lived apart at all times during the year are each allowed a \$12,500 maximum special allowance for losses from passive real estate activities. See *Limits on Rental Losses* in chapter 10.

Joint Return After Separate Returns

You can change your filing status by filing an amended return using Form 1040X.

If you or your spouse (or both of you) file a separate return, you generally can change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status.

Separate Returns After Joint Return

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

Exception. A personal representative for a decedent can change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has 1 year from the due date of the return to make the change. See chapter 4 for more information on filing a return for a decedent.

Head of Household

You may be able to file as **head of household** if you meet all of the following requirements.

- 1) You are unmarried or considered unmarried on the last day of the year.
- 2) You paid more than half the cost of keeping up a home for the year.

3) A qualifying person lived with you in the home for more than half the year (except for temporary absences, such as school). However, your dependent parent does not have to live with you. See *Special rule for parent*, later, under *Qualifying Person*. A foster child must live with you all year.



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

Kidnapped children. A child may qualify you to file as head of household, even if the child has been kidnapped. For more information, see Publication 501.

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

Considered Unmarried

You are considered unmarried on the last day of the year if you are legally separated from your spouse, according to your state law, under a divorce or separate maintenance decree.

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

- 1) You file a separate return.
- 2) You paid more than half the cost of keeping up your home for the tax year.
- 3) Your spouse did not live in your home during the last 6 months of the tax year. Your spouse is considered to live in your home even if he or she is temporarily absent due to special circumstances. See *Temporary absences*, later.
- 4) Your home was the main home of your child, stepchild, or adopted child for more than half the year or was the main home of your foster child for the entire year. (See *Home of qualifying person*, later, for rules applying to a child's birth, death, or temporary absence during the year.)
- 5) You must be able for to claim an exemption for the child. However, you can still meet this test if you cannot claim the exemption only because the noncustodial parent is allowed to claim the exemption for the child. See *Exception under Support Test for Child of Divorced or Separated Parents* in chapter 3 for situations where the noncustodial parent is allowed to claim the exemption for the child.

The general rules for claiming an exemption for a dependent are explained in chapter 3.



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

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

Earned income credit. Even if you are considered unmarried for head of household purposes because you are married to a nonresident alien, you are still considered married for purposes of the earned income credit (unless you meet the five tests listed earlier). You are not entitled to the credit unless you file a joint return with your spouse and meet other qualifications. See Publication 596, *Earned Income Credit*, for more information.

Choice to treat spouse as resident. You are considered married if you choose to treat your spouse as a resident alien.

Keeping Up a Home

To qualify for head of household status, you must pay more than half of the cost of keeping up a home for the year. You can determine whether you paid more than half of the cost of keeping up a home by using the *Cost of Keeping Up a Home* worksheet, shown later.

Costs you include. Include in the cost of upkeep expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home.

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



Cost of Keeping Up a Home

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

If the total amount you paid is more than the amount others paid, you meet the requirement of paying more than half the cost of keeping up the home.

Qualifying Person

See *Table 2-1* to see who is a qualifying person.

Any person not described in *Table 2-1* is not a qualifying person.

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

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

Temporary absences. You and your qualifying person are considered to live together even if one or both of you are temporarily absent from your home due to special circumstances such as illness, education, business, vacation, or military service. It must be reasonable to assume that the absent person will return to the household after the temporary absence. You must continue to keep up the home during the absence.

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

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

Qualifying Widow(er) With Dependent Child

If your spouse died in 2001, you can use married filing jointly as your filing status for 2001 if you otherwise qualify to use that status. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly*, earlier.

You may be eligible to use **qualifying widow(er) with dependent child** as your filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 2000, and you have not remarried, you may be able to use this filing status for 2001 and 2002.

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

How to file. If you file as qualifying widow(er) with dependent child, you can use either Form 1040A or Form 1040. Indicate your filing status

by checking the box on line 5 of either form. Write the year your spouse died in the space provided on line 5. Use the *Married filing jointly* column of the Tax Table or *Schedule Y-1* of the Tax Rate Schedules to figure your tax.

Eligibility rules. You are eligible to file your 2001 return as a qualifying widow(er) with dependent child if you meet all of the following tests.

- 1) You were entitled to file a joint return with your spouse for the year your spouse died. It does not matter whether you actually filed a joint return.
- 2) You did not remarry before the end of 2001.
- 3) You have a child, stepchild, adopted child, or foster child for whom you can claim an exemption.

- 4) You paid more than half the cost of keeping up a home that is the main home for you and that child for the entire year, except for temporary absences. See *Temporary absences* and *Keeping Up a Home*, discussed earlier under *Head of Household*.



As mentioned earlier, this filing status is only available for 2 years following the year of death of your spouse.

Example. John Reed's wife died in 1999. John has not remarried. During 2000 and 2001,

he continued to keep up a home for himself and his child (for whom he can claim an exemption). For 1999 he was entitled to file a joint return for himself and his deceased wife. For 2000 and 2001 he can file as qualifying widower with a dependent child. After 2001 he can file as head of household if he qualifies.

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

3.

Personal Exemptions and Dependents

Important Changes

Exemption amount. The amount you can deduct for each exemption has increased from \$2,800 in 2000 to \$2,900 in 2001.

Exemption phaseout. You will lose all or part of the benefit of your exemptions if your adjusted gross income is above a certain amount. The amount at which this phaseout begins depends on your filing status. For 2001, the phaseout begins at \$99,725 for married persons filing separately, \$132,950 for unmarried individuals, \$166,200 for heads of household, and \$199,450 for married persons filing jointly. See *Phaseout of Exemptions*, later.

Introduction

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

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

Exemptions reduce your taxable income. Generally, you can deduct \$2,900 for each exemption you claim in 2001. How you claim an exemption on your tax return depends on which form you file.

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

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6d. Also complete line 24 (Form 1040A) or line 38 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by \$2,900.



If your adjusted gross income is more than \$99,725, see *Phaseout of Exemptions*, later.

Useful Items

You may want to see:

Publication

- ❑ **501** Exemptions, Standard Deduction, and Filing Information

Form (and Instructions)

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

Exemptions

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

Personal Exemptions

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

Your Own Exemption

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

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

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

Your Spouse's Exemption

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

Joint return. On a joint return you can claim one exemption for yourself and one for your spouse.

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

Death of spouse. If your spouse died during the year, you can generally claim your spouse's

exemption under the rules just explained under *Joint return* and *Separate return*.

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

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

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

Exemptions for Dependents

You are allowed one exemption for each person you can claim as a dependent. To claim the exemption for a dependent, you must meet **all five** of the dependency tests, discussed later. You can claim an exemption for your dependent even if your dependent files a return. But that dependent cannot claim his or her own personal exemption if you are entitled to do so. However, see *Joint Return Test*, later in this chapter.

Kidnapped children. You may be eligible to claim the exemption for a child, even if the child has been kidnapped. For more information, see Publication 501.

Child born alive. If your child was born alive during the year, and the dependency tests are met, you can claim the exemption. This is true even if the child lived only for a moment. State or local law must treat the child as having been born alive. There must be proof of a live birth shown by an official document, such as a birth certificate.

Stillborn child. You cannot claim an exemption for a stillborn child.

Death of dependent. If your dependent died during the year and otherwise met the dependency tests, you can claim the exemption for your dependent.

Example. Your dependent mother died on January 15. The five dependency tests are met. You can claim the exemption for her on your return.

Housekeepers, maids, or servants. If these people work for you, you cannot claim exemptions for them.

Child tax credit. You may be entitled to a child tax credit for each of your qualifying children for whom you can claim an exemption. For more information, see chapter 35.

Dependency tests. The following five tests must be met for you to claim an exemption for a dependent.

- 1) Member of Household or Relationship Test.
- 2) Citizen or Resident Test.
- 3) Joint Return Test.

- 4) Gross Income Test.
- 5) Support Test.

Member of Household or Relationship Test

To meet this test, a person must either:

- 1) Live with you for the entire year as a member of your household, or
- 2) Be related to you in one of the ways listed later under *Relatives who do not have to live with you*.

If at any time during the year the person was your spouse, that person cannot be your dependent. However, see *Personal Exemptions*, earlier.

Temporary absences. A person lives with you as a member of your household even if either (or both) of you are temporarily absent due to special circumstances. Temporary absences due to special circumstances include absences because of illness, education, business, vacation, or military service.

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

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

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

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

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

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

Adoption. Even if your adoption of a child is not yet final, the child is considered to be your child if he or she was placed with you for legal

adoption by an authorized placement agency. Also, the child must have been a member of your household. An authorized placement agency includes any person authorized by state law to place children for legal adoption.

If the child was not placed with you by an authorized agency, the child will meet this test only if he or she was a member of your household for your entire tax year.

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

Cousin. You can claim an exemption for your cousin only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother.

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

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

Citizen or Resident Test

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

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

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

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

Foreign students' place of residence. Foreign students brought to this country under a qualified international education exchange program and placed in American homes for a temporary period generally are not U.S. residents and do not meet the citizen or resident test. You cannot claim exemptions for them. However, if you provided a home for a foreign student, you may be able to take a charitable contribution deduction. See *Expenses Paid for Student Living With You* in chapter 26.

Joint Return Test

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

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

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

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

Gross Income Test

Generally, you cannot take an exemption for a dependent if that person had gross income of \$2,900 or more for 2001. This test does not apply if the person is your child and is either:

- 1) Under age 19 at the end of the year, or
- 2) A student under age 24 at the end of the year.

The exceptions for children under age 19 and students under age 24 are discussed in detail later.

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

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

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

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

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

Gross income also includes all unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates that are used for tuition, fees, supplies, books, and equipment required for particular courses are not included in gross income. For more information, see chapter 13.

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

Disabled dependents. For this gross income test, gross income does not include income received by a permanently and totally disabled individual for services performed at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop. Also, the income must come solely from activities at the workshop that are incident to this medical care. A sheltered workshop is a school operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession,

the United States, or the District of Columbia, that provides special instruction or training designed to alleviate the disability of the individual.

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

Child under age 19. If your child is under 19 at the end of the year, the gross income test does not apply. Your child can have any amount of income and you can still claim an exemption if the other dependency tests, including the support test, are met.

Example. Marie, 18, earned \$3,000. Her father provided more than half her support. Because Marie is under 19, the gross income test does not apply. If the other dependency tests were met, Marie's father can claim an exemption for her.

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

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

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

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

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

Example. James, 22, attends college as a full-time student. During the summer, James earned \$3,000. If the other dependency tests are met, his parents can take the exemption for James.

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

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

Support Test

Generally, you must provide more than half of a person's total support during the calendar year to meet the support test. However, there are special rules that apply in the following two situations.

- 1) Two or more persons provide support, but no one person provides more than half of a person's total support. See *Multiple Support Agreement*, later.
- 2) The person supported is the child of divorced or separated parents. See *Support Test for Child of Divorced or Separated Parents*, later.

You figure whether you have provided more than half of a person's total support by comparing the amount you contributed to that person's support with the entire amount of support that person received from all sources. This includes support the person provided from his or her own funds.

You may find *Table 3-1* helpful in figuring whether you provided more than half of a person's support.

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

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

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

Child's wages used for own support. You cannot include in your contribution to your child's support any support that is paid for by the child with the child's own wages, even if you paid the wages.

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

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

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

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

Tax-exempt military quarters allowances. These allowances are treated the same way as dependency allotments in figuring support. The

allotment of pay and the tax-exempt basic allowance for quarters are both considered as provided by you for support.

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

Example 1. You provide \$4,000 toward your mother's support during the year. She has earned income of \$600, nontaxable social security benefit payments of \$4,800, and tax-exempt interest of \$200. She uses all these for her support. You cannot claim an exemption for your mother because the \$4,000 you provide is not more than half of her total support of \$9,600.

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

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

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

Support provided by the state (food stamps, housing, etc.). Benefits provided by the state to a needy person generally are considered to be used for support. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that part of the payments were not used for that purpose.

Foster care payments and expenses. Payments you receive for the support of a foster child from a child placement agency are considered support provided by the agency. Similarly, payments you receive for the support of a foster child from a state or county are considered support provided by the state or county.

If you are not in the trade or business of providing foster care to a child and your unreimbursed out-of-pocket expenses in caring for a foster child were mainly to benefit an organization qualified to receive deductible charitable contributions, the expenses are deductible as charitable contributions, but are not considered support you provided. For more information about the deduction for charitable contributions, see Publication 526. If your unreimbursed expenses are not deductible as charitable contributions, they are considered support you provided.

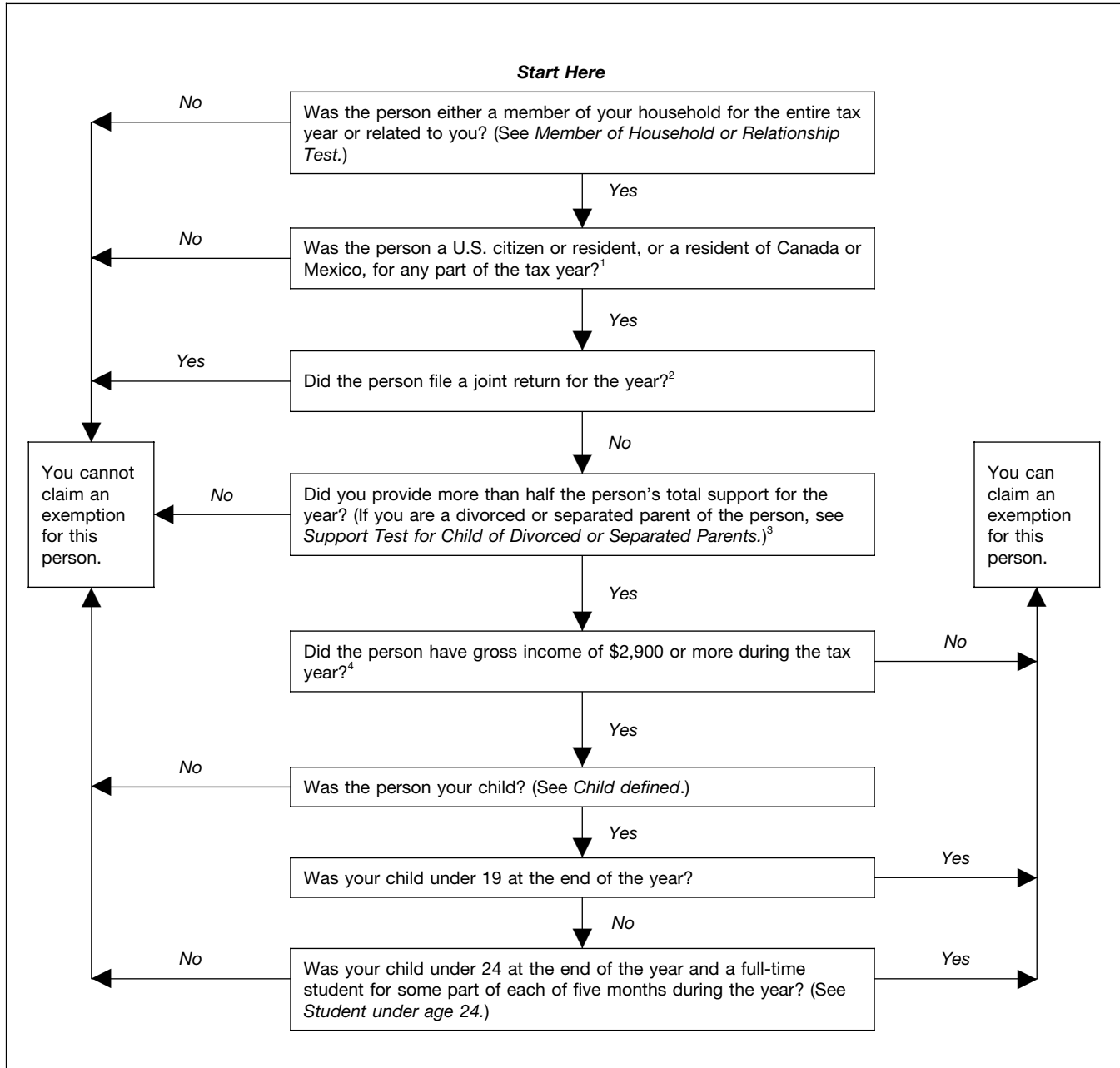
If you are in the trade or business of providing foster care, your unreimbursed expenses are not considered support provided by you.

Home for the aged. If you make a lump-sum advance payment to a home for the aged to take care of your relative for life and the payment is

Table 3–1. **Worksheet for Determining Support**

Funds Belonging to the Person You Supported	
1) Total funds belonging to the person you supported, including income received (taxable and nontaxable) and amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year	\$
2) Amount used for support	\$
3) Amount used for other purposes	\$
4) Amount in savings and other accounts at the end of the year	\$
(The total of lines 2, 3, and 4 should equal line 1)	\$
Expenses for Entire Household (where the person you supported lived)	
5) Lodging (Complete item a or b)	
a) Rent paid	\$
b) If not rented, show fair rental value of home. If the person you supported owned the home, include the amount in line 19.	\$
6) Food	\$
7) Utilities (heat, light, water, etc. not included in line 5a or 5b)	\$
8) Repairs (not included in line 5a or 5b)	\$
9) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	\$
10) Total household expenses (Add lines 5 through 9)	\$
11) Total number of persons who lived in household	
Expenses for the Person You Supported	
12) Each person's part of household expenses (line 10 divided by line 11)	\$
13) Clothing	\$
14) Education	\$
15) Medical, dental	\$
16) Travel, recreation	\$
17) Other (specify)	\$
18) Total cost of support for the year (Add lines 12 through 17)	\$
Did You Provide More Than Half?	
19) Amount the person provided for own support (line 2, plus line 5b if the person you supported owned the home)	\$
20) Amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 1.	\$
21) Amount you provided for the person's support (line 18 minus lines 19 and 20)	\$
22) 50% of line 18	\$
Is line 21 more than line 22? Yes. You meet the support test for the person. If the other exemption tests are met, you may claim an exemption for the person. No. You do not meet the support test for the person. You cannot claim an exemption for the person unless you can do so under a multiple support agreement. See <i>Multiple Support Agreement</i> in this chapter.	

Figure 3–A. Can You Claim an Exemption for a Dependent?



¹If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.
²If neither the person nor the person's spouse is required to file a return, but they file a joint return only to claim a refund of tax withheld, answer "no" to this question.
³Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement*.
⁴Gross income for this purpose does not include income received by a permanently disabled individual at a sheltered workshop. See *Disabled dependents*.

based on that person's life expectancy, the amount of support you provide each year is the lump-sum payment divided by the relative's life expectancy. The amount of support you provide also includes any other amounts that you provided during the year.

Total Support

To figure if you provided more than half of the support of a person, you must first determine the total support provided for that person. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

Generally, the amount of an item of support is the amount of the expense incurred in providing that item. For lodging, the amount of support is the fair rental value of the lodging.

Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household.

Example. Your parents live with you, your spouse, and your two children in a house you own. The fair rental value of your parents' share of lodging is \$2,000 a year, which includes furnishings and utilities. Your father receives a nontaxable pension of \$4,200, which he spends equally between your mother and himself for items of support such as clothing, transporta-

tion, and recreation. Your total food expense for the household is \$6,000. Your heat and utility bills amount to \$1,200. Your mother has hospital and medical expenses of \$600, which you pay during the year. Figure your parents' total support as follows:

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

You must apply the support test separately to each parent. You provide \$2,000 (\$1,000 lodging, \$1,000 food) of your father's total support of \$4,100 — less than half. You provide

\$2,600 to your mother (\$1,000 lodging, \$1,000 food, \$600 medical) — more than half of her total support of \$4,700. You meet the support test for your mother, but not your father. Heat and utility costs are included in the fair rental value of the lodging, so these are not considered separately.

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

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

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

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

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

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

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

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

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

Example 1. You buy a \$200 power lawn mower for your 13-year-old child. The child is given the duty of keeping the lawn trimmed. Because a lawn mower is ordinarily an item you buy for personal and family reasons that benefits all members of the household, you cannot include the cost of the lawn mower in the support of your child.

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

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

Example 4. Your 17-year-old son, using personal funds, buys a car for \$4,500. You provide all the rest of your son's support — \$4,000. Since the car is bought and owned by your son, the car's fair market value (\$4,500) must be included in his support. The \$4,000 support you provide is less than half of his total support of \$8,500. You cannot claim an exemption for your son.

Medical insurance premiums. Medical insurance premiums you pay, including premiums for supplementary Medicare coverage, are included in the support you provide.

Medical insurance benefits. Medical insurance benefits, including basic and supplementary Medicare benefits, are not part of support.

Tuition payments and allowances under the GI Bill. Amounts veterans receive under the GI Bill for tuition payments and allowances while they attend school are included in total support.

Example. During the year, your son receives \$2,200 from the government under the GI Bill. He uses this amount for his education. You provide the rest of his support — \$2,000. Because GI benefits are included in total support, your son is not your dependent.

Other support items. Other items may be considered as support depending on the facts in each case. For example, if you pay someone to provide child care or disabled dependent care, you can include these payments as support, even if you claim a credit for them. For information on the credit, see chapter 33.

Do Not Include in Total Support

The following items are not included in total support.

- 1) Federal, state, and local income taxes paid by persons from their own income.
- 2) Social security and Medicare taxes paid by persons from their own income.
- 3) Life insurance premiums.

- 4) Funeral expenses.
- 5) Scholarships received by your child if your child is a full-time student.
- 6) Survivors' and Dependents' Educational Assistance payments used for support of the child who receives them.

Multiple Support Agreement

Sometimes no one provides more than half of the support of a person. Instead, two or more persons, each of whom would be able to take the exemption but for the support test, together provide more than half of the person's support.

When this happens, you can agree that any one of you who individually provides more than 10% of the person's support, but **only one**, can claim an exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption. **Form 2120, Multiple Support Declaration**, can be used for this purpose.

Example 1. You, your sister, and your two brothers provide the entire support of your mother for the year. You provide 45%, your sister 35%, and your two brothers each provide 10%. Either you or your sister can claim an exemption for your mother. The other must sign a Form 2120 or a similar statement agreeing not to take an exemption for her. Because neither brother provides more than 10% of the support, neither can take the exemption. Your brothers do not have to sign a Form 2120 or the written statement.

Example 2. You and your brother each provide 20% of your mother's support for the year. The remaining 60% of her support is provided equally by two persons who are not related to her. She does not live with them. Because more than half of her support is provided by persons who cannot claim an exemption for her, no one can take the exemption.

Example 3. Your father lives with you and receives 25% of his support from social security, 40% from you, 24% from his brother, and 11% from a friend. Either you or your uncle can take the exemption for your father. A Form 2120 or a similar statement from the one not taking the exemption must be attached to the return of the one who takes the exemption.

Support Test for Child of Divorced or Separated Parents

The support test for a child of divorced or separated parents is based on the special rules explained here and shown in *Figure 3-B*. However, these special rules apply only if all of the following are true.

- 1) The parents are divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement, or lived

apart at all times during the last 6 months of the calendar year.

- 2) One or both parents provide more than half of the child's total support for the calendar year.
- 3) One or both parents have custody of the child for more than half of the calendar year.

"Child" is defined earlier under *Gross Income Test*.

This discussion does not apply if the support of the child is determined under a multiple support agreement, discussed earlier.

General rule. The parent who has custody of the child for the greater part of the year (the **custodial parent**) is generally treated as the parent who provides more than half of the child's support. It does not matter whether the custodial parent actually provided more than half of the support.

Custody. Custody is usually determined by the terms of the most recent decree of divorce or separate maintenance, or a later custody decree. If there is no decree, use the written separation agreement. If neither a decree nor agreement establishes custody, then the parent who has the physical custody of the child for the greater part of the year is considered to have custody of the child. This also applies if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

If the parents are divorced or separated during the year and had joint custody of the child before the separation, the parent who has custody for the greater part of the rest of the year is considered to have custody of the child for the tax year.

Example 1. Under the terms of your divorce, you have custody of your child for 10 months of the year. Your former spouse has custody for the other 2 months. You and your former spouse provide the child's total support. You are considered to have provided more than half of the support of the child. However, see *Exception*, later.

Example 2. You and your former spouse provided your child's total support for 2001. For the first 8 months of the year, you had custody of your child under your 1994 divorce decree (the most recent decree at the time). On August 31, 2001, a new custody decree granted custody to your former spouse. Because you had custody for the greater part of the year, you are considered to have provided more than half of your child's support, unless the exception described next applies.

Exception. The **noncustodial parent** will be treated as providing more than half of the child's support if:

- 1) The custodial parent signs a written declaration that he or she will not claim the exemption for the child, and the noncustodial parent attaches this written declaration to his or her return,
- 2) A decree or agreement went into effect after 1984 and states the noncustodial parent can claim the child as a dependent

without regard to any condition, such as payment of support, or

- 3) A decree or agreement executed before 1985 provides that the noncustodial parent is entitled to the exemption, and he or she provides at least \$600 for the child's support during the year, unless the pre-1985 decree or agreement is modified after 1984 to specify that this provision will not apply.

Noncustodial parent. The noncustodial parent is the parent who has custody of the child for the shorter part of the year or who does not have custody at all.

Example. Under the terms of your 1984 divorce decree, your former spouse has custody of your child. The decree specifically states that you are entitled to the exemption. You provide at least \$600 in child support during the calendar year. You are considered to have provided more than half of the child's support.

Written declaration. The custodial parent may use either **Form 8332** or a similar statement to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

The exemption can be released for a single year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than one year, the original release must be attached to the return of the noncustodial parent for the first year of such release, and a copy must be attached for each later year.

Divorce decree or separation agreement. If your divorce decree or separation agreement went into effect after 1984 and it states you can claim the child as your dependent without regard to any condition, such as payment of support, you can attach a copy of the following pages from the decree or agreement instead of Form 8332.

- 1) Cover page. (Write the other parent's social security number on this page.)
- 2) The page that states you can claim the child as your dependent.
- 3) Signature page with the other parent's signature and the date of the agreement.



If your divorce decree or separation agreement went into effect after 1984 and it states that you can claim the child as your dependent if you meet certain conditions, you must attach to your return Form 8332 or a similar statement from the custodial parent releasing the exemption.

Child support. All child support payments actually received from the noncustodial parent are considered used for the support of the child.

Example. The noncustodial parent provides \$1,200 for the child's support. This amount is considered support provided by the noncustodial parent even if the \$1,200 was actually spent on things other than support.

Paid in a later year. If you fail to pay child support in the year it is due, but pay it in a later year, your payment of the overdue amount is not considered paid for the support of your child, either for the year the payment was due or for the year it is paid. It is payment of an amount you owed to the custodial parent, but it is not considered paid by you for the support of your child.

Example. You owed but failed to pay child support last year. This year, you pay all of the amount owed from last year and the full amount due for this year. Your payment of this year's child support counts as support for this year, but your payment of the amount owed from last year does not count as support either for this year or for last year.

Third-party support. Support provided by a third party for a divorced or separated parent is not included as support provided by that parent. However, see *Remarried parent*, later.

Example. You are divorced. During the entire year, you and your child live with your mother in a house she owns. The fair rental value of the lodging provided by your mother for your child is \$3,000. The home provided by your mother is not included in the amount of support you provide.

Remarried parent. If you remarry, the support provided by your new spouse is treated as provided by you.

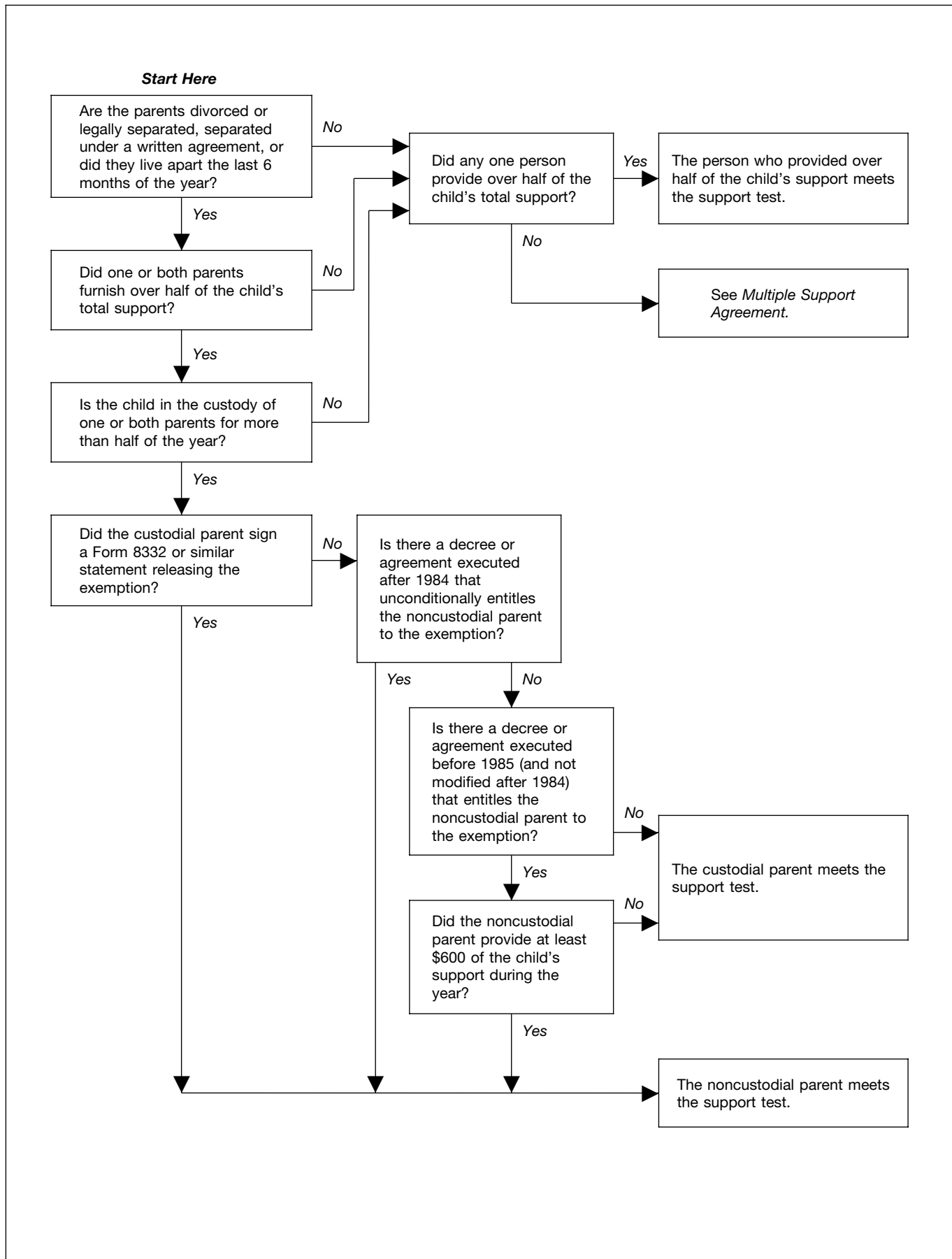
Example. You have two children from a former marriage who live with you. You have remarried and are living in a home owned by your new spouse. The fair rental value of the home provided to the children by your new spouse is treated as provided by you.

Home jointly owned. If you and your former spouse have the right to use and live in the home, each of you is considered to provide half of your child's lodging. However, if the divorce decree gives only you the right to use and live in the home, you are considered to provide your child's entire lodging. It does not matter if the legal title to the home remains in the names of both parents.

Parents who never married. These special rules for divorced or separated parents do not apply to parents who never married each other. If this is your situation, you must provide more than half the support of your child or enter into a multiple support agreement, as discussed earlier, to satisfy the support test.

Example. You never married the father of your child and do not live with him, but he provides the home you and your child live in. The fair rental value of the lodging he provides to your child is \$3,000 a year. You provide the rest of your child's support for the year, which is \$1,200. The special rules for a child of divorced or separated parents do not apply because you and the child's father never married. As a result, you cannot claim an exemption for your child because you did not provide more than half of the child's support.

Figure 3–B. **Support Test for Children of Divorced or Separated Parents**



Phaseout of Exemptions

The amount you can claim as a deduction for exemptions is phased out once your adjusted gross income (AGI) goes above a certain level for your filing status. These levels are as follows:

<u>Filing Status</u>	<u>AGI Level Which Reduces Exemption Amount</u>
Married filing separately	\$99,725
Single	132,950
Head of household	166,200
Married filing jointly	199,450
Qualifying widow(er)	199,450

If your AGI exceeds the level for your filing status, use the *Deduction for Exemptions Worksheet* in the instructions for Form 1040 to figure the amount of your deduction for exemptions.

You must reduce the dollar amount of your exemptions by 2% for each \$2,500, or part of \$2,500 (\$1,250 if you are married filing separately), that your AGI exceeds the amount shown for your filing status. If your AGI exceeds the amount shown by more than \$122,500 (\$61,250 if married filing separately), the amount of your deduction for exemptions is reduced to zero.

Social Security Numbers for Dependents

You must list the social security number (SSN) of **any** person for whom you claim an exemption

in column (2) of line 6c of your Form 1040 or Form 1040A.



If you do not list the dependent's SSN when required or if you list an incorrect SSN, the exemption may be disallowed.

Note. If your dependent does not have and cannot get an SSN, you must list the individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN) instead of an SSN. See Taxpayer identification numbers for aliens or Taxpayer identification number for adoptees, later.

No social security number. If a person for whom you expect to claim an exemption on your return does not have an SSN, either you or that person should apply for an SSN as soon as possible by filing **Form SS-5, Application for a Social Security Card**, with the Social Security Administration (SSA). Information about applying for an SSN and Form SS-5 is available at your local SSA office.

It usually takes about 2 weeks to get an SSN. If you do not have a required SSN by the filing due date, you can file Form 4868 for an extension of time to file.

Born and died in 2001. If your child was born and died in 2001, and you do not have an

SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter "DIED" in column (2) of line 6c of your Form 1040 or Form 1040A.

Taxpayer identification numbers for aliens. If your dependent is a resident or nonresident alien who does not have and is not eligible to get an SSN, the IRS will issue your dependent an individual taxpayer identification number (ITIN) instead of an SSN. Write the number in column (2) of line 6c of your Form 1040 or Form 1040A. To apply for an ITIN, use **Form W-7, Application for IRS Individual Taxpayer Identification Number**.

It usually takes about 4 to 6 weeks to get an ITIN.

Taxpayer identification numbers for adoptees. If you have a child who was placed with you by an authorized placement agency, you may be able to claim an exemption for the child. However, if you cannot get an SSN or an ITIN for the child, you must get an adoption taxpayer identification number (ATIN) for the child from the IRS. See **Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions**, for details.

4.

Decedents

Important Changes

Rollovers by surviving spouses. For distributions after 2001, an employee's surviving spouse who receives an eligible rollover distribution may roll it over into an eligible retirement plan, including an IRA, a qualified plan, a section 403(b) annuity, or a section 457 plan. For distributions before 2002, surviving spouses could only roll the distribution over into an IRA.

Assets held on January 1, 2001. If the estate held certain assets on January 1, 2001, you can treat the assets as being sold and reacquired on the same date. Any gain on the deemed sale must be recognized and included in income. This treatment allows future gains on those assets to be taxed at a rate of 18% (instead of 20%) if the asset is held by the estate for more than 5 years from the reacquired date. For more information, see the instructions for Schedule D of Form 1041.

Estate tax return. Generally, if the decedent died during 2001, an estate tax return (Form 706) must be filed if the gross estate is more than \$675,000. If death occurs in 2002, Form 706 must be filed if the gross estate is more than \$1,000,000.

Estate tax repeal. The estate tax is repealed for decedents dying after 2009.

Important Reminder

Consistent treatment of estate items. Beneficiaries must generally treat estate items the same way on their individual returns as they are treated on the estate's return. For more information, see *How and When To Report* under *Distributions to Beneficiaries From an Estate* in Publication 559, *Survivors, Executors, and Administrators*.

Introduction

This chapter discusses the tax responsibilities of the person who is in charge of the property (estate) of an individual who has died (decedent). It also covers the following topics.

- Filing the decedent's final return.
- Tax effects on survivors.

This chapter does **not** discuss the requirements for filing an income tax return of an estate (Form 1041). For information on Form 1041, see *Income Tax Return of an Estate—Form 1041* in Publication 559. This chapter also does not discuss the requirements for filing an estate tax

return (Form 706). For information, see Form 706 and its instructions.

Useful Items

You may want to see:

Publication

- **559** Survivors, Executors, and Administrators

Form (and Instructions)

- **56** Notice Concerning Fiduciary Relationship
- **1310** Statement of Person Claiming Refund Due a Deceased Taxpayer
- **4810** Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)

Personal Representative

A personal representative of an estate is an executor, administrator, or anyone who is in charge of the decedent's property.

Executor. Generally, an executor (or executrix) is named in a decedent's will to administer the estate (property and debts left by the decedent) and distribute properties as the decedent has directed.

Administrator. An administrator (or administratrix) is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve.

Personal representative. In general, an executor and an administrator perform the same duties and have the same responsibilities. Because a personal representative for a decedent's estate can be an executor, administrator, or anyone in charge of the decedent's property, the term **personal representative** will be used throughout this chapter.

The surviving spouse may or may not be the personal representative, depending on the terms of the decedent's will or the court appointment.

Duties

The primary duties of a personal representative are to collect all of the decedent's assets, pay the creditors, and distribute the remaining assets to the heirs or other beneficiaries.

The personal representative also must perform the following duties.

- 1) Notify the IRS (as discussed below) that he or she is acting as the personal representative.
- 2) File any income tax and estate tax return when due. (See *Final Return for the Decedent*, next.)
- 3) Pay any tax determined up to the date of discharge from duties.

- 4) Provide the payers of any interest and dividends the name(s) and identification number(s) of the new owner(s). (See *Interest and Dividend Income (Forms 1099)*, later.)

For more information on the duties and responsibilities of the personal representative, see *Duties under Personal Representative* in Publication 559.

Notifying the IRS. File a written notice (or Form 56) with the IRS office where the returns are filed for the person (or estate) for whom you are acting. See the instructions for Form 56 for more information.

Final Return for the Decedent

The same filing requirements that apply to individuals determine if a final income tax return must be filed for the decedent. Filing requirements are discussed in chapter 1.

Filing to get a refund. A return should be filed to obtain a refund if tax was withheld from salaries, wages, pensions, or annuities, or if estimated tax was paid, even if a return is not required to be filed. See *Claiming a refund*, later. Also, the decedent may be entitled to other credits that result in a refund. See chapters 37 and 38 for additional information on refundable credits and see chapter 35 for information on the child tax credit.

Determining income and deductions. The method of accounting regularly used by the decedent before death generally determines what income you must include and what deductions you can take on the final return. Generally, individuals use one of two methods of accounting: cash or accrual.

Cash method. If the decedent used the cash method of accounting, include only the items of income actually or constructively received before death and deduct only the expenses the decedent paid before death. For an exception for certain medical expenses not paid before death, see *Decedents* in chapter 23.

Accrual method. If the decedent used an accrual method of accounting, report only those items of income that the decedent accrued, or earned, before death. Deduct those expenses the decedent was liable for before death, regardless of whether the expenses were paid.

Additional information. For more information on the cash and accrual methods, see *Accounting Methods* in chapter 1.

Who must file the return? The personal representative (defined earlier) must file the final income tax return (Form 1040) of the decedent for the year of death and any returns not filed for preceding years. A surviving spouse, under certain circumstances, may have to file the returns for the decedent. See *Joint Return*, later.

Example. Samantha Smith died on March 21, 2001, before filing her 2000 tax return. Her personal representative must file her 2000 re-

turn by April 16, 2001. Her final tax return is due April 15, 2002.

Filing the return. The word “DECEASED,” the decedent’s name, and the date of death should be written across the top of the tax return. In the name and address space, you should write the name and address of the decedent and, if a joint return, the surviving spouse. If a joint return is not being filed, the decedent’s name should be written in the name space and the personal representative’s name and address should be written in the remaining space.

Example. John Stone died in early 2001. He was survived by his wife Jane. The top of their final joint return on Form 1040, which includes the required information, is illustrated on the next page.

Signing the return. If a personal representative has been appointed, that person must sign the return. If it is a joint return, the surviving spouse must also sign it.

If no personal representative has been appointed, the surviving spouse (on a joint return) should sign the return and write in the signature area “Filing as surviving spouse.” See *Joint return*, later.

If no personal representative has been appointed and if there is no surviving spouse, the person in charge of the decedent’s property must file and sign the return as “personal representative.”

Example. Assume in the previous example that no personal representative has been appointed. The bottom of the final joint return, which shows that Jane is filing the return as the surviving spouse, is illustrated on the next page.



Beginning with your tax return for 2001, you can check the “Yes” box in the “Third Party Designee” area of your return to authorize the IRS to discuss your return with a friend, family member, or any other person you choose. This allows the IRS to call the person you identified as your designee to answer any questions that may arise during the processing of your return. It also allows your designee to perform certain actions. See your income tax package for details.

Claiming a refund. Generally, a person who is filing a return for a decedent and claiming a refund must file Form 1310 with the return. However, if the person claiming the refund is a surviving spouse filing a joint return with the decedent, or a court-appointed or certified personal representative filing an original return for the decedent, Form 1310 is not needed. The personal representative must attach to the return a copy of the court certificate showing that he or she was appointed the personal representative.

Example. Mr. Green died before filing his tax return. You were appointed the personal representative for Mr. Green’s estate and you file his Form 1040 showing a refund due. You do not need Form 1310 to claim the refund if you attach a copy of the court certificate showing you were appointed the personal representative.

When and where to file. The final income tax return is due at the same time the decedent’s return would have been due had death not oc-

curred. The final return for a decedent who was a calendar year taxpayer is generally due April 15 following the year death occurred. However, when the due date falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

Generally, you must file the final income tax return of the decedent with the Internal Revenue Service Center for the place where you live. A tax return for a decedent cannot be electronically filed.

Request for prompt assessment (charge) of tax. The IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to charge any additional tax that is due. However, as a personal representative, you may request a prompt assessment of tax after the return has been filed. This reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. This request can be made for any income tax return of the decedent and for the income tax return of the decedent’s estate. This may permit a quicker settlement of the tax liability of the estate and an earlier final distribution of the assets to the beneficiaries.

You can request prompt assessment of any of the decedent’s taxes (other than federal estate taxes) for any years for which the statutory period for assessment is open. This applies even though the returns were filed before the decedent’s death.

Form 4810. You can use Form 4810 to make this request. It must be filed separately from any other document. The request should be filed with the IRS office where the return was filed. If Form 4810 is not used, you must clearly indicate that you are making a request for prompt assessment under section 6501(d) of the Internal Revenue Code. You must identify the type of tax and the tax period for which the prompt assessment is requested.

Failure to report income. If you or the decedent failed to report substantial amounts of gross income (more than 25% of the gross income reported on the return) or filed a false or fraudulent return, your request for prompt assessment will not shorten the period during which the IRS may assess the additional tax. However, such a request may relieve you of personal liability for the tax if you did not have knowledge of the unpaid tax.

Request for discharge from personal liability for tax. An executor can make a written request for a discharge from personal liability for a decedent’s income and gift taxes. The request must be made after the returns for those taxes are filed. It must clearly indicate that the request is for discharge from personal liability under section 6905 of the Internal Revenue Code. For this purpose, an executor is an executor or administrator that is appointed, qualified, and acting within the United States.

Within 9 months after receipt of the request, the IRS will notify the executor of the amount of taxes due. If this amount is paid, the executor will be discharged from personal liability for any future deficiencies. If the IRS has not notified the executor, he or she will be discharged from personal liability at the end of the 9-month period.



Even if the executor is discharged from personal liability, the IRS still will be able to assess tax deficiencies against the executor to the extent that he or she still has any of the decedent’s property.

Joint return. Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if no personal representative has been appointed before the due date for filing the final joint return for the year of death. This also applies to the return for the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return. The income of the decedent that was includable on his or her return for the year up to the date of death (as explained under *Determining income and deductions*, earlier) and the income of the surviving spouse for the entire year must be included in the final joint return.

A final joint return with the decedent cannot be filed if the surviving spouse remarried before the end of the year of the decedent’s death. The filing status of the decedent in this instance is “married filing separate return.”

Personal representative may revoke joint return election. A court-appointed personal representative may revoke an election to file a joint return that was previously made by the surviving spouse alone. This is done by filing a separate return for the decedent within one year from the due date of the return (including any extensions). The joint return made by the surviving spouse will then be regarded as the separate return of that spouse by excluding the decedent’s items and refiguring the tax liability.

How To Report Certain Income

This section explains how to report certain types of income on the final return. The rules on income discussed in the other chapters of this publication also apply to a decedent’s final return. See chapters 6 through 17, if they apply.

Interest and Dividend Income (Forms 1099)

A Form 1099 should be received for the decedent to report interest and dividends earned before death. These amounts must be included on the decedent’s final return. A separate Form 1099 should show the interest and dividends earned after the date of the decedent’s death and paid to the estate or other recipient that must include those amounts on its return. You can request corrected Forms 1099 if these forms do not properly reflect the right recipient or amounts.

For example, a Form 1099-INT reporting interest payable to the decedent may include income that should be reported on the final income tax return of the decedent, as well as income that the estate or other recipient should report, either as income earned after death or as income in respect of the decedent (discussed later). For income earned after death, you should ask the payer for a Form 1099 that prop-

Form 1040

Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return 2001

IRS Use Only—Do not write or staple in this space.

Label

(See instructions on page 19.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE

For the year Jan. 1-Dec. 31, 2001, or other tax year beginning , 2001, ending , 20
LP JOHN S & JANE M STONE 1772 OAK ST SHERIDAN WY 82801
CAR-RT SORT**CRO1 S29 30 IRS

OMB No. 1545-0074
Your social security number 765 00 4321
Spouse's social security number 123 00 4567

Important! You must enter your SSN(s) above.

Presidential Election Campaign

Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund? Yes No

Filing Status

1 Single
2 Married filing joint return (even if only one had income)

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? Yes. Complete the following. No

Designee's name Phone no. () Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Joint return? See page 19. Keep a copy for your records.

Your signature Jane M. Stone Date 4/1/02 Your occupation Engineer Daytime phone number ()
Spouse's signature. If a joint return, both must sign. Filing as surviving spouse

Paid Preparer's Use Only

Preparer's signature Date Check if self-employed Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code EIN Phone no. ()

Form 1040 (2001)

erly identifies the recipient (by name and identification number) and the proper amount. If that is not possible, or if the form includes an amount that represents income in respect of the decedent, report the interest, as shown next under How to report.

See U.S. savings bonds acquired from decedent in Publication 559 for information on savings bond interest that may have to be reported on the final return.

How to report. If you are preparing the decedent's final return and you have received a Form 1099-INT for the decedent that includes amounts belonging to the decedent and to another recipient (the decedent's estate or another beneficiary), report the total interest shown on Form 1099-INT on Schedule 1 (Form 1040A) or on Schedule B (Form 1040). Next, enter a subtotal of the interest shown on Forms 1099 and the interest reportable from other sources for which you did not receive Forms 1099. Then, show any interest (including any interest you receive as a nominee) belonging to another recipient separately and subtract it from the subtotal. Identify this adjustment as a "Nominee Distribution" or other appropriate designation.

Report dividend income for which you received a Form 1099-DIV, Dividends and Distributions, on the appropriate schedule using the same procedure.

Note. If the decedent received amounts as a nominee, you must give the actual owner a Form 1099, unless the owner is the decedent's

spouse. See General Instructions for Forms 1099, 1098, 5498, and W-2G, for more information on filing forms 1099.

Accelerated Death Benefits

Accelerated death benefits are amounts received under a life insurance contract before the death of the insured individual. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider.

Generally, if the decedent received accelerated death benefits either on his or her own life or on the life of another person, those benefits are not included in the decedent's income. This exclusion applies only if the insured was a terminally or chronically ill individual. For more information, see Accelerated death benefits under Gifts, Insurance, and Inheritances in Publication 559.

Business Income

This section discusses some of the business income which may have to be included on the final return.

Partnership income. The death of a partner closes the partnership's tax year for that partner. Generally, it does not close the partnership's tax year for the remaining partners. The decedent's distributive share of partnership items must be

figured as if the partnership's tax year ended on the date the partner died. To avoid an interim closing of the partnership books, the partners can agree to estimate the decedent's distributive share by prorating the amounts the partner would have included for the entire partnership tax year.

On the decedent's final return, include the decedent's distributive share of partnership items for the following periods.

- 1) The partnership's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
2) The period, if any, from the end of the partnership's tax year in (1) to the decedent's date of death.

S corporation income. If the decedent was a shareholder in an S corporation, include on the final return the decedent's share of the S corporation's items of income, loss, deduction, and credit for the following periods.

- 1) The corporation's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
2) The period, if any, from the end of the corporation's tax year in (1) to the decedent's date of death.

Self-employment income. Include self-employment income actually or constructively received or accrued, depending on the decedent's

accounting method. (See *Constructive receipt of income*, under *Income To Include*, in Publication 559 for an explanation of the concept.) For self-employment tax purposes only, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For this purpose, the partnership income or loss is considered to be earned ratably over the partnership's tax year. For more information on how to compute self-employment income, see Publication 533, *Self-Employment Tax*.

Roth IRA

Any amount not previously reported must be included on the decedent's final return, if the decedent:

- Died in 2001,
- Withdrew an amount from a traditional IRA in 1998,
- Converted the amount to a Roth IRA, and
- Included the taxable conversion amount in income over the 4-year period beginning in 1998.

For more information on Roth IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs)*.

Coverdell Education Savings Account (ESA)

Generally, the balance in a Coverdell ESA must be distributed within 30 days after the individual for whom the account was established reaches age 30, or dies, whichever is earlier. The treatment of the Coverdell ESA at the death of an individual under age 30 depends on who acquires the interest in the account. If the decedent's estate acquires the interest, the earnings on the account must be included on the final income tax return of the decedent. The estate tax deduction, discussed later, does not apply to this amount. If a beneficiary acquires the interest, see the discussion under *Income in Respect of the Decedent*, later.



For tax years beginning after 2001, the age 30 limit does not apply if the individual for whom the account was established or the beneficiary that acquires the account is an individual with special needs. This includes an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

For more information on Coverdell ESAs, see Publication 970, *Tax Benefits for Higher Education*.

Archer MSA

The treatment of an Archer MSA (medical savings account), including a Medicare+Choice MSA, at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquires the

interest, the fair market value of the assets in the account on the date of death is included in income on the decedent's final return. The estate tax deduction, discussed later, does not apply to this amount.

If a beneficiary acquires the interest, see the discussion under *Income in Respect of the Decedent*, later. For more information on Archer MSAs, see Publication 969, *Medical Savings Accounts (MSAs)*.

Exemptions, Deductions, and Credits

Generally, the rules for exemptions, deductions, and credits allowed to an individual also apply to the decedent's final income tax return. Show on the final return deductible items the decedent paid (or accrued, if the decedent reported deductions on an accrual method) before death.

Exemptions

You can claim the decedent's personal exemption on the final income tax return. If the decedent was another person's dependent (for example, a parent's), you cannot claim the personal exemption on the decedent's final return.

Standard Deduction

If you do not itemize deductions on the final return, the full amount of the appropriate standard deduction is allowed regardless of the date of death. For information on the appropriate standard deduction, see chapter 21.

Itemized Deductions

If the total of the decedent's itemized deductions is more than the decedent's standard deduction, the federal income tax will generally be less if you claim itemized deductions on the final return. See chapters 23 through 30 for the types of expenses that are allowed as itemized deductions.

Medical expenses. Medical expenses paid before death by the decedent are deductible, subject to limits, on the final income tax return if deductions are itemized. This includes expenses for the decedent as well as for the decedent's spouse and dependents.



Qualified medical expenses are not deductible if paid with a tax-free distribution from an Archer MSA.

For information on certain medical expenses that were not paid before death, see *Decedents* in chapter 23.

Unrecovered investment in pension. If the decedent was receiving a pension or annuity and died without a surviving annuitant, you can take a deduction on the decedent's final return for the amount of the decedent's investment in the pension or annuity contract that remained unrecovered at death. The deduction is a miscellaneous itemized deduction that is not subject to the 2% limit on adjusted gross income. See chapter 30.

Deduction for Losses

A decedent's net operating loss deduction from a prior year and any capital losses (including capital loss carryovers) can be deducted only on the decedent's final income tax return. A net operating loss on the decedent's final income tax return can be carried back to prior years. You cannot deduct any unused net operating loss or capital loss on the estate's income tax return.

Credits

Any of the tax credits discussed in this publication also apply to the final return if the decedent was eligible for the credits at the time of death. These credits are discussed in chapters 33 through 38.

Tax withheld and estimated payments. There may have been income tax withheld from the decedent's pay, pensions, or annuities before death, and the decedent may have paid estimated income tax. To get credit for these tax payments, you must claim them on the decedent's final return. For more information, see *Credit for Withholding and Estimated Tax* in chapter 5.

Tax Effect on Others

This section contains information about the effect of an individual's death on the income tax liability of the survivors (including the widow or widower and any beneficiaries) and the estate. A survivor should coordinate the filing of his or her own tax return with the personal representative handling the decedent's estate. The personal representative can coordinate filing status, exemptions, income, and deductions so that the decedent's final return and the income tax returns of the survivors and the estate are all filed correctly.

Gifts and inheritances. Property received as a gift, bequest, or inheritance is not included in your income. However, if property you receive in this manner later produces income, such as interest, dividends, or rent, that income is taxable to you. If the gift, bequest, or inheritance you receive is the income from property, that income is taxable to you.

If you inherited the right to receive income in respect of the decedent, see *Income in Respect of the Decedent*, later.

Joint return by surviving spouse. A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following 2 years. For more information, see *Qualifying Widow(er) With Dependent Child* in chapter 2.

Decedent as your dependent. If the decedent qualified as your dependent for the part of the year before death, you can claim the exemption for the dependent on your tax return, regardless of when death occurred during the year.

If the decedent was your qualifying child, you may be able to claim the child tax credit. See chapter 35.

Income in Respect of the Decedent

All gross income that the decedent would have received had death not occurred and that was not properly includible on the final return, discussed earlier, is income in respect of the decedent.

How To Report

Income in respect of a decedent must be included in the income of one of the following.

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.



If you have to include income in respect of the decedent in your gross income, you may be able to claim a deduction for the estate tax paid on that income. For more information, see Estate Tax Deduction, later.

Example 1. Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for \$2,000, but did not receive payment before his death. The proceeds from the sale are income in respect of the decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the \$2,000, she must include that amount in her return. It is not to be reported on the final return of the decedent or on the return of the estate.

Example 2. Assume the same facts as in Example 1, except that Frank used the accrual method of accounting. The amount accrued from the sale of the apples would be included on his final return. Neither the estate nor the widow will realize income in respect of the decedent when the money is later paid.

Example 3. Cathy O'Neil was entitled to a large salary payment at the date of her death. The amount was to be paid in five annual installments. The estate, after collecting two installments, distributed the right to the remaining installments to you, the beneficiary. The payments are income in respect of the decedent. None of the payments were includible in Cathy's final return. The estate must include in its income the two installments it received, and you must include in your income each of the three installments as you receive them.

Transferring your right to income. If you transfer your right to income in respect of a decedent, you must include in your income the greater of:

- 1) The amount you receive for the right, or
- 2) The fair market value of the right at the time of the transfer.

Fair market value (FMV). FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

Giving your right to income as a gift. If you give your right to receive income in respect of a decedent as a gift, you must include in your income the fair market value of the right at the time you make the gift.

Type of income. The character or type of income that you receive in respect of a decedent is the same as it would be to the decedent if he or she were alive. If the income would be a capital gain to the decedent, it will be a capital gain to you.

Interest accrued on savings certificates. The interest accrued on savings certificates (redeemable after death without forfeiture of interest) that is for the period from the date of the last interest payment to the date of the decedent's death, but not received as of that date, is income in respect of the decedent. Interest for a period after the decedent's death that becomes payable on the certificates after death is not income in respect of the decedent, but is taxable income includible in the income of the respective recipients.

Installment obligations. If the decedent had sold property using the installment method and you have the right to collect the payments, use the same gross profit percentage the decedent would have used to figure the part of each payment that represents profit. Include in your income the same profit the decedent would have included had death not occurred. For more information on installment sales, see Publication 537, *Installment Sales*.

If you dispose of an installment obligation acquired from a decedent (other than by transfer to the obligor), the rules explained in Publication 537 for figuring gain or loss on the disposition apply to you.

Inherited IRAs. If a beneficiary receives a lump-sum distribution from a traditional IRA he or she inherited, all or some of it may be taxable. The distribution is taxable in the year received as income in respect of a decedent up to the decedent's taxable balance. This is the decedent's balance at the time of death, including unrealized appreciation and income accrued to date of death, minus any basis (nondeductible contributions). Amounts distributed that are more than the decedent's entire IRA balance (including taxable and nontaxable amounts) at the time of death are the income of the beneficiary.

If the beneficiary of a traditional IRA is the decedent's surviving spouse who properly rolls over the distribution into another traditional IRA or into a Roth IRA, the distribution is not currently taxed. For distributions after 2001, a surviving spouse can also roll over tax free the taxable part of the distribution into a qualified plan, section 403 annuity, or section 457 plan.

Example 1. At the time of his death, Greg owned a traditional IRA. All of the contributions by Greg to the IRA had been deductible contributions. Greg's nephew, Mark, was the sole beneficiary of the IRA. The entire balance of the IRA, including income accruing before and after

Greg's death, was distributed to Mark in a lump sum. Mark must include the total amount received in his income. The portion of the lump-sum distribution that equals the amount of the balance in the IRA at Greg's death, including the income earned before death, is income in respect of the decedent. Mark may take a deduction for any federal estate taxes that were paid on that portion.

Example 2. Assume the same facts as in Example 1, except that some of Greg's contributions to the IRA had been nondeductible contributions. To determine the amount to include in income, Mark must subtract the total nondeductible contributions made by Greg from the total amount received (including the income that was earned in the IRA both before and after Greg's death). Income in respect of the decedent is the total amount included in income less the income earned after Greg's death.

For more information on inherited IRAs, see Publication 590.

Roth IRAs. Qualified distributions from a Roth IRA are not subject to tax. A distribution made to a beneficiary or to the Roth IRA owner's estate on or after the date of death is a qualified distribution if it is made after the 5-year tax period beginning with the first tax year in which a contribution was made to any Roth IRA of the owner.



A distribution cannot be a qualified distribution unless it is made after 2002.

Generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over his or her life or life expectancy. If paid as an annuity, the distributions must begin before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, the spouse can delay the distributions until the decedent would have reached age 70½ or can treat the Roth IRA as his or her own Roth IRA.

Part of any distribution to a beneficiary that is not a qualified distribution may be includible in the beneficiary's income. Generally, the part includible is the earnings in the Roth IRA. Earnings attributable to the period ending with the decedent's date of death are income in respect of the decedent. Additional earnings are the income of the beneficiary.

For more information on Roth IRAs, see Publication 590.

Coverdell education savings account (ESA). Generally, the balance in a Coverdell ESA must be distributed within 30 days after the individual for whom the account was established reaches age 30 or dies, whichever is earlier. The treatment of the Coverdell ESA at the death of an individual under age 30 depends on who acquires the interest in the account. If the decedent's estate acquires the interest, see the discussion under *How To Report Certain Income*, earlier.



For tax years beginning after 2001, the age 30 limit does not apply if the individual for whom the account was established or the beneficiary that acquires the account is an individual with special needs. This includes an individual who because of a physi-

cal, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

If the decedent's spouse or other family member is the designated beneficiary of the decedent's account, the Coverdell ESA becomes that person's Coverdell ESA. It is subject to the rules discussed in Publication 970.

Any other beneficiary (including a spouse or family member who is not the designated beneficiary) must include in income the earnings portion of the distribution. Any balance remaining at the close of the 30-day period is deemed to be distributed at that time. The amount included in income is reduced by any qualified higher education expenses of the decedent that are paid by the beneficiary within 1 year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary other than the decedent's spouse or family member.

Archer MSA. The treatment of an Archer MSA, including a Medicare+Choice MSA, at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquires the interest, see the earlier discussion under *How To Report Certain Income*.

If the decedent's spouse is the designated beneficiary of the account, the account becomes that spouse's Archer MSA. It is subject to the rules discussed in Publication 969.

Any other beneficiary (including a spouse that is not the designated beneficiary) must in-

clude in income the fair market value of the assets in the account on the decedent's date of death. This amount must be reported for the beneficiary's tax year that includes the decedent's date of death. The amount included in income is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within 1 year after the decedent's date of death. An estate tax deduction, discussed later, applies to the amount included in income by a beneficiary other than the decedent's spouse.

Other income. For examples of other income situations concerning decedents, see *Specific Types of Income in Respect of a Decedent* in Publication 559.

Deductions in Respect of the Decedent

Items such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but that are not properly allowable as deductions on the decedent's final income tax return will be allowed as a deduction to one of the following when paid.

- The estate.
- The person who acquired an interest in the decedent's property (subject to such obligations) because of the decedent's

death, if the estate was not liable for the obligation.

Estate Tax Deduction

Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income.

The deduction for estate tax can be claimed only for the same tax year in which the income in respect of the decedent must be included in the recipient's income. (This also is true for income in respect of a prior decedent.)

You can claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions as discussed in chapter 30.

If the income in respect of the decedent is capital gain income, the gain must be reduced, but not below zero, by any estate tax deduction attributable to that gain when figuring the maximum capital gain tax, the 50% exclusion for gain on small business stock, or any net capital loss limitation.

For more information, see *Estate Tax Deduction* in Publication 559.

5.

Tax Withholding and Estimated Tax

Important Change for 2001

Estimated tax safe harbor for higher income taxpayers. For installment payments for tax years beginning in 2001, the estimated tax safe harbor for higher income individuals (other than farmers and fishermen) has been modified. If your adjusted gross income was more than \$150,000 (\$75,000 if you are married filing a separate return), you must have deposited the smaller of 90% of your expected tax for 2001 or 110% of the tax shown on your 2000 return to avoid an estimated tax penalty.

Important Changes for 2002

Tax law changes for 2002. When you figure how much income tax you want withheld from your pay and when you figure your estimated tax for 2002, consider tax law changes effective in 2002. See *Important Changes for 2002* in the front of this publication, or get Publication 553, *Highlights of 2001 Tax Changes*.

Certain withholding rates decreased. The withholding rates on the following items have been decreased.

- 1) **Gambling winnings.** The rate has decreased from 28% to 27%.
- 2) **Unemployment compensation.** The rate has decreased from 15% to 10%.
- 3) **Federal payments.** Withholding on certain federal payments is voluntary. The elective rates have been decreased to 7%, 10%, 15%, and 27%.
- 4) **Backup withholding.** The rate has decreased from 31% to 30%.
- 5) **Supplemental wages.** The rate has decreased from 28% to 27%.

Withholding on these items is discussed later in this chapter.

Important Reminders

Unemployment compensation. You can choose to have income tax withheld from your unemployment compensation. See *Unemploy-*

ment Compensation under *Withholding*, later, for more information.

Federal payments. You can choose to have income tax withheld from certain federal payments you get. These payments include social security and tier 1 railroad retirement benefits. For more information, see *Federal Payments* under *Withholding*, later.

Claiming withholding and estimated tax payments. When you file a federal income tax return, be sure to take credit for all federal income tax and excess social security or railroad retirement taxes withheld from your salary, wages, pensions, etc., and any backup withholding shown on Forms 1099. Also, take credit for all estimated tax payments you made for that year. For example, all estimated tax payments made for 2001 should be claimed on the tax return you file for the 2001 tax year. You should file a return and claim these credits even if you do not owe tax. See *Credit for Withholding and Estimated Tax*, later, in this chapter.

Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go.

- **Withholding.** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income — including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service (IRS) in your name.
- **Estimated tax.** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, capital gains, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- **Credit for withholding and estimated tax.** When you file your 2001 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 2001, and
- **Underpayment penalty.** If you did not pay enough tax during the year either through withholding or by making estimated tax payments, you may have to pay a penalty. The IRS usually can figure this penalty for you. See *Underpayment Penalty* at the end of this chapter.

Useful Items

You may want to see:

Publication

- 505** Tax Withholding and Estimated Tax
- 553** Highlights of 2001 Tax Changes
- 919** How Do I Adjust My Tax Withholding?

Form (and Instructions)

- W-4** Employee's Withholding Allowance Certificate
- W-4P** Withholding Certificate for Pension or Annuity Payments
- W-4S** Request for Federal Income Tax Withholding From Sick Pay
- W-4V** Voluntary Withholding Request
- 1040-ES** Estimated Tax for Individuals
- 2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

Withholding

This chapter discusses withholding on these types of income:

- Salaries and wages,
- Tips,
- Taxable fringe benefits,
- Sick pay,
- Pensions and annuities,
- Gambling winnings,
- Unemployment compensation, and
- Certain federal payments.

This chapter explains in detail the rules for withholding tax from each of these types of income.

This chapter also covers backup withholding on interest, dividends, and other payments.

Salaries and Wages

Income tax is withheld from the pay of most employees. Your pay includes your regular pay, bonuses, commissions, and vacation allowances. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages*, later, for more information about reimbursements and allowances paid under a nonaccountable plan.

Military retirees. Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

Household workers. If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated

tax payments, as discussed later under *Estimated Tax*.

Farmworkers. Income tax is generally withheld from your cash wages for work on a farm unless your employer both:

- 1) Pays you cash wages of less than \$150 during the year, and
- 2) Has expenditures for agricultural labor totaling less than \$2,500 during the year.

If you receive either noncash wages or cash wages not subject to withholding, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax*.

Determining Amount of Tax Withheld

The amount of income tax your employer withholds from your regular pay depends on two things.

- 1) The amount you earn.
- 2) The information you give your employer on **Form W-4**.

Form W-4 includes three types of information that your employer will use to figure your withholding.

- 1) Whether to withhold at the single rate or at the lower married rate.
- 2) How many withholding allowances you claim. (Each allowance reduces the amount withheld.)
- 3) Whether you want an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. This is explained under *Exemption From Withholding*, later.

Note. You must specify a filing status and a number of withholding allowances on Form W-4. You cannot specify only a dollar amount of withholding.

New job. When you start a new job, you must fill out Form W-4 and give it to your employer. Your employer should have copies of the form. If you need to change the information, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method. See *Part-year method* in chapter 1 of Publication 505 for more information.

Changing your withholding. Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

You **must** give your employer a new Form W-4 within 10 days after either of the following.

- 1) Your divorce, if you have been claiming married status.
- 2) Any event that decreases the number of withholding allowances you can claim.

Generally, you can submit a new Form W-4 whenever you wish to change the number of your withholding allowances for any other reason.

Changing your withholding for 2003. If events in 2002 will decrease the number of your withholding allowances for 2003, you **must** give your employer a new Form W-4 by December 1, 2002. If the event occurs in December 2002, submit a new Form W-4 within 10 days.

Cumulative wage method. If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, bi-weekly, etc.) since the beginning of the year.

Checking your withholding. After you have given your employer a Form W-4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of Tax Withheld*, later. If too much or too little tax is being withheld, you should give your employer a new Form W-4 to change your withholding.

Note. You cannot give your employer either a payment to cover withholding for past pay periods or a payment for estimated tax.

Completing Form W-4

Form W-4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

You do not have to use the worksheets if you use a more accurate method of figuring the number of withholding allowances. See *Alternative method of figuring withholding allowances* under *Completing Form W-4 and Worksheets* in chapter 1 of Publication 505 for more information.

Two jobs. If you have income from two jobs at the same time, complete only one set of Form W-4 worksheets. Then split your allowances between the Forms W-4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them any other way.

Married individuals. If both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances any way, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

Personal allowances worksheet. Use the *Personal Allowances Worksheet* on page 1 of Form W-4 to figure your withholding allowances for exemptions and any special allowances that apply.

Deductions and adjustments worksheet. Fill out this worksheet to adjust the number of your withholding allowances for deductions, adjustments to income, and tax credits. The *Deductions and Adjustments Worksheet* is on page 2 of Form W-4. Chapter 1 of Publication 505 explains this worksheet.

Two-earner/two-job worksheet. You may need to complete this worksheet if you have two jobs or a working spouse. You can also add to the amount, if any, on line 8 of this worksheet, any additional withholding necessary to cover any amount you expect to owe other than income tax, such as self-employment tax.

Getting the Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if you follow these two rules.

- 1) You accurately complete all the Form W-4 worksheets that apply to you.
- 2) You give your employer a new Form W-4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

- You are married and both you and your spouse work.
- You have more than one job at a time.
- You have nonwage income, such as interest, dividends, alimony, unemployment compensation, or self-employment income.
- You will owe additional amounts with your return, such as self-employment tax.
- Your withholding is based on obsolete Form W-4 information for a substantial part of the year.
- Your earnings are more than \$150,000 if you are single or \$200,000 if you are married.

To make sure you are getting the right amount of tax withheld, get Publication 919. It will help you compare the total tax to be withheld during the year with the tax you can expect to figure on your return. It also will help you determine how much additional withholding, if any, is needed each payday to avoid owing tax when you file your return. If you do not have enough tax withheld, you may have to make estimated tax payments, as explained under *Estimated Tax*, later.

Rules Your Employer Must Follow

It may be helpful for you to know some of the withholding rules your employer must follow. These rules can affect how to fill out your Form W-4 and how to handle problems that may arise.

New Form W-4. When you start a new job, your employer should give you a Form W-4 to fill out. Your employer will use the information you give on the form to figure your withholding beginning with your first payday.

If you later fill out a new Form W-4, your employer can put it into effect as soon as possible. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

No Form W-4. If you do not give your employer a completed Form W-4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

Repaying withheld tax. If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W-4. Your employer cannot repay any of the tax previously withheld.

However, if your employer has withheld more than the correct amount of tax for the Form W-4 you have in effect, you do not have to fill out a new Form W-4 to have your withholding lowered to the correct amount. Your employer can repay the amount that was incorrectly withheld. If you are not repaid, your Form W-2 will reflect the full amount actually withheld.

Exemption From Withholding

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 2002 only if **both** the following situations apply.

- 1) For **2001** you had a right to a refund of all federal income tax withheld because you had no tax liability.
- 2) For **2002** you expect a refund of all federal income tax withheld because you expect to have no tax liability.

Student. If you are a student, you are not automatically exempt. See chapter 1 to see whether you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

Age 65 or older or blind. If you are 65 or older or blind, use one of the worksheets in chapter 1 of Publication 505, under *Exemption From Withholding*, to help you decide whether you can claim exemption from withholding. Do not use either of those worksheets if you will itemize deductions or claim exemptions for dependents or claim tax credits on your 2002 return. See *Itemizing deductions or claiming exemptions or tax credits* in Publication 505.

Claiming exemption from withholding. To claim exemption, you must give your employer a Form W-4. Print "EXEMPT" on line 7.

Your employer must send the IRS a copy of your Form W-4 if you claim exemption from withholding and your pay is expected to usually be more than \$200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W-4 within 10 days after the change. If you claim exemption in 2002, but you expect to owe income tax for 2003, you must file a new Form W-4 by December 1, 2002.

An exemption is good for only one year. You must give your employer a new Form W-4 by February 15 each year to continue your exemption.

Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. The payer can figure withholding on supplemental wages using the same method used for your regular wages. If these payments are identified separately from your regular wages, your employer or other payer of supplemental wages can withhold income tax from these wages at a flat rate of 27%.

Expense allowances. Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan that are more than your proven expenses are treated as paid under a nonaccountable plan if you do not return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in chapter 28.

Penalties

You may have to pay a penalty of \$500 if both of the following apply.

- 1) You make statements or claim withholding allowances on your Form W-4 that reduce the amount of tax withheld.
- 2) You have no reasonable basis for those statements or allowances at the time you prepare your Form W-4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W-4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to \$1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W-4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error — an honest mistake — will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances cor-

rectly, but claims seven when the proper number is six, will not be charged a W-4 penalty.

Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income*.

How employer figures amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways.

- 1) By withholding at the regular rate on the sum of your pay plus your reported tips.
- 2) By withholding at the regular rate on your pay plus an amount equal to 27% of your reported tips.

Not enough pay to cover taxes. If your regular pay is too low for your employer to withhold all the tax (including social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you can give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security tax, Medicare tax, or railroad retirement tax as possible, up to the proper amount, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you also may have to pay any social security tax, Medicare tax, or railroad retirement tax your employer could not withhold.

Allocated tips. Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your **reported tips**. Your employer should refund to you any incorrectly withheld tax. See *Allocated Tips* in chapter 7 for more information.

Taxable Fringe Benefits

The value of certain fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay for the period the benefits are paid or considered paid.

For information on fringe benefits, see *Fringe Benefits* under *Employee Compensation* in chapter 6.

Your employer can choose not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle provided by your employer. Your employer must notify you if this choice is made.

For more information on withholding on taxable fringe benefits, see chapter 1 of Publication 505.

Sick Pay

Sick pay is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as sick pay, it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld. An agent who does not pay regular wages to you may choose to withhold income tax at a flat 27% rate.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W-4S*, later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

Union agreements. If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding. See your union representative or your employer for more information.

Form W-4S. If you choose to have income tax withheld from sick pay paid by a third party, such as an insurance company, you must fill out *Form W-4S, Request for Federal Income Tax Withholding From Sick Pay*. Its instructions contain a worksheet you can use to figure the amount you want withheld. They also explain restrictions that may apply.

Give the completed form to the payer of your sick pay. The payer must withhold according to your directions on the form.

If you do not request withholding on *Form W-4S*, or if you do not have enough tax withheld, you may have to make estimated tax payments. If you do not pay enough estimated tax or have enough income tax withheld, you may have to pay a penalty.

Pensions and Annuities

Income tax usually will be withheld from your pension or annuity distributions, unless you choose not to have it withheld. This rule applies to distributions from:

- A traditional individual retirement arrangement (IRA),
- A life insurance company under an endowment, annuity, or life insurance contract,
- A pension, annuity, or profit-sharing plan,
- A stock bonus plan, and
- Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments), within one year (nonperiodic payments), or as an eligible

rollover distribution (ERD). You cannot choose not to have income tax withheld from an ERD.

More information. For more information on taxation of annuities and distributions (including eligible rollover distributions) from qualified retirement plans, see chapter 11. For information on IRAs, see chapter 18. For more information on withholding on pensions and annuities, including a discussion of **Form W-4P**, see *Pensions and Annuities* in chapter 1 of Publication 505.

Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. For 2002, the amount withheld is 27% of the proceeds paid (the amount of your winnings minus the amount of your bet).

Gambling winnings of more than \$5,000 from the following sources are subject to income tax withholding.

- Any sweepstakes, wagering pool, or lottery.
- Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not paid in cash are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines generally are not subject to income tax withholding. However, you may need to provide the payer with a social security number to avoid withholding. See *Backup withholding on gambling winnings* in Publication 505. If you receive gambling winnings not subject to withholding, you may need to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax through withholding or estimated tax payments, you may be subject to a penalty. See *Underpayment Penalty*, later.

Form W-2G. If a payer withholds income tax from your gambling winnings, you should receive a *Form W-2G, Certain Gambling Winnings*, showing the amount you won and the amount withheld. Report the tax withheld on line 59 of *Form 1040*.

Unemployment Compensation

You can choose to have income tax withheld from unemployment compensation. To make this choice, you will have to fill out **Form W-4V, Voluntary Withholding Request** (or a similar form provided by the payer) and give it to the payer. The amount withheld will be 10% of each payment.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty*, later, for information.

Federal Payments

You can choose to have income tax withheld from certain federal payments you receive. These payments are:

- 1) Social security benefits,
- 2) Tier 1 railroad retirement benefits,
- 3) Commodity credit loans you choose to include in your gross income, and
- 4) Payments under the Agricultural Act of 1949 (7 U.S.C. 1421 et. seq.), or title II of the Disaster Assistance Act of 1988, as amended, that are treated as insurance proceeds and that you receive because:
 - a) Your crops were destroyed or damaged by drought, flood, or any other natural disaster, or
 - b) You were unable to plant crops because of a natural disaster described in (a).

To make this choice, you will have to fill out **Form W-4V, Voluntary Withholding Request**, (or a similar form provided by the payer) and give it to the payer. For 2002, you can choose to have 7%, 10%, 15%, or 27% of each payment withheld.

If you do not choose to have income tax withheld, you may have to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. See *Underpayment Penalty*, later, for information.

More information. For more information about the tax treatment of social security and railroad retirement benefits, see chapter 12. Get Publication 225, *Farmer's Tax Guide*, for information about the tax treatment of commodity credit loans or crop disaster payments.

Backup Withholding

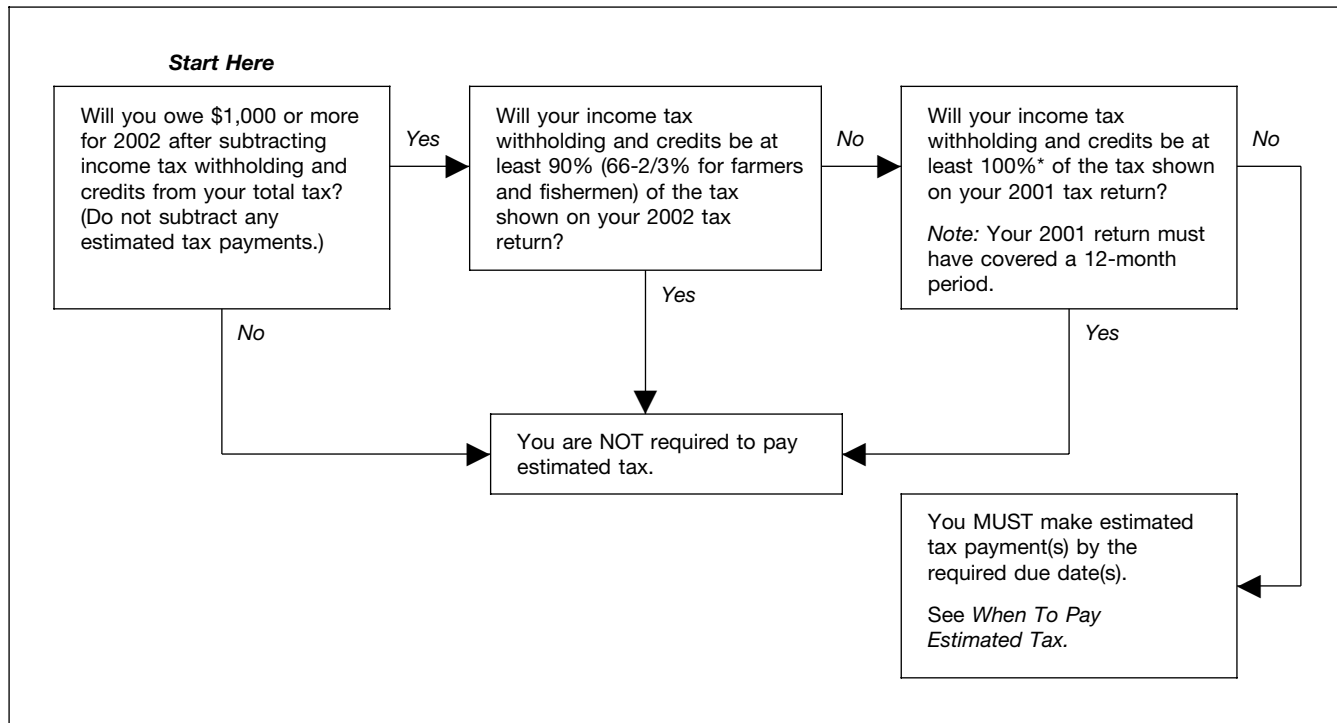
Banks and other businesses that pay you certain kinds of income must file an information return (*Form 1099*) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). TINs are explained in chapter 1.

These payments generally are not subject to withholding. However, "backup" withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on *Form 1099*.

For 2002, the payer must withhold at a flat 30% rate in the following situations.

- You do not give the payer your TIN in the required manner.
- The IRS notifies the payer that the TIN you gave is incorrect.
- You are required, but fail, to certify that you are not subject to backup withholding.
- The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS

Figure 5–A. Do You Have To Pay Estimated Tax?



* 112% if less than two-thirds of your gross income for 2001 and 2002 is from farming or fishing and your 2001 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 2002 is married filing a separate return).

will do this only after it has mailed you four notices over at least a 120-day period.

See *Backup Withholding* in chapter 1 of Publication 505 for more information.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000, or imprisonment of up to one year, or both.

Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax*, later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty*, later.

Who Must Make Estimated Tax Payments?

If you had a tax liability for 2001, you may have to pay estimated tax for 2002.

General rule. You must make estimated tax payments for 2002 if both of the following apply.

- 1) You expect to owe at least \$1,000 in tax for 2002 after subtracting your withholding and credits.
- 2) You expect your withholding and credits to be less than the smaller of:

- 90% of the tax to be shown on your 2002 tax return, or
- 100% of the tax shown on your 2001 tax return. Your 2001 tax return must cover all 12 months.

Special rules for farmers, fishermen, and higher income taxpayers. There are exceptions to the general rule for farmers, fishermen, and certain higher income taxpayers. See *Figure 5–A* and chapter 2 of Publication 505 for more information.

Aliens. Resident and nonresident aliens may also have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040–ES(NR)**, *U.S. Estimated Tax for Nonresident Alien Individuals*.

Avoiding estimated tax. If you receive salaries or wages, you can avoid having to make estimated tax payments by asking your employer to take more tax out of your earnings. To do this, file a new Form W–4 with your employer.

Estimated payments not required. You do not have to pay estimated tax for 2002 if you meet all three of the following conditions:

- 1) You had no tax liability for 2001.
- 2) You were a U.S. citizen or resident for the whole year.
- 3) Your 2001 tax year covered a 12-month period.

You had no tax liability for 2001 if your total tax was zero or you did not have to file an income tax return.

Married taxpayers. To figure whether you must make estimated tax payments, apply the rules discussed here to your separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint estimated tax payments even if you are not living together.

You and your spouse cannot make joint estimated tax payments if:

- 1) You are legally separated under a decree of divorce or separate maintenance,
- 2) Either spouse is a nonresident alien, or
- 3) You and your spouse have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 2002.

2001 separate returns and 2002 joint return. If you plan to file a joint return with your spouse for 2002, but you filed separate returns for 2001, your 2001 tax is the total of the tax shown on your separate returns. You filed a

separate return if you filed as single, head of household, or married filing separately.

2001 joint return and 2002 separate returns. If you plan to file a separate return for 2002, but you filed a joint return for 2001, your 2001 tax is your share of the tax on the joint return. You file a separate return if you file as single, head of household, or married filing separately. To figure your share of the tax on the joint return, first figure the tax both you and your spouse would have paid had you filed separate returns for 2001 using the same filing status as for 2002. Then multiply the tax on the joint return by the following fraction:

$$\frac{\text{The tax you would have paid had you filed a separate return}}{\text{The total tax you and your spouse would have paid had you filed separate returns}}$$

Example. Joe and Heather filed a joint return for 2001 showing taxable income of \$48,000 and a tax of \$7,557. Of the \$48,000 taxable income, \$40,000 was Joe's and the rest was Heather's. For 2002, they plan to file married filing separately. Joe figures his share of the tax on the 2001 joint return as follows:

Tax on \$40,000 based on a separate return	\$ 8,172
Tax on \$8,000 based on a separate return	1,204
Total	<u>\$ 9,376</u>
Joe's percentage of total (\$8,172 ÷ \$9,376)	87%
Joe's share of tax on joint return (\$7,557 × 87%)	<u>\$ 6,574</u>

How To Figure Estimated Tax

To figure your estimated tax, you must figure your expected adjusted gross income, taxable income, taxes, deductions, and credits for the year.

When figuring your 2002 estimated tax, it may be helpful to use your income, deductions, and credits for 2001 as a starting point. Use your 2001 federal tax return as a guide. You can use Form 1040-ES to figure your estimated tax.

You must make adjustments both for changes in your own situation and for recent changes in the tax law. For 2002, there are several changes in the law. These changes are discussed in Publication 553, *Highlights of 2001 Tax Changes*, or visit the IRS Web Site at www.irs.gov.

Form 1040-ES includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For more complete information and examples of how to figure your estimated tax for 2002, see chapter 2 of Publication 505.

When To Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the

payment periods and due dates for estimated tax payments.

For the period:	Due date:
Jan. 1* through Mar. 31	April 15
Apr. 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 next year**

*If your tax year does not begin on January 1, see *Fiscal year taxpayers*, later.
**See *January payment*, later.

Saturday, Sunday, holiday rule. If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. For example, a payment due Saturday, June 15, 2002, will be on time if you make it by Monday, June 17, 2002.

January payment. If you file your 2002 Form 1040 or Form 1040A by January 31, 2003, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 15, 2003.

Fiscal year taxpayers. If your tax year does not start on January 1, see the Form 1040-ES instructions for your payment due dates.

When To Start

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in installments. If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installment payments by the due dates for the later periods.

No income subject to estimated tax during first period. If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments.

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
Before Apr. 1	Apr. 15	June 15 Sep. 15 Jan. 15 next year*
After Mar. 31 and before June 1	June 15	Sep. 15 Jan. 15 next year*
After May 31 and before Sep. 1	Sep. 15	Jan. 15 next year*

After Aug. 31 Jan. 15 (None)
next year*

*See *January payment*, and *Saturday, Sunday, holiday rule* under *When To Pay Estimated Tax*, earlier.

Change in estimated tax. After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

How much to pay to avoid a penalty. To determine how much you should pay by each payment due date, see *How To Figure Each Payment*, next. If the earlier discussions of *No income subject to estimated tax during first period* or *Change in estimated tax* apply to you, you may need to read *Annualized Income Installment Method* in Publication 505, for information on how to avoid a penalty.

How To Figure Each Payment

You should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. You can figure your required payment for each period by using either the regular installment method or the annualized income installment method. These methods are described in Publication 505. If you do not pay enough each payment period, you may be charged a penalty even if you are due a refund when you file your tax return.

File Form 2210 to avoid a penalty. If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return. To avoid the penalty, you must file Form 2210 with your 2002 tax return. You must also show that the total of your withholding and estimated tax payment for the period was at least as much as your annualized income installment. See chapter 4 of Publication 505 for more information.

Estimated Tax Payments Not Required

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your return under \$1,000.

How To Pay Estimated Tax

There are five ways to pay estimated tax.

- 1) By crediting an overpayment on your 2001 return to your 2002 estimated tax.
- 2) By sending in your payment with a payment-voucher from **Form 1040-ES**.

- 3) By paying electronically using the Electronic Federal Tax Payment System (EFTPS).
- 4) By direct debit if you are filing Form 1040 or Form 1040A electronically.
- 5) By credit card using a pay-by-phone system.

Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 2001 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 2002. On line 69 of Form 1040, or line 44 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments.

You can use all the credited amount toward your first payment, or you can spread it out in any way you choose among any or all of your payments.

If you ask that an overpayment be credited to your estimated tax for the next year, the payment is considered to have been made on the due date of the first estimated tax installment (April 15 for calendar year taxpayers). You cannot have any of that amount refunded to you after that due date until the close of that tax year. You also cannot use that overpayment in any other way after that date.

Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040-ES. If you made estimated tax payments last year, you should receive a copy of the 2002 Form 1040-ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040-ES from the IRS. After you make your first payment, a Form 1040-ES package with the preprinted vouchers will be mailed to you. Follow the instructions in the package to make sure you use the vouchers correctly.

Use the window envelopes that came with your Form 1040-ES package. If you use your own envelope, make sure you mail your payment-vouchers to the address shown in the Form 1040-ES instructions for the place where you live.



Do not use the address shown in the Form 1040 or Form 1040A instructions.

If you file a joint return and you are making joint estimated tax payments, please enter the names and social security numbers on the payment voucher in the same order as they will appear on the joint return.

Change of address. You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement

to the IRS Service Center where you filed your last return and provide all of the following:

- Your full name (and your spouse's full name),
- Your signature (and spouse's signature),
- Your old address (and spouse's old address if different),
- Your new address, and
- Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address*, for this purpose.

You can continue to use your old preprinted payment-vouchers until the IRS sends you new ones. However, **do not** correct the address on the old voucher.

Payment by Direct Debit or Credit Card

If you want to make estimated payments by direct debit or by credit card, see the Form 1040-ES instructions or *How To Pay Estimated Tax* in Publication 505.

Credit for Withholding and Estimated Tax

When you file your 2001 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 2001. These credits are subtracted from your tax. You should file a return and claim these credits, even if you do not owe tax.

If you had two or more employers and were paid wages of more than \$80,400 during 2001, too much social security or railroad retirement tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in chapter 38.

Withholding

If you had income tax withheld during 2001, you should receive a statement by January 31, 2002, showing your income and the tax withheld. Depending on the source of your income, you will receive:

- Form W-2, *Wage and Tax Statement*,
- Form W-2G, *Certain Gambling Winnings*, or
- A form in the 1099 series.

Forms W-2 and W-2G. You file Form W-2 with your income tax return. File Form W-2G with your return if it shows any federal income tax withheld from your winnings.

You should get at least two copies of each form you receive. Attach one copy to the front of your federal income tax return. Keep one copy for your records. You should also receive copies to file with your state and local returns.

Form W-2

Your employer should give you a Form W-2 for 2001 by January 31, 2002. You should receive a separate Form W-2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W-2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday).

If you ask for the form, your employer must give it to you within 30 days after receiving your written request or within 30 days after your final wage payment, whichever is later.

If you have not received your Form W-2 by February 1, 2002, you should ask your employer for it. If you do not receive it by February 15, call the IRS.

Form W-2 shows your total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. Include the federal income tax withheld (as shown on Form W-2) on:

- Line 59 if you file Form 1040,
- Line 37 if you file Form 1040A, or
- Line 8 if you file Form 1040EZ.

Form W-2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

Form W-2G

If you had gambling winnings in 2001, the payer may have withheld 27½% or 28% as income tax. If tax was withheld, the payer will give you a Form W-2G showing the amount you won and the amount of tax withheld.

Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 59 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ.

The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by February 1, 2002. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*,
- Form 1099-DIV, *Dividends and Distributions*,
- Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*,
- Form 1099-INT, *Interest Income*,
- Form 1099-MISC, *Miscellaneous Income*,
- Form 1099-OID, *Original Issue Discount*,
- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*,

- Form SSA-1099, *Social Security Benefit Statement*, and
- Form RRB-1099, *Payments by the Railroad Retirement Board*.

If you received the types of income reported on some forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

Form 1099-R. Attach Form 1099-R to your return if box 4 shows federal income tax withheld. Include the amount withheld in the total on line 59 of Form 1040 or line 37 of Form 1040A. You cannot use Form 1040EZ if you received payments reported on Form 1099-R.

Backup withholding. If you were subject to backup withholding on income you received during 2001, include the amount withheld, as shown on your Form 1099, in the total on line 59 of Form 1040, or line 37 of Form 1040A.

Form Not Correct

If you receive a form with incorrect information on it, you should ask the payer for a corrected form. Call the telephone number or write to the address given for the payer on the form. The corrected Form W-2G or Form 1099 you receive will be marked "Corrected." A special form, Form W-2c, *Corrected Wage and Tax Statement*, is used to correct a Form W-2.

Form Received After Filing

If you file your return and you later receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in chapter 1.

Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

Community property states are listed in chapter 2. For more information on these rules, and some exceptions, see Publication 555, *Community Property*.

Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day

of any month except December), you must follow special rules to determine your credit for federal income tax withholding. For a discussion of how to take credit for withholding on a fiscal year return, see *Fiscal Years* in chapter 3 of Publication 505.

Estimated Tax

Take credit for all your estimated tax payments for 2001 on line 60 of Form 1040 or line 38 of Form 1040A. Include any overpayment from 2000 that you had credited to your 2001 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

Name changed. If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

- When you made the payments,
- The amount of each payment,
- Which IRS address you sent the payments to,
- Your name when you made the payments, and
- Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

Separate Returns

If you and your spouse made separate estimated tax payments for 2001 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 2000.

Divorced Taxpayers

If you made joint estimated tax payments for 2001, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to

each spouse's individual tax as shown on your separate returns for 2001.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number (SSN) in the space provided on the front of Form 1040 or Form 1040A. If you divorced and remarried in 2001, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 60, Form 1040, or line 38, Form 1040A.

Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. Generally, you will **not** have to pay a penalty for 2001 if any of the following situations applies.

- The total of your withholding and estimated tax payments was at least as much as your 2000 tax (or 110% of your 2000 tax if your adjusted gross income was more than \$150,000 — \$75,000 if your 2001 filing status is married filing separately) and you paid all required estimated tax payments on time.
- The tax balance due on your return is no more than 10% of your total 2001 tax, and you paid all required estimated tax payments on time.
- Your total 2001 tax minus your withholding is less than \$1,000.
- You did not have a tax liability for 2000.
- You did not have any withholding taxes and your current year tax less any household employment taxes is less than \$1,000.

Special rules apply if you are a farmer or fisherman. See *Farmers and Fishermen* in chapter 4 of Publication 505 for more information.

IRS can figure the penalty for you. If you think you owe the penalty but you do not want to figure it yourself when you file your tax return, you may not have to. Generally, the IRS will figure the penalty for you and send you a bill. However, you must complete Form 2210 and file it with your return if you are able to lower or eliminate your penalty. See chapter 4 of Publication 505.

Part Two.

Income

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.

6.

Wages, Salaries, and Other Earnings

Important Reminder

Foreign income. If you are a U.S. citizen or resident alien, you must report income from sources outside the United States (foreign income) on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2, *Wage and Tax Statement*, or Form 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents, and royalties).

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

Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The topics include:

- Bonuses and awards,
- Sickness and injury benefits, and
- Special rules for certain employees.

The chapter explains what income is included in the employee's gross income and what is not included.

Useful Items

You may want to see:

Publication

- ❑ **463** Travel, Entertainment, Gift, and Car Expenses
- ❑ **503** Child and Dependent Care Expenses
- ❑ **505** Tax Withholding and Estimated Tax

- ❑ **525** Taxable and Nontaxable Income

Employee Compensation

This section discusses many types of employee compensation followed by a detailed explanation of fringe benefits.

If you are an employee, you should receive Form W-2 from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

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

Baby sitting. If you baby sit for relatives or neighborhood children, whether on a regular basis or only periodically, the rules for child-care providers apply to you.

Miscellaneous Compensation

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

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

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment. If you repay them in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in chapter 13.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, get Publication 463. If you are

reimbursed for moving expenses, get Publication 521, *Moving Expenses*.

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

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

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

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

- A length-of-service award if you received it for less than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

Example. Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at \$250, and two qualified plan awards of a stereo valued at \$1,000 and a set of golf clubs valued at \$500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, since the \$1,750 total value of the awards is more than \$1,600, Ben must include \$150 (\$1,750 - \$1,600) in his income.

Government cost-of-living allowances.

Cost-of-living allowances are generally included in your income. However, they are not included in your income if you are a federal civilian employee or a federal court employee who is stationed in Alaska, Hawaii, or outside the United States.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials. For more information, get Publication 516, *U.S. Government Civilian Employees Stationed Abroad*.

Note received for services. If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

If your employer gives you an unsecured note as payment for your services, payments on the note that are credited toward the principal amount of the note are compensation income when you receive them.

Retirement plan contributions. Generally, you must include in income amounts you pay into a retirement plan through payroll deductions. You recover your contributions tax free when you retire and receive benefits from the plan. See chapter 11 for more information about the tax treatment of retirement plan benefits.

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

Elective deferrals. If you chose to set aside part of your pay for retirement under a qualified deferred compensation arrangement (for example, a section 401(k) plan), the amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan, subject to a limit. For 2001, this limit is \$10,500 for all elective deferrals. If you set aside more than \$10,500, the excess must be included in your income for that year. See Publication 525 for a discussion of the tax treatment of corrective distributions of excess deferrals.

Elective deferrals are not excluded from wages for social security and Medicare taxes and benefits.

If you are a federal employee, this treatment applies to your contributions to the Thrift Savings Plan.

Employer's contributions to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. However, if your interest in the plan is subject to

a substantial risk of forfeiture (meaning you have a good chance of losing it) at the time of contribution, do not include the value of your interest in your income until it is no longer subject to a substantial risk of forfeiture.

Severance pay. Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract must be included in your income in the tax year you receive it.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included as wages on your Form W-2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. Attach to your tax return a copy of the receipt or statement given to you by the agency you repaid to explain the difference between the wages on the return and the wages on your Forms W-2.

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

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

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

- 1) A welfare fund.
- 2) A state sickness or disability fund.
- 3) An association of employers or employees.
- 4) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable.

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

Stock appreciation rights. Do not include a stock appreciation right granted by your employer in income until you exercise (use) the right. When you use the right, you are entitled to a cash payment equal to the fair market value of

the corporation's stock on the date of use minus the fair market value on the date the right was granted. You include the cash payment in your income in the year you use the right.

Stock options. If you receive a nonstatutory option to buy or sell stock or other property as payment for your services, you will usually have income either when you receive the option or when you exercise the option (use it to buy or sell the stock or other property). However, if your option is a statutory stock option, you usually will not have any income until you sell or exchange your stock. Your employer can tell you which kind of option you hold. For details, get Publication 525.

Restricted property. Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you may not have to include the value of the property in your income in the year you receive it. For details, see *Restricted Property* in Publication 525.

Dividends you receive on restricted stock are extra compensation to you. Your employer should include these payments on your Form W-2.

Stock you chose to include in income. Dividends you receive on restricted stock you chose to include in your income in the year transferred are treated the same as any other dividends. Report them on your return as dividends. For a discussion of dividends, see chapter 9.

For information on how to treat dividends reported on both your Form W-2 and Form 1099-DIV, see *Dividends received on restricted stock* in Publication 525.

Fringe Benefits

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

Accounting period. You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable noncash fringe benefits by using either of the following rules.

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

Your employer does not have to use the same accounting period for each fringe benefit, but

must use the same period for all employees who receive a particular benefit.

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

Form W-2. Your employer reports your taxable fringe benefits in box 1 (*Wages, tips, other compensation*) of Form W-2. The total value of your fringe benefits may also be noted in box 12. The value of your fringe benefits may be added to your other compensation on one Form W-2, or you may receive a separate Form W-2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

Accident or Health Plan

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

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Contributions you make to the plan are discussed in Publication 502, *Medical and Dental Expenses*.

Archer MSA contributions. Contributions by your employer to your Archer MSA (previously called a medical savings account) are not included in your income. Their total will be reported in box 12 of Form W-2 with code R. You must report this amount on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, and attach the form to your return.

If your employer does not make contributions to your MSA, you can make your own contributions to your MSA. These contributions are discussed in Publication 969, *Medical Savings Accounts (MSAs)*. Also, see Form 8853.

Adoption Assistance

You may be able to exclude from income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. See Publication 968, *Tax Benefits for Adoption*, for more information.

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

De Minimis (Minimal) Benefits

If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for

it, the value is not included in your income. Generally, the value of these benefits, such as discounts at company cafeterias, cab fares home when working overtime, and company picnics, is not included in your income.

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

Educational Assistance

You can exclude from your income up to \$5,250 of qualified employer-provided educational assistance. The exclusion does not apply to graduate-level courses beginning before January 1, 2002. For more information, see Publication 508, *Tax Benefits for Work-Related Education*.

Employer-Provided Vehicles

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

Your employer must determine the actual value of this fringe benefit to include in your income.



Certain employer-provided transportation can be excluded from gross income. See the discussion on Transportation, next.

Transportation

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

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

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

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of \$65 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than \$175 a month, regardless of its value.

If the benefits have a value that is more than these limits, the excess must be included in your income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- 1) For transporting employees between their homes and work place, and
- 2) On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, fare-card, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualified parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work in a commuter highway vehicle or carpool. It does not include parking at or near the employee's home.

Group-Term Life Insurance Premiums

Generally, the cost of up to \$50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of \$50,000 of coverage. If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you would otherwise include in your income. However, you cannot reduce the amount to include in your income by:

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

The amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 12 with code C.

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

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

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost

of the permanent benefits minus the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

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

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

- 1) You are permanently and totally disabled and have ended your employment.
- 2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
- 3) A charitable organization (defined in chapter 26) is the only beneficiary of the policy for the entire period the insurance is in force during the tax year. (You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.)

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

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

Life insurance agents. Full-time life insurance agents who are considered employees for social security and Medicare tax withholding purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

More than \$50,000 from one employer. If you have only one employer and you were insured at any time during the tax year for more than \$50,000 under a group-term life insurance policy, your taxable income from this source is included as other compensation on the Form W-2 you receive.

More than \$50,000 from two or more employers. If two or more employers provide you group-term life insurance coverage totaling more than \$50,000, you must figure how much to include in your income. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

Figuring the taxable cost. You figure the taxable cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage for the month (figured to the nearest tenth), less 50, by the cost from the following table. Use your age on the last day of the tax year. You must prorate the cost from the table if less than a full month of coverage is involved.

COST PER \$1,000 OF PROTECTION FOR ONE MONTH

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

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

Employer A coverage (in thousands)	\$35
Employer B coverage (in thousands)	+ 45
Total coverage (in thousands)	\$80
Minus: Exclusion (in thousands)	- 50
Excess amount (in thousands)	\$30
Multiply by cost per \$1,000 per month, age 51 (from table)	× .23
Cost of excess insurance for 1 month	\$6.90
Multiply by number of full months coverage at this cost	× 12
Cost of excess insurance for tax year	\$82.80
Minus: Premiums you paid (\$4.15 × 12 months)	-49.80
Cost to include in income as wages	\$33.00

Special Rules for Certain Employees

This section deals with special rules for people in certain types of employment: members of the clergy, members of religious orders, people working for foreign employers, military personnel, veterans, and certain volunteers.

Clergy

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. See chapter 26.

Housing. Special rules apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a housing allowance provided to you as part of your pay. The home or allowance must be provided as compensation for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allow-

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

Designation requirement. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

Homeowner. If you own your home or are buying it, you can exclude your housing allowance from your income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. The fair rental value of a home includes the fair rental value of the furnishings in it.

You can deduct on Schedule A (Form 1040) the qualified mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments. See chapters 24 and 25.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the housing exclusion. However, if you perform services as a teacher or administrator on the faculty of a nonchurch college, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.

TIP *If you live in faculty lodging as an employee of an educational institution or an academic health center, all or part of the value of that lodging may be nontaxable under a different rule. See Faculty lodging in the discussion on meals and lodging in Publication 525.*

If you serve as a minister of music or minister of education or serve in an administrative or other function of your religious organization, but are not authorized to perform substantially all of the religious duties of an ordained minister in your church (even if you are commissioned as a **minister of the gospel**), the housing exclusion does not apply to you.

Theological students. The housing exclusion does not apply if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. If you are an ordained minister and are providing evangelistic services,

you can exclude amounts received from out-of-town churches that are designated as a housing allowance, provided you actually use them to maintain your permanent home.

Retired members of the clergy. The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, the amount of your housing allowance that you spend for utilities, maintenance, repairs, and similar expenses that are directly related to providing a home is not income to you. These amounts are also not included in net earnings from self-employment.

The general convention of a national religious denomination can designate a housing allowance for retired ministers that can be excluded from income. This applies if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, include them on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

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

Members of Religious Orders

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

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

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your income.

Services performed outside the order. If you are directed to work outside the order, your services are not an exercise of duties required

by the order unless they meet both of the following requirements.

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

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

Example. Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his income.

Foreign Employer

Special rules apply if you work for a foreign employer.

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

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

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by employees of the United States in that foreign country and the foreign government gives an equal exemption to employees of the United States in that country.

Waiver of alien status. If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply. See *Foreign Employer* in Publication 525.

Employment abroad. For information on income earned abroad, get Publication 54.

Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more information on the tax treatment of military allowances and benefits, get Publication 3, *Armed Forces' Tax Guide*.

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your income as a pension on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. Do not include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For more information on survivor annuities, see chapter 11.

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

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

- 1) Education, training, and subsistence allowances.
- 2) Disability compensation and pension payments for disabilities paid either to veterans or their families.
- 3) Grants for homes designed for wheelchair living.
- 4) Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- 5) Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- 6) Interest on insurance dividends you leave on deposit with the VA.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are not treated as nontaxable veterans' benefits. Report these payments as income on line 21 of Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps or similar agency is covered in the following discussions.

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

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

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

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

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

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

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

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

Volunteer tax counseling. Do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

Sickness and Injury Benefits

This section discusses many types of sickness and injury benefits including disability benefits and military and government disability pensions.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, see chapter 34.

Disability pensions. Generally, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury.

Cost paid by you. If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive from the plan for personal injury or sickness as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Reimbursement in a later year* in chapter 23.

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

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your income in the tax year you receive it.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity. For more information on pensions, see chapter 11.

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

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. The rules for reporting pensions are explained in *How To Report* in chapter 11.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

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

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

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

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

Pension based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But if it is a result of active service in one of the listed government services and one of the listed conditions applies, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

Terrorist attack. Do not include in your income disability payments you receive for injuries resulting directly from a terrorist attack that occurs while you are a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

VA disability benefits. Disability benefits you receive from the VA are not included in your income. If you are a military retiree and you receive disability benefits from other than the VA, do not include in your income the amount of

disability benefits equal to the VA benefits to which you are entitled.

Retroactive VA determination. If you retire from the armed services based on years of service and are later given a retroactive service-connected disability rating by the VA, your retirement pay for the retroactive period is excluded from income up to the amount of VA disability benefits you would have been entitled to receive. You can claim a refund of any tax paid on the excludable amount (subject to the statute of limitations) by filing an amended return on Form 1040X for each previous year during the retroactive period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, do not include in your income the portion of the severance payment equal to the VA benefit you would have been entitled to receive in that same year. However, you must include in your income any lump-sum readjustment or other nondisability severance payment you received on release from active duty, even if you are later given a retroactive disability rating by the VA.

Long-Term Care Insurance Contracts

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

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

- 1) Must be guaranteed renewable,
- 2) Must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,
- 3) Must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits, and
- 4) Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

- 1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and

- 2) Maintenance or personal care services required by a **chronically ill individual** as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified as one of the following.

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

The certification must have been made by a licensed health care practitioner within the previous 12 months.

Limit on exclusion. You can generally exclude from gross income up to \$200 a day for 2001. The \$200 is indexed for inflation. See *Limit on exclusion*, under *Long-Term Care Insurance Contracts*, under *Sickness and Injury Benefits* in Publication 525 for more information.

Workers' Compensation

Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of occupational sickness or injury.



If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For more information, see Publication 915, Social Security and Equivalent Railroad Retirement Benefits.

Return to work. If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Other Sickness and Injury Benefits

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

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

If you received income because of a disability, see *Disability Income*, earlier.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as **continuation of pay** for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

You can deduct the amount you spend to buy back sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you use it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

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

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments.
- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see chapter 23.

7.

Tip Income

Introduction

This chapter is for employees who receive tips from customers.

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement.

The value of noncash tips, such as tickets, passes, or other items of value are also income and subject to tax.

Reporting your tip income correctly is not difficult. You must do three things.

- 1) Keep a daily tip record.
- 2) Report tips to your employer.
- 3) Report all your tips on your income tax return.

This chapter will show you how to do these three things and what to do on your tax return if you have not done the first two. This chapter will also show you how to treat allocated tips.

Useful Items

You may want to see:

Publication

- 531** Reporting Tip Income
- 1244** Employee's Daily Record of Tips and Report to Employer

Form (and Instructions)

- 4137** Social Security and Medicare Tax on Unreported Tip Income
- 4070** Employee's Report of Tips to Employer

Keeping a Daily Tip Record

Why keep a daily tip record? You must keep a daily tip record so you can:

- Report your tips accurately to your employer,
- Report your tips accurately on your tax return, and
- Prove your tip income if your return is ever questioned.

How to keep a daily tip record. There are two ways to keep a daily tip record. You can either:

- 1) Write information about your tips in a tip diary, or
- 2) Keep copies of documents that show your tips, such as restaurant bills and credit card charge slips.

You should keep your daily tip record with your personal records. You must keep your records for as long as they are important for administration of the federal tax law.

If you keep a tip diary, you can use Form 4070A, *Employee's Daily Record of Tips*. To get Form 4070A, ask the Internal Revenue Service (IRS) or your employer for Publication 1244. Publication 1244 includes a year's supply of Form 4070A. Each day, write in the information asked for on the form.

If you do not use Form 4070A, start your records by writing your name, your employer's name, and the name of the business if it is different from your employer's name. Then, each workday, write the date and the following information.

- Cash tips you get directly from customers or from other employees.
- Tips from credit card charge customers that your employer pays you.
- The value of any noncash tips you get, such as tickets, passes, or other items of value.
- The amount of tips you paid out to other employees through tip pools or tip splitting, or other arrangements, and the names of the employees to whom you paid the tips.



Do not write in your tip diary the amount of any service charge that your employer adds to a customer's bill and then pays to you and treats as wages. This is part of your wages, not a tip.

Electronic tip record. You may use an electronic system provided by your employer to record your daily tips. You must receive and keep a paper copy of this record.

Reporting Tips to Your Employer

Why report tips to your employer? You must report tips to your employer so that:

- Your employer can withhold federal income tax and social security and Medicare taxes or railroad retirement tax,
- Your employer can report the correct amount of your earnings to the Social Security Administration or Railroad Retirement Board (which affects your benefits when you retire or if you become disabled, or your family's benefits if you die), and
- You can avoid the penalty for not reporting tips to your employer (explained later).

What tips to report. Report to your employer only cash, check, or credit card tips you receive.

If your total tips for any one month from any one job are less than \$20, do not report them to your employer.

Do not report the value of any noncash tips, such as tickets or passes, to your employer. You do not pay social security and Medicare taxes or railroad retirement tax on these tips.

How to report. If your employer does not give you any other way to report tips, you can use Form 4070. To get a year's supply of the form, ask the IRS or your employer for Publication 1244. Fill in the information asked for on the form, sign and date the form, and give it to your employer.

If you do not use Form 4070, give your employer a statement with the following information.

- Your name, address, and social security number.
- Your employer's name, address, and business name (if it is different from the employer's name).
- The month (or the dates of any shorter period) in which you received tips.
- The total tips required to be reported for that period.

You must sign and date the statement. You should keep a copy with your personal records.

Your employer may require you to report your tips more than once a month. However, the statement cannot cover a period of more than one calendar month.

Electronic tip statement. Your employer can have you furnish your tip statements electronically.

When to report. Give your report for each month to your employer by the 10th of the next month. If the 10th falls on a Saturday, Sunday, or legal holiday, give your employer the report by the next day that is not a Saturday, Sunday, or legal holiday.

Example 1. You must report your tips received in June 2002 by July 10, 2002.

Example 2. You must report your tips received in January 2002 by February 11, 2002. February 10 is on a Sunday, and the 11th is the next day that is not a Saturday, Sunday, or legal holiday.

Final report. If your employment ends during the month, you can report your tips when your employment ends.

Penalty for not reporting tips. If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the social security and Medicare taxes or railroad retirement tax you owe on the unreported tips. (For information about these taxes, see *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Tax Return*, later.) The penalty amount is in addition to the taxes you owe.

You can avoid this penalty if you can show reasonable cause for not reporting the tips to your employer. To do so, attach a statement to your return explaining why you did not report them.

Giving your employer money for taxes. Your regular pay may not be enough for your employer to withhold all the taxes you owe on your regular pay plus your reported tips. If this happens, you can give your employer money until the close of the calendar year to pay the rest of the taxes.

If you do not give your employer enough money, your employer will apply your regular pay and any money you give to the taxes in the following order.

- 1) All taxes on your regular pay.
- 2) Social security and Medicare taxes or railroad retirement tax on your reported tips.
- 3) Federal, state, and local income taxes on your reported tips.

Any taxes that remain unpaid can be collected by your employer from your next paycheck. If withholding taxes remain uncollected at the end of the year, you may be subject to a penalty for underpayment of estimated taxes. See Publication 505, *Tax Withholding and Estimated Tax*, for more information.



You must report on your tax return any social security and Medicare taxes or railroad retirement tax that remained uncollected at the end of 2001. See Reporting uncollected social security and Medicare taxes on tips under Reporting Tips on Your Tax Return, later. These uncollected taxes will be shown in box 12 of your 2001 Form W-2 (codes A and B).

Tip Rate Determination and Education Program

Your employer may participate in the Tip Rate Determination and Education Program. The program was developed to help employees and employers understand and meet their tip reporting responsibilities.

There are two agreements under the program — the *Tip Rate Determination Agreement (TRDA)* and the *Tip Reporting Alternative Commitment (TRAC)*. In addition, employers in the food and beverage industry may be able to get approval of an employer-designed EmTRAC program. For information on the EmTRAC program, see Notice 2001-1 in Internal Revenue Bulletin No. 2001-2.

Your employer can provide you with a copy of the agreement. If you want to learn more about these agreements, contact the local tip coordinator. A list of tip coordinators is available at www.irs.gov.

Reporting Tips on Your Tax Return

How to report tips. Report your tips with your wages on line 1, Form 1040EZ, or line 7, Form 1040A or Form 1040.

What tips to report. You must report all tips you received in 2001, including both cash tips and noncash tips, on your tax return. Any tips

you reported to your employer for 2001 are included in the wages shown in box 1 of your Form W-2. Add to the amount in box 1 only the tips you did not report to your employer.



If you received \$20 or more in cash and charge tips in a month and did not report all of those tips to your employer, see Reporting social security and Medicare taxes on tips not reported to your employer, later.



If you did not keep a daily tip record as required and an amount is shown in box 8 of your Form W-2, see Allocated Tips, later.

If you kept a daily tip record and reported tips to your employer as required under the rules explained earlier, add the following tips to the amount in box 1 of your Form W-2.

- Cash and charge tips you received that totaled less than \$20 for any month.
- The value of noncash tips, such as tickets, passes, or other items of value.

Example. John Allen began working at the Diamond Restaurant (his only employer in 2001) on June 30 and received \$10,000 in wages during the year. John kept a daily tip record showing that his tips for June were \$18 and his tips for the rest of the year totaled \$7,000. He was not required to report his June tips to his employer, but he reported all of the rest of his tips to his employer as required.

John's Form W-2 from Diamond Restaurant shows \$17,000 (\$10,000 wages plus \$7,000 reported tips) in box 1. He adds the \$18 unreported tips to that amount and reports \$17,018 as wages on his tax return.

Reporting social security and Medicare taxes on tips not reported to your employer.

If you received \$20 or more in cash and charge tips in a month from any one job and did not report all of those tips to your employer, you must report the social security and Medicare taxes on the unreported tips as additional tax on your return. To report these taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Use **Form 4137** to figure these taxes. Enter the tax on line 54, Form 1040, and attach Form 4137 to your return.

Reporting uncollected social security and Medicare taxes on tips.

If your employer could not collect all the social security and Medicare taxes or railroad retirement tax you owe on tips reported for 2001, the uncollected taxes will be shown in box 12 of your Form W-2 (codes A and B). You must report these amounts as additional tax on your return. You may have uncollected taxes if your regular pay was not enough for your employer to withhold all the taxes you owe and you did not give your employer enough money to pay the rest of the taxes.

To report these uncollected taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.) Include the taxes in your total tax amount on line 58, and write

"UT" and the total of the uncollected taxes on the dotted line next to line 58.

Allocated Tips

If your employer allocated tips to you, they are shown separately in box 8 of your Form W-2. They are not included in box 1 with your wages and reported tips. If box 8 is blank, this discussion does not apply to you.

What are allocated tips? These are tips that your employer assigned to you in addition to the tips you reported to your employer for the year. Your employer will have done this only if:

- You worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees, and
- The tips you reported to your employer were less than your share of 8% of food and drink sales.

How were your allocated tips figured? The tips allocated to you are your share of an amount figured by subtracting the reported tips of all employees from 8% (or an approved lower rate) of food and drink sales (other than carryout sales and sales with a service charge of 10% or more). Your share of that amount was figured using either a method provided by an employer-employee agreement or a method provided by IRS regulations based on employees' sales or hours worked. For information about the exact allocation method used, ask your employer.

Must you report your allocated tips on your return? You must report allocated tips on your tax return unless either of the following exceptions applies.

- 1) You kept a daily tip record, or other evidence that is as credible and as reliable as a daily tip record, as required under rules explained earlier.
- 2) Your tip record is incomplete, but it shows that your actual tips were more than the tips you reported to your employer plus the allocated tips.

If either exception applies, report your actual tips on your return. Do not report the allocated tips. See *What tips to report under Reporting Tips on Your Tax Return*, earlier.

How to report allocated tips. If you must report allocated tips on your return, add the amount in box 8 of your Form W-2 to the amount in box 1. Report the total as wages on line 7 of Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Because social security and Medicare taxes were not withheld from the allocated tips, you must report those taxes as additional tax on your return. Complete Form 4137, and include the allocated tips on line 1 of the form. See *Reporting social security and Medicare taxes on tips not reported to your employer under Reporting Tips on Your Tax Return*, earlier.

8.

Interest Income

Important Reminder

Foreign-source income. If you are a U.S. citizen with interest income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later in this chapter.

You may be able to deduct expenses you have in earning this income on Schedule A (Form 1040) if you itemize your deductions. See chapter 30.



Recordkeeping. You should keep a list showing sources and amounts of interest received during the year. Also, keep the forms you receive that show your interest income (Forms 1099–INT, for example) as an important part of your records.

Useful Items

You may want to see:

Publication

- ❑ **537** Installment Sales
- ❑ **550** Investment Income and Expenses
- ❑ **1212** List of Original Issue Discount Instruments

Form (and Instructions)

- ❑ **Schedule B (Form 1040)** Interest and Ordinary Dividends
- ❑ **Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040A Filers
- ❑ **3115** Application for Change in Accounting Method

- ❑ **8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- ❑ **8818** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989

General Information

A few items of general interest are covered here.

Tax on investment income of a child under age 14. Part of a child's 2001 investment income may be taxed at the parent's tax rate. This may happen if all the following are true.

- 1) The child was under age 14 on January 1, 2002.
- 2) The child had more than \$1,500 of investment income (such as taxable interest and dividends) and has to file a tax return.
- 3) Either parent was alive at the end of 2001.

If all these statements are true, **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500**, must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814, Parents' Election To Report Child's Interest and Dividends**, for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

Beneficiary of an estate or trust. Interest, dividends, and other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K–1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K–1 and its instructions will tell you where to report the income on your Form 1040.

Social security number (SSN). You must give your name and SSN to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest.

SSN for joint account. If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts*, later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

These rules apply both to joint ownership by a married couple and to joint ownership by other individuals. For example, if you open a joint savings account with your child using funds belonging to the child, list the child's name first on the account and give the child's SSN.

Custodian account for your child. If your child is the actual owner of an account that is recorded in your name as custodian for the child,

give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

Penalty for failure to supply SSN. If you do not give your SSN to the payer of interest, you may have to pay a penalty. See *Failure to supply social security number under Penalties* in chapter 1. Backup withholding also may apply.

Backup withholding. Your interest income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on the income. Under backup withholding, the payer of interest must withhold, as income tax, a percentage of the amount you are paid. For 2002, the percentage is 30%.

Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

Reporting backup withholding. If backup withholding is deducted from your interest income, the payer must give you a Form 1099–INT for the year that indicates the amount withheld. The Form 1099–INT will show any backup withholding as "Federal income tax withheld."

Joint accounts. If two or more persons hold property (such as a savings account or bond) as joint tenants, tenants by the entirety, or tenants in common, each person's share of any interest from the property is determined by local law.

Income from property given to a child. Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, becomes the child's property.

Income from the property is taxable to the child, except that any part used to satisfy a legal obligation to support the child is taxable to the parent or legal guardian having that legal obligation.

Savings account with parent as trustee. Interest income from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child if, under the law of the state in which the child resides, both of the following are true.

- 1) The savings account legally belongs to the child.
- 2) The parents are not legally permitted to use any of the funds to support the child.

Form 1099–INT. Interest income is generally reported to you on Form 1099–INT, *Interest Income*, or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that you receive for the tax year. This includes amounts reported to you on Form 1099–INT and amounts for which you did not receive a Form 1099–INT.

Nominees. Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT showing the interest received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions under *How To Report Interest Income* in chapter 1 of Publication 550, or see the Schedule 1 (Form 1040A) or Schedule B (Form 1040) instructions.

Incorrect amount. If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099–INT you receive will be marked “Corrected.”

Form 1099–OID. Reportable interest income may also be shown on Form 1099–OID, *Original Issue Discount*. For more information about amounts shown on this form, see *Original Issue Discount (OID)*, later in this chapter.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information-reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file. This is an information-reporting requirement and does not change the exempt-interest dividends to taxable income.

Note. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 31 for more information. Chapter 1 of Publication 550 contains a discussion on private activity bonds, under *State or Local Government Obligations*.

Interest on VA dividends. Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. You must report as interest so-called “dividends” on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,

- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Money market certificates, savings certificates, and other deferred interest accounts. If you open any of these accounts, interest may be paid at fixed intervals of 1 year or less during the term of the account. You generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount (OID)*, later.

Interest subject to penalty for early withdrawal. If you withdraw funds from a deferred interest account before maturity, you may have to pay a penalty. You must report the total amount of interest paid or credited to your account during the year, without subtracting the penalty. See *Penalty on early withdrawal of savings* in chapter 1 of Publication 550, for more information on how to report the interest and deduct the penalty.

Money borrowed to invest in money market certificate. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. If you itemize deductions, you can deduct the interest you pay as investment interest, up to the amount of your net investment income. See *Interest Expenses* in chapter 3 of Publication 550.

Example. You deposited \$5,000 with a bank and borrowed \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6–month money market certificate. The certificate earned \$575 at maturity in 2001, but you received only \$265, which represented the \$575 you earned minus \$310 interest charged on your \$5,000 loan. The bank gives you a Form 1099–INT for 2001 showing the \$575 interest you earned. The bank also gives you a statement showing that you paid \$310 interest for 2001. You must include the \$575 in your income. If you itemize your deductions on Schedule A (Form 1040), you can deduct \$310, subject to the net investment income limit.

Gift for opening account. If you receive non-cash gifts or services for making deposits or for opening an account in a savings institution, you may have to report the value as interest.

For deposits of less than \$5,000, gifts or services valued at more than \$10 must be reported as interest. For deposits of \$5,000 or more, gifts or services valued at more than \$20 must be reported as interest. The value is determined by the cost to the financial institution.

Example. You open a savings account at your local bank and deposit \$800. The account

earns \$20 interest. You also receive a \$15 calculator. If no other interest is credited to your account during the year, the Form 1099–INT you receive will show \$35 interest for the year. You must report \$35 interest income on your tax return.

Interest on insurance dividends. Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

Treasury bills generally have a 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of \$1,000 and multiples of \$1,000. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity.

Treasury notes have maturity periods of more than 1 year, ranging up to 10 years. Maturity periods for **Treasury bonds** are longer than 10 years. Both notes and bonds generally pay interest every 6 months. Generally, you report this interest for the year paid. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in chapter 1 of Publication 550.



For other information on Treasury notes or bonds, write to:

Bureau of the Public Debt
Attn: Customer Information
Parkersburg, WV 26106–2186



Or, on the Internet, visit:
www.publicdebt.treas.gov

For information on series EE, series I, and series HH savings bonds, see *U.S. Savings Bonds*, later.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when you receive it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest. See *Unstated Interest and Original Issue Discount* in Publication 537, *Installment Sales*.

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is interest charged at an illegal rate. This is taxable as interest unless state law automatically changes it to a payment on the principal.

Individual retirement arrangements (IRAs). Interest on a Roth IRA generally is not taxable. Interest on a traditional IRA is tax deferred. You generally do not include it in your income until you make withdrawals from the IRA. See chapter 18.

Interest income on frozen deposits. Exclude from your gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, you cannot withdraw any part of the deposit because:

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

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

- 1) The net amount you withdrew from these deposits during the year, and
- 2) The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099-INT for interest income on deposits that were frozen at the end of 2001, see *Frozen deposits* under *How To Report Interest Income* in chapter 1 of Publication 550, for information about reporting this interest income exclusion on your 2001 tax return.

The interest you exclude is treated as credited to your account in the following year. You must include it in income when you can withdraw it.

Example. \$100 of interest was credited on your frozen deposit during the year. You withdrew \$80 but could not withdraw any more as of the end of the year. You must include \$80 in your income for the year. You must exclude \$20.

Bonds traded flat. If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year it is received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. See *Below-Market Loans* in chapter 1 of Publication 550 for more information.

U.S. Savings Bonds

This section provides tax information on U.S. savings bonds. It explains how to report the interest income on these bonds and how to treat transfers of these bonds.



For other information on U.S. savings bonds, write to:

Bureau of the Public Debt
Attn: Savings Bond Operations Office
Parkersburg, WV 26106-1328



Or, on the Internet, visit:
www.savingsbonds.gov

Cash method taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it. The cash method of accounting is explained in chapter 1 under *Accounting Methods*.

Accrual method taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in chapter 1 under *Accounting Methods*.

Series HH Bonds. These bonds are issued at face value. Interest is paid twice a year by direct deposit to your bank account. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it. Series HH Bonds were first offered in 1980. Before 1980, **series H bonds** were issued. Series H bonds are treated the same as series HH bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years.

Series EE and series I bonds. Interest on these bonds is payable when you redeem the bonds. The difference between the purchase price and the redemption value is taxable interest.

Series EE bonds were first offered in July 1980. They have a maturity period of 30 years. Before July 1980, **series E bonds** were issued. The original 10-year maturity period of series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Series EE and series E bonds are issued at a discount. The face value is payable to you at maturity.

Series I bonds were first offered in 1998. These are inflation-indexed bonds issued at their face amount with a maturity period of 30 years. The face value plus accrued interest is payable to you at maturity.

If you use the cash method of reporting income, you can report the interest on series EE, series E, and series I bonds in either of the following ways.

- 1) **Method 1.** Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year they mature. (However, see *Savings bonds traded, later.*) **Note.** Series E bonds issued in

1961 and 1971 matured in 2001. If you have used method 1, you generally must report the interest on these bonds on your 2001 return.

- 2) **Method 2.** Choose to report the increase in redemption value as interest each year.

You must use the same method for all series EE, series E, and series I bonds you own. If you do not choose method 2 by reporting the increase in redemption value as interest each year, you must use method 1.



If you plan to cash your bonds in the same year that you will pay for higher education expenses, you may want to use method 1 because you may be able to exclude the interest from your income. To learn how, see Education Savings Bond Program, later.

Change from method 1. If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all series EE, series E, and series I bonds you own and for any you get later, unless you request permission to change, as explained next.

Change from method 2. To change from method 2 to method 1, you must request permission from the IRS. Permission for the change is automatically granted if you send the IRS a statement that meets all the following requirements.

- 1) You have typed or printed at the top, "*Change in Method of Accounting Under Section 6.01 of the Appendix of Rev. Proc. 99-49 (or later update).*"
- 2) It includes your name and social security number under the label in (1).
- 3) It identifies the savings bonds for which you are requesting this change.
- 4) It includes your agreement to:
 - a) Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and
 - b) Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.
- 5) It includes your signature.

You must attach this statement to your tax return for the year of change, which you must file by the due date (including extensions).

You can have an automatic extension of 6 months from the due date of your return (including extensions) to file the statement with an amended return. To get this extension, you must have filed your original return by the due date (including extensions). At the top of the state-

Table 8-1. Who Pays the Tax on U.S. Savings Bond Interest

IF ...	THEN the tax on the bond interest must be paid by ...
You buy a bond in your name and the name of another person as co-owners, using only your own funds	You.
You buy a bond in the name of another person, who is the sole owner of the bond	The person for whom you bought the bond.
You and another person buy a bond as co-owners, each contributing part of the purchase price	Both you and the other co-owner, in proportion to the amount each paid for the bond.
You and your spouse, who live in a community property state, buy a bond that is community property	You and your spouse. If you file separate returns, both you and your spouse generally pay tax on one-half of the interest.

ment, write "Filed pursuant to section 301.9100-2."



By the date you file the original statement, you must also send a copy to the address below.

Internal Revenue Service
Attention: CC:PA:T
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20044

If you use a private delivery service, send the copy to the address below.

Internal Revenue Service
Attention: CC:PA:T
1111 Constitution Avenue, NW
Room 6561
Washington, DC 20044

Instead of filing this statement, you can request permission to change from method 2 to method 1 by filing **Form 3115**. In that case, follow the form instructions for an automatic change. No user fee is required.

Co-owners. If a U.S. savings bond is issued in the names of co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

One co-owner's funds used. If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099-INT at the time of redemption, the other co-owner must provide you with another Form 1099-INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a "nominee." See *Nominee distributions under How To Report Interest Income* in chapter 1 of Publication 550 for more information about how a person who is a nominee reports interest income belonging to another person.

Both co-owners' funds used. If you and the other co-owner each contribute part of the bond's purchase price, the interest is generally taxable to each of you, in proportion to the amount each of you paid.

Community property. If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you

generally must report one-half of the bond interest. For more information about community property, see Publication 555, *Community Property*.

Table 8-1. These rules are also shown in *Table 8-1*.

Ownership transferred. If you bought series E, series EE, or series I bonds **entirely with your own funds** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time.

This same rule applies when bonds (other than bonds held as community property) are transferred between spouses incident to divorce.

Purchased jointly. If you and a co-owner each contributed funds to buy series E, series EE, or series I bonds **jointly** and later have the bonds reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income-reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought **jointly** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example 1. You and your spouse each spent an equal amount to buy a \$1,000 series EE savings bond. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

Example 2. You bought a \$1,000 series EE savings bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue.

Transfer to a trust. If you own series E, series EE, or series I bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income in the year you cash or dispose of the bonds or the year the bonds finally mature, whichever is earlier.

The same rules apply to previously unreported interest on series EE or series E bonds if the transfer to a trust consisted of series HH or series H bonds you acquired in a trade for the series EE or series E bonds. See *Savings bonds traded, later*.

Decedents. The manner of reporting interest income on series E, series EE, or series I bonds, after the death of the owner, depends on the accounting and income-reporting method previously used by the decedent. This is explained in chapter 1 of Publication 550.

Savings bonds traded. If you postponed reporting the interest on your series EE or series E bonds, you did not recognize taxable income when you traded the bonds for series HH or series H bonds, unless you received cash in the trade. (You cannot trade series I bonds for series HH bonds.) Any cash you received is income up to the amount of the interest earned on the bonds traded. When your series HH or series H bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded series EE or series E bonds plus any amount you had to pay at the time of the trade.

Example. You own series E bonds with accrued interest of \$523 and a redemption value of \$2,723 and have postponed reporting the interest. You trade the bonds for \$2,500 in series HH bonds and \$223 in cash. You must report the \$223 as taxable income in the year of the trade.

Choice to report interest in year of trade. You can choose to treat all of the previously unreported accrued interest on the series EE or series E bonds traded for series HH bonds as income in the year of the trade. If you make this choice, it is treated as a change from method 1. See *Change from method 1 under Series EE and series I bonds, earlier*.

Form 1099-INT for U.S. savings bonds interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099-INT if the interest part of the payment you receive is \$10 or more. Box 3 of your Form 1099-INT should show the interest as the difference between the amount you received and the

amount paid for the bond. However, your Form 1099-INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

- 1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099-INT will not be reduced by amounts previously included in income.
- 2) You received the bond from a decedent. The interest shown on your Form 1099-INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
- 3) Ownership of the bond was transferred. The interest shown on your Form 1099-INT will not be reduced by interest that accrued before the transfer.
- 4) You were named as a co-owner and the other co-owner contributed funds to buy the bond. The interest shown on your Form 1099-INT will not be reduced by the amount you received as nominee for the other co-owner. (See *Co-owners*, earlier in this chapter, for more information about the reporting requirements.)
- 5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099-INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest. (This amount is generally shown on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year of distribution.)

For more information on including the correct amount of interest on your return for (1), (2), (3), and (4) above, see *How To Report Interest Income*, later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5) above), see *How To Report Interest Income* in Publication 550 for information on how to report the interest.



Interest on U.S. savings bonds is exempt from state and local taxes. The Form 1099-INT you receive will indicate the amount that is for U.S. savings bond interest in box 3. Do not include this amount on your state or local income tax return.

Education Savings Bond Program

You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. savings bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program*.

If you are married, you can qualify for this exclusion only if you file a joint return with your spouse.

Form 8815. Use Form 8815 to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a series EE bond *issued after 1989* or a series I bond. The bond must be issued either in your name (sole owner) or in your and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date.



The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased.

Beneficiary. You can designate any individual (including a child) as a beneficiary of the bond.

Verification by IRS. If you claim the exclusion, the IRS will check it by using bond redemption information from the Department of the Treasury.

Qualified expenses. Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution.

Qualified expenses include any contribution you make to a qualified state tuition program or to a Coverdell education savings account.

Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

Eligible educational institutions. These institutions include most public, private, and nonprofit universities, colleges and vocational schools that are accredited and are eligible to participate in student aid programs run by the Department of Education.

Reduction for certain benefits. You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include:

- 1) Qualified scholarships that are exempt from tax (see chapter 13 for information on qualified scholarships), and
- 2) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as:
 - a) Veterans' educational assistance benefits,
 - b) Benefits under a qualified state tuition program, or
 - c) Certain employer-provided educational assistance benefits.

Effect of other tax benefits. Do not include in your qualified expenses any expenses used to:

- 1) Figure an education credit on Form 8863, or
- 2) Figure how much of a distribution from an education IRA you can exclude from your income.

Amount excludable. If the total proceeds (interest and principal) from the qualified U.S. savings bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you can exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Example. In February 2001, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in April 1993. They received proceeds of \$7,256, representing principal of \$5,000 and interest of \$2,256. In 2001, they paid \$4,000 of their daughter's college tuition. They are not claiming an education credit for that amount, and they do not have an education IRA. They can exclude \$1,244 ($\$2,256 \times (\$4,000 \div \$7,256)$) of interest in 2001. They must pay tax on the remaining \$1,012 ($\$2,256 - \$1,244$) interest.

Modified adjusted gross income limit. The interest exclusion is limited if your modified adjusted gross income (modified AGI) is:

- \$55,750 to \$70,750 for taxpayers filing single or head of household, and
- \$83,650 to \$113,650 for married taxpayers filing jointly or for a qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 20 of Form 1040A or line 34 of Form 1040) figured before the interest exclusion, and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion or deduction,
- 3) Exclusion of income for bona fide residents of American Samoa,
- 4) Exclusion for income from Puerto Rico,
- 5) Exclusion for adoption benefits received under an employer's adoption assistance program, and
- 6) Deduction for student loan interest.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you claim any of the exclusion or deduction items listed above (except item 6), add the amount of the exclusion or deduction (except any deduction for student loan interest) to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

If you have investment interest expense incurred to earn royalty income, see *Education Savings Bond Program* in chapter 1 of Publication 550.



Recordkeeping. If you claim the interest exclusion, you must keep a written record of the qualified U.S. savings bonds you redeem. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You can use **Form 8818, *Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989***, to record this information. You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

Bonds Sold Between Interest Dates

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment, rather than interest income, by reducing your basis in the bond. See *Accrued interest on bonds* under *How To Report Interest Income* in chapter 1 of Publication 550 for information on reporting the payment.

Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are usually not taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

For more information about insurance proceeds received in installments, see Publication 525, *Taxable and Nontaxable Income*.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See chapter 11 for information on pension and annuity income.

Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You generally include OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue). See *Discount on Short-Term Obligations* in chapter 1 of Publication 550.

De minimis OID. You can treat the discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as “de minimis” OID.

Example 1. You bought a 10-year bond with a stated redemption price at maturity of \$1,000, issued at \$980 with OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize \$20 (\$1,000 – \$980) of capital gain.)

Example 2. The facts are the same as in *Example 1*, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in *Example 1*, you must include the OID in income as it accrues over the term of the bond.

Debt instrument bought after original issue. If you buy a debt instrument with de minimis OID at a premium, the discount is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules. See *Market Discount Bonds* in chapter 1 of Publication 550.

Exceptions to reporting OID. The OID rules discussed in this chapter do not apply to the following debt instruments.

- 1) Tax-exempt obligations. (However, see *Stripped tax-exempt obligations* under *Stripped Bonds and Coupons* in chapter 1 of Publication 550).
- 2) U.S. savings bonds.
- 3) Short-term debt instruments (those with a fixed maturity date of not more than 1 year from the date of issue).
- 4) Obligations issued by an individual before March 2, 1984.
- 5) Loans between individuals, if all the following are true.
 - a) The lender is not in the business of lending money.
 - b) The amount of the loan, plus the amount of any outstanding prior loans between the same individuals, is \$10,000 or less.
 - c) Avoiding any federal tax is not one of the principal purposes of the loan.

Form 1099–OID. The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099–OID, *Original Issue Discount*, or a similar statement, if the total OID for the calendar year is \$10 or more. Form 1099–OID will show, in box 1, the amount of OID for the part of the year that you held the bond. It also will show, in box 2, other interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records.

In most cases, you must report the entire amount in boxes 1 and 2 of Form 1099–OID as interest income. But see *Refiguring OID shown on Form 1099–OID*, later in this discussion, for more information.

Nominee. If someone else is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

Refiguring OID shown on Form 1099–OID. You must refigure the OID shown in box 1 of Form 1099–OID if either of the following apply.

- 1) You bought the debt instrument after its original issue and paid a premium or an acquisition premium.
- 2) The debt instrument is a stripped bond or a stripped coupon (including certain zero coupon instruments).

For information about figuring the correct amount of OID to include in your income, see *Figuring OID on Long-Term Debt Instruments* in Publication 1212.

Form 1099–OID not received. If you had OID for the year but did not receive a Form 1099–OID, see Publication 1212, which lists total OID on certain debt instruments and has information that will help you figure OID. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the accrued OID for the year.

Refiguring periodic interest shown on Form 1099–OID. If you disposed of a debt instrument or acquired it from another holder during the year, see *Bonds Sold Between Interest Dates*, earlier, for information about the treatment of periodic interest that may be shown in box 2 of Form 1099–OID for that instrument.

Certificates of deposit (CDs). If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits,
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

Bearer CDs. CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs that are not in registered form. They are not issued in the depositor’s name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099–INT.

More information. See chapter 1 of Publication 550 for more information about OID and related topics, such as market discount bonds.

State or Local Government Obligations

Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is taxable.

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in chapter 1 of Publication 550.

Information reporting requirement. If you must file a tax return, you are required to show any tax-exempt interest you received on your return. This is an information-reporting requirement only. It does not change tax-exempt interest to taxable interest.

When To Report Interest Income

When to report your interest income depends on whether you use the cash method or an accrual method to report income.

Cash method. Most individual taxpayers use the cash method. If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds* and *Original Issue Discount*, earlier.

Example. On September 1, 1999, you loaned another individual \$2,000 at 12%, compounded annually. You are not in the business of lending money. The note stated that principal and interest would be due on August 31, 2001. In 2001, you received \$2,508.80 (\$2,000 principal and \$508.80 interest). If you use the cash method, you must include in income on your 2001 return the \$508.80 interest you received in that year.

Constructive receipt. You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

- 1) Make withdrawals in multiples of even amounts,

- 2) Give a notice to withdraw before making the withdrawal,
- 3) Withdraw all or part of the account to withdraw the earnings, or
- 4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

Accrual method. If you use an accrual method, you report your interest income when you earn it, whether or not you have received it. Interest is earned over the term of the debt instrument.

Example. If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1999, \$80; 2000, \$249.60; and 2001, \$179.20.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

How To Report Interest Income

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ.

You cannot use Form 1040EZ if your interest income is more than \$400. Instead, you must use Form 1040A or Form 1040.

Form 1040A. You must complete Part I of Schedule 1 (Form 1040A) if you file Form 1040A and any of the following are true.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program (discussed earlier).
- 3) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
- 4) You received a Form 1099–INT for tax-exempt interest.
- 5) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 2001.
- 6) You received, as a nominee, interest that actually belongs to someone else.
- 7) You received a Form 1099–INT for interest or frozen deposits.

List each payer's name and the amount of interest income received from each payer on line 1. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

You cannot use Form 1040A if you must use Form 1040, as described next.

Form 1040. You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

- 1) You forfeited interest income because of the early withdrawal of a time deposit,
- 2) You received or paid accrued interest on securities transferred between interest payment dates,
- 3) You had a financial account in a foreign country, unless the combined value of all foreign accounts was \$10,000 or less during all of 2001 or the accounts were with certain U.S. military banking facilities,
- 4) You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (see *Bond Premium Amortization* in chapter 3 of Publication 550), or
- 5) You are reporting OID in an amount more or less than the amount shown on Form 1099–OID.

Schedule B. You must complete Part I of Schedule B (Form 1040) if you file Form 1040 and any of the following apply.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program (discussed earlier).
- 3) You had a foreign account.
- 4) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
- 5) You received a Form 1099–INT for tax-exempt interest.
- 6) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 2001.
- 7) You received, as a nominee, interest that actually belongs to someone else.
- 8) You received a Form 1099–INT for interest on frozen deposits.
- 9) You received a Form 1099–INT for interest on a bond that you bought between interest payment dates.
- 10) Statement (4) or (5) in the preceding list is true.

On line 1, Part I, list each payer's name and the amount received from each. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

Form 1099–INT. Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099–INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT in box 2. See *Penalty on early withdrawal of savings* in chapter 1 of Publication 550.

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Add the amount shown in box 3

to any other taxable interest income you received, unless part of the amount in box 3 was previously included in interest income. If part of the amount shown in box 3 was previously included in your interest income, see *U.S. savings bond interest previously reported*, later.

Box 4 of Form 1099–INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. Report the amount from box 4 on Form 1040EZ, line 8, on Form 1040A, line 37, or on Form 1040, line 59 (federal income tax withheld).

Box 5 of Form 1099–INT shows investment expenses you may be able to deduct as an itemized deduction. See chapter 3 of Publication 550 for more information about investment expenses.

U.S. savings bond interest previously reported. If you received a Form 1099–INT for U.S. savings bond interest, the form may show interest you do not have to report. See *Form 1099–INT for U.S. savings bonds interest*, earlier, under *U.S. Savings Bonds*.

On line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), report all the interest shown on your Form 1099–INT. Then follow these steps.

1) Several lines above line 2, enter a subtotal of all interest listed on line 1.

2) Below the subtotal write “U.S. Savings Bond Interest Previously Reported” and enter amounts previously reported or interest accrued before you received the bond.

3) Subtract these amounts from the subtotal and enter the result on line 2.

More information. For more information about how to report interest income, see chapter 1 of Publication 550 or the instructions for the form you must file.

9.

Dividends and Other Corporate Distributions

Important Reminder

Foreign income. If you are a U.S. citizen with dividend income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

Introduction

This chapter discusses the tax treatment of:

- Ordinary dividends,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. (See *Dividends that are actually interest* under *Taxable Interest* in chapter 8.)

Most distributions are paid in cash (or check). However, distributions can consist of more stock, stock rights, other property, or services.

Useful Items

You may want to see:

Publication

- **514** Foreign Tax Credit for Individuals
- **550** Investment Income and Expenses
- **564** Mutual Fund Distributions

Form (and Instructions)

- **Schedule B (Form 1040)** Interest and Ordinary Dividends
- **Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040A Filers

General Information

This section discusses general rules on dividend income.

Tax on investment income of a child under age 14. Part of a child's 2001 investment income may be taxed at the parent's tax rate. This may happen if all of the following are true.

- 1) The child was under age 14 on January 1, 2002.
- 2) The child had more than \$1,500 of investment income (such as taxable interest and dividends) and has to file a tax return.
- 3) Either parent was alive at the end of 2001.

If all of these statements are true, **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500**, must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814, Parents' Election To Report Child's Interest and Dividends**, for this purpose.

For more information about the tax on investment income of children and the parents' election, see chapter 32.

Beneficiary of an estate or trust. Dividends and other distributions you receive as a beneficiary of an estate or trust are generally taxable income. You should receive a **Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.**, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the income on your Form 1040.

Social security number (SSN). You must give your name and SSN (or individual taxpayer identification number (ITIN)) to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of dividends. If you do not give your SSN or ITIN to the payer of dividends, you may have to pay a penalty.

For more information on SSNs and ITINs, see *Social security number (SSN)* in chapter 8.

Backup withholding. Your dividend income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on the income. Under backup withholding, the payer of dividends must withhold, as income tax, a percentage of the amount you are paid. For 2002, this percentage is 30%.

Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 5.

Stock certificate in two or more names. If two or more persons hold stock as joint tenants, tenants by the entirety, or tenants in common, each person may receive a share of any dividends from the stock. Each person's share is determined by local law.

Form 1099-DIV. Most corporations use Form 1099-DIV, *Dividends and Distributions*, to show

you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099-DIV, you must still report all of your taxable dividend income.

Reporting tax withheld. If tax is withheld from your dividend income, the payer must give you a Form 1099-DIV that indicates the amount withheld.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099-DIV, which will show distributions received on your behalf.

Form 1099-MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099-MISC, *Miscellaneous Income*, or a similar statement. See *Reporting Substitute Payments* under *Short Sales* in chapter 4 of Publication 550 for more information about reporting these payments.

Incorrect amount shown on a Form 1099. If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked "Corrected."

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

Dividends received in January. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November, or December payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, you are considered to have received the dividend on December 31. You report the dividend in the year it was declared.

Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1 of the Form 1099-DIV you receive.

Dividends used to buy more stock. The corporation in which you own stock may have a **dividend reinvestment plan**. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you still must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as dividend income the fair market value of the additional stock on the dividend payment date.

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as dividend income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

Money market funds. Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by **regulated investment companies** (commonly called **mutual funds**) and **real estate investment trusts (REITs)**. They will be shown in box 2a of the Form 1099-DIV you receive from the mutual fund or REIT.

Report capital gain distributions as long-term capital gains regardless of how long you owned your shares in the mutual fund or REIT.

Undistributed capital gains of mutual funds and REITs. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you on **Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains**.

Report undistributed capital gains as long-term capital gains in column (f) on line 11 of Schedule D (Form 1040). The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439. You take credit for this tax by including it on line 65, Form 1040, and checking box a on that line. Attach Copy B of Form 2439 to your return, and keep Copy C for your records.

Basis adjustment. Increase your basis in your mutual fund or your interest in a REIT by the difference between the gain you report and the credit you claim for the tax paid.

Additional information. For more information on the treatment of distributions from mutual funds, see Publication 564.

Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099-DIV or other statement from the corporation showing you what part of the distribution is a return of capital. On Form 1099-DIV, a nontaxable return of capital will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.

Basis adjustment. A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 15.

Example. You bought stock in 1989 for \$100. In 1992, you received a return of capital of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a return of capital of \$30 in 2001. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 2001. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating distributions. Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 8 or 9.

For more information on liquidating distributions, see chapter 1 of Publication 550.

Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as “stock options”) are distributions by a corporation of rights to acquire the corporation’s stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

- 1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
- 2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation’s assets or earnings and profits to other shareholders.
- 3) The distribution is in convertible preferred stock and has the same result as in (2).
- 4) The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders.
- 5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term “stock” includes rights to acquire stock, and the term “shareholder” includes a holder of rights or of convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

Preferred stock redeemable at a premium. If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock. For more information, see chapter 1 of Publication 550.

Basis. Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550 for information on how to figure their basis.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 1993, for \$100. The corporation declared a common stock dividend of 5% on June 30, 2001. The fair market value of the stock at the time the stock dividend was declared was \$200. You were paid \$10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	\$200.00
Fair market value of stock dividend (cash received)	+10.00
Fair market value of old stock and stock dividend	<u>\$210.00</u>
Basis (cost) of old stock after the stock dividend $((\$200 + \$210) \times \$100)$. .	\$95.24
Basis (cost) of stock dividend $((\$10 + \$210) \times \$100)$	+ 4.76
Total	<u>\$100.00</u>
Cash received	\$10.00
Basis (cost) of stock dividend	- 4.76
Gain	<u>\$5.24</u>

Because you had held the share of stock for more than 1 year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Scrip dividends. A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the portion of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include its fair market value in income on the date you receive it.

Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.

Alternative minimum tax treatment. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 31 for more information.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the

interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. (For information on the treatment of a distribution from a modified endowment contract, see *Distribution Before Annuity Starting Date From a Nonqualified Plan* under *Taxation of Nonperiodic Payments* in Publication 575, *Pension and Annuity Income*.) Report any taxable distributions on insurance policies on line 16b (Form 1040) or line 12b (Form 1040A).

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

- 1) Property bought for your personal use, or
- 2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, report these amounts on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

How To Report Dividend Income

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. Report the total of your ordinary dividends on line 9 of Form 1040 or Form 1040A.

If you receive capital gain distributions, you may be able to use Form 1040A or you may have to use Form 1040. See *Capital gain distributions* only in chapter 17. If you receive nontaxable distributions required to be reported as capital gains, you must use Form 1040. You cannot use Form 1040EZ if you receive any dividend income.

Form 1099-DIV. If you owned stock on which you received \$10 or more in dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

See Form 1099-DIV for more information on how to report dividend income.

Form 1040A. You must complete Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

- 1) Your ordinary dividends (box 1 of Form 1099-DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

List on line 5 each payer's name and the amount of ordinary dividends you received. If you received a Form 1099-DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040A.

Form 1040. You must fill in Part II of Schedule B and attach it to your Form 1040, if:

- 1) Your ordinary dividends (box 1 of Form 1099-DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

If your ordinary dividends are more than \$400, you must also complete Part III of Schedule B.

List on line 5, Part II of Schedule B, each payer's name and the amount of ordinary dividends you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099-DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040.

Expenses related to dividend income. You may be able to deduct expenses related to dividend income if you itemize your deductions on Schedule A (Form 1040). See chapter 30 for general information about deducting expenses of producing income.

More information. For more information about how to report dividend income, see chapter 1 of Publication 550 or the instructions for the form you must file.

10.

Rental Income and Expenses

Introduction

This chapter discusses rental income and expenses. It covers the following topics.

- Rental income.
- Rental expenses.
- Personal use of dwelling unit (including vacation home).
- Depreciation.
- Limits on rental losses.
- How to report your rental income and expenses.

If you sell or otherwise dispose of your rental property, see Publication 544, *Sales and Other Dispositions of Assets*.

If you have a loss from damage to, or theft of, rental property, see Publication 547, *Casualties, Disasters, and Thefts*.

If you rent a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527, *Residential Rental Property*, for more information.

Useful Items

You may want to see:

Publication

- 527** Residential Rental Property
- 534** Depreciating Property Placed in Service Before 1987
- 535** Business Expenses
- 925** Passive Activity and At-Risk Rules
- 946** How To Depreciate Property

Form (and Instructions)

- 4562** Depreciation and Amortization
- 6251** Alternative Minimum Tax—Individuals
- 8582** Passive Activity Loss Limitations
- Schedule E (Form 1040)** Supplemental Income and Loss

Rental Income

You generally must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. In addition to amounts you

receive as normal rent payments, there are other amounts that may be rental income.

When to report. Report rental income on your return for the year you actually or constructively receive it, if you are a cash basis taxpayer. You are a cash basis taxpayer if you report income in the year you receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in chapter 1.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example. You sign a 10-year lease to rent your property. In the first year, you receive \$5,000 for the first year's rent and \$5,000 as rent for the last year of the lease. You must include \$10,000 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses*, later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See *Personal Use of Dwelling Unit (Including Vacation Home)*, later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your rental income, is discussed later.

When to deduct. You generally deduct your rental expenses in the year you pay them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Depreciation. You can begin to depreciate rental property when it is ready and available for rent. See *Placed-in Service Date* under *Depreciation*, later.


Expenses for rental property sold. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Dwelling Unit (Including Vacation Home)*, later.

Part interest. If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

Repairs and Improvements

You can deduct the cost of repairs to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later).

 Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of your property, prolongs its useful life, or

adapts it to new uses. Improvements include the following items.

- Putting a recreation room in an unfinished basement.
- Paneling a den.
- Adding a bathroom or bedroom.
- Putting decorative grillwork on a balcony.
- Putting up a fence.
- Putting in new plumbing or wiring.
- Putting in new cabinets.
- Putting on a new roof.
- Paving a driveway.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

Other Expenses

Other expenses you can deduct from your rental income include advertising, cleaning and maintenance services, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

Rental payments for property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Travel expenses. You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. For information on travel expenses, see chapter 28.



To deduct travel expenses, you must keep records that follow the rules in chapter 28.

Local transportation expenses. You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2001, the standard mileage rate for all business miles is 34.5 cents a mile. For more information, see chapter 28.



To deduct car expenses under either method, you must keep records that follow the rules in chapter 28. In addition, you must complete Part V of Form 4562 and attach it to your tax return.

Tax return preparation. You can deduct, as a rental expense, the part of the tax return preparation fees you paid to prepare Part I of Schedule E (Form 1040). You can also deduct, as a rental expense, any portion of the total expense you paid to resolve a tax underpayment related to your rental activities. On your 2001 Schedule E, you can deduct fees paid in 2001 to prepare Part I of your 2000 Schedule E.

Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. Any rental expenses in excess of rental income cannot be carried forward to the next year. For more information about the rules for an activity not engaged in for profit, see chapter 1 of Publication 535.

Where to report. Report your not-for-profit rental income on line 21, Form 1040. You can include your mortgage interest (if you use the property as your main home or second home), real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040), *Itemized Deductions*, if you itemize your deductions.

Claim your other rental expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A (Form 1040). You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income.

Property Changed to Rental Use

If you change your home or other property, (or a part of it), to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year

the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example. Your tax year is the calendar year. You moved from your home in May and started renting it on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses the amounts you pay for items generally billed monthly, such as utilities.

Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest and real estate taxes, as rental expenses on Schedule E (Form 1040). You can deduct the expenses for the part of the property used for personal purposes, subject to certain limitations, only if you itemize your deductions on Schedule A (Form 1040). You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house. You cannot deduct any part of the cost of the first phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. For example, if you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenants' use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for rental purposes.

How to divide expenses. If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between the rental use and the personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in your home and one based on the square footage of your home.

Personal Use of Dwelling Unit (Including Vacation Home)

If you have **any** personal use of a dwelling unit (including vacation home) that you rent, you **must** divide your expenses between rental use and personal use. See *Figuring Days of Personal Use* and *How To Divide Expenses*, later.

If you used your dwelling unit for personal purposes long enough during 2001, it will be considered a “dwelling unit used as a home.” If so, you cannot deduct rental expenses that exceed rental income for that property. See *Dwelling Unit Used as Home* and *How To Figure Rental Income and Deductions*, later. If your dwelling unit is not considered a dwelling unit used as a home, you can deduct rental expenses that exceed rental income for that property subject to certain limits. See *Limits on Rental Losses*, later.

Exception for minimal rental use. If you use the dwelling unit as a home and you rent it fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. See *Dwelling Unit Used as Home*, later.

Dwelling unit. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you allow only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dwelling Unit Used as Home

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. (See *How To Figure Rental Income and Deductions*, later.)

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

- 1) 14 days, or
- 2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use*, later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in

applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

Examples

The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days).

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brother is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2. You rented the guest bedroom in your home at a fair rental price during the local college’s homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3. You own a cottage in a resort area. You 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 cottage and allowed you to use it even though you did not refund any of the rent. Your family actually used the cottage for 10 of those days. Therefore, the cottage is treated as having been rented for 160 (170 – 10) days. Your family also used the cottage for 7 other days during the year.

You used the cottage as a home because you 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).

Use As Main Home Before or After Renting

For purposes of determining whether a dwelling unit was used as a home, do not count as days of personal use the days you used the property as your main home before or after renting it or offering it for rent in either of the following circumstances.

- 1) You rented or tried to rent the property for 12 or more consecutive months.

- 2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

- 1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later).
- 2) A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
- 3) Anyone under an arrangement that lets you use some other dwelling unit.
- 4) Anyone at less than a fair rental price.

Main home. If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The “purchaser” uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Joshua. Joshua rents his house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Joshua uses it because your house is used by Joshua under an arrangement that allows you to use his house.

Days Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. Expenses for the rental use of the unit are deductible under the rules explained in *How To Figure Rental Income and Deductions*, next.

When dividing your expenses follow these rules.

- 1) Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
- 2) Any day that the unit is available for rent but not actually rented is not a day of rental use.

Example. Your beach cottage was available for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

- 1) The cottage was used for rental a total of 85 days (92 – 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
- 2) You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
- 3) The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
- 4) Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use, you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Property Used as a Home* in the following discussion.

How To Figure Rental Income and Deductions

How you figure your rental income and deductions depends on whether the dwelling unit was used as a home (see *Dwelling Unit Used as Home*, earlier) and, if used as a home, how many days the property was rented.

Property Not Used As a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses*, later.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses*, later.

Property Used As a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home*, earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it fewer than 15 days during the year, do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

Rented 15 days or more. If you use a dwelling unit as a home and rent it 15 days or more during the year, you include all your rental income in your income. See *How To Report Rental Income and Expenses*, later. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. How-

ever, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Table 10–1* to figure your deductible expenses.

Depreciation

You recover your cost in income producing property through yearly tax deductions. You do this by **depreciating** the property; that is, by deducting some of your cost on your tax return each year.

Three basic factors determine how much depreciation you can deduct. They are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use Form 4562 to figure and report your depreciation. See *How To Report Rental Income and Expenses*, later.

Claiming the correct amount of depreciation.

You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You generally cannot deduct the unclaimed depreciation in the current year or any later tax year. However, you may be able to claim the correct amount of depreciation on an amended return (Form 1040X) for the earlier year. See *Claiming the correct amount of depreciation* in Publication 527 for more information.

Changing your accounting method to deduct unclaimed depreciation. If you claimed less depreciation than allowable in an earlier year, you can change your accounting method to take a deduction in the current year for the unclaimed depreciation. To change your accounting method, you must have the consent of the IRS. In some instances, you can receive automatic consent. For more information, see chapter 1 of Publication 946.

Land. You can never depreciate land. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

Depreciation Systems

There are three ways to figure depreciation. The depreciation system you use depends on the type of property and when the property was placed in service. For property used in rental activities you use:

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986.
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987, or

Table 10–1. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer “yes” to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as Home*.)
- Did you rent the dwelling unit 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

1. Enter rents received	_____
2.a. Enter the rental portion of deductible home mortgage interest (see instructions)	_____
b. Enter the rental portion of real estate taxes	_____
c. Enter the rental portion of deductible casualty and theft losses (see instructions)	_____
d. Enter direct rental expenses (see instructions)	_____
e. Fully deductible rental expenses. Add lines 2a–2d	_____
3. Subtract line 2e from line 1. If zero or less, enter zero	_____
4.a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	_____
b. Enter the rental portion of excess mortgage interest (see instructions)	_____
c. Add lines 4a and 4b	_____
d. Allowable operating expenses. Enter the smaller of line 3 or line 4c	_____
5. Subtract line 4d from line 3. If zero or less, enter zero	_____
6.a. Enter the rental portion of excess casualty and theft losses (see instructions)	_____
b. Enter the rental portion of depreciation of the dwelling unit	_____
c. Add lines 6a and 6b	_____
d. Allowable excess casualty and theft losses and depreciation. Enter the smaller of line 5 or line 6c.	_____
7.a. Operating expenses to be carried over to next year. Subtract line 4d from line 4c	_____
b. Excess casualty and theft losses and depreciation to be carried over to next year. Subtract line 6d from line 6c.	_____

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, *Casualties and Thefts*, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income

figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet.

Note. Do not file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 4b. On line 2a, you entered the rental portion of the mortgage interest you could deduct on Schedule A if you had not rented the dwelling unit. Enter on line 4b of this worksheet the rental portion of the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the

dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

- A.** Enter the amount from line 10 of Form 4684 _____
- B.** Enter the rental portion of **A.** _____
- C.** Enter the amount from line 2c of this worksheet _____
- D.** Subtract **C** from **B.** Enter the result here and on line 6a of this worksheet _____

Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.



This chapter discusses MACRS only. If you need more information about depreciating property placed in service before 1987, see Publication 534, Depreciating Property Placed in Service Before 1987.

If you placed property in service before 2001, continue to use the same method of figuring depreciation that you used in the past.

Section 179 election. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business). See chapter 2 of Publication 946.

No deduction greater than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Cooperative apartments. If you rent your cooperative apartment to others, you can deduct

your share of the cooperative housing corporation’s depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

MACRS

In general, tangible property placed in service during 2001 is depreciated using MACRS.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System**

Table 10–2. MACRS Recovery Periods for Property Used in Rental Activities

Type of Property	MACRS Recovery Period to Use	
	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as:		
Typewriters		
Calculators		
Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as:		
Stoves		
Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as:		
Desks		
Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Fences	15 years	20 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.,	27.5 years	40 years
Additions and improvements, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

(ADS). GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

- 1) Its recovery period,
- 2) Its placed-in-service date, and
- 3) Its depreciable basis.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 2001.

Excluded property. You cannot use MACRS for certain personal property placed in service in your rental property in 2001 if it had been previously placed in service before MACRS became effective in 1987 (before August 1, 1986, if election made).

In addition, you may elect to exclude certain property from the application of MACRS. See Publication 946 for more information.

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. The property classes are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and

- Residential rental property.

Recovery periods for property used in rental activities are shown in *Table 10–2*.

The class to which property is assigned is determined by its class life. Class lives and recovery periods for most assets are listed in *Appendix B* in Publication 946.

Additions or improvements to property.

Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

- 1) The date the addition or improvement is placed in service, or
- 2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

Example. You own a residential rental house that you have been renting since 1986 and are depreciating under ACRS. You put an addition onto the house and you placed it in service in 2001. You must use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property over 27.5 years.

Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Cost Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any additions or improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See chapter 14.

Conventions

To figure your depreciation deduction for both the year in which you place property in service and the year in which you dispose of property, you use one of the following conventions.

- 1) Mid-month convention.
- 2) Half-year convention.
- 3) Mid-quarter convention.

Mid-month convention. A mid-month convention is used for residential rental property in all situations. Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

Half-year convention. The half-year convention is used in rental activities other than residential rental property. The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year in which the recovery period ends. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Mid-quarter convention. A mid-quarter convention must be used in certain circumstances for property other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the tax year.

Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

Exception. If the third quarter of your 2001 tax year includes September 11, 2001, you may elect to apply the half-year convention, as discussed above, to all property (other than non-residential real property and residential rental property) placed in service during your 2001 tax year. The third quarter begins on the first day of the seventh month of the tax year.

To make the election, write "Election Pursuant to Notice 2001-70" across the top of Form 4562.

Example. During the tax year, Jordan Gregory purchased the following items to use in his rental property.

- A dishwasher for \$400, that he placed in service in January.
- Used furniture for \$100, that he placed in service in September.
- A refrigerator for \$500, that he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is \$1,000. The \$500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$400 (40% × \$1,000).

Ordinarily, Jordan must use the mid-quarter convention instead of the half-year convention for all three items. However, for 2001 he can use the half-year convention for all three items if he makes the election as discussed under *Exception* above.

Table 10-3. Optional MACRS Tables

Table 10-3-A. MACRS 5-Year property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 10-3-B. MACRS 7-Year property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

Table 10-3-C. MACRS 15-Year property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 10-3-D. Residential Rental Property (27.5-year)

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

MACRS Depreciation Under GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

- 1) Use the percentage from the optional MACRS tables, see *Table 10-3*, or

- 2) Actually figure the deduction using the depreciation method and convention that apply over the recovery period of the property.

Publication 946 discusses computing depreciation using the proper method and convention.

Using the Optional Tables

You can use the tables in *Table 10-3* to compute annual depreciation under MACRS. The

tables show the percentages for the first 6 years. The percentages in Tables 10-3-A, 10-3-B, and 10-3-C make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Appendix A* of Publication 946 for complete tables.

If you elect to use the straight line method for 5-, 7-, or 15-year property, or the 150% declining balance method for 5- or 7-year property, use the tables in *Appendix A* of Publication 946.

How to use the tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your **unadjusted basis** in the property by the percentage shown in the appropriate table. Your unadjusted basis is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

- 1) Depreciation allowed or allowable, or
- 2) An addition or improvement that is depreciated as a separate item of property.

If there is an adjustment for any other reason (for example, because of a deductible casualty loss), you can no longer use the table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained in *MACRS Depreciation Under GDS* in Publication 527.

Tables 10-3-A, 10-3-B, and 10-3-C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 10-3-A for 5-year property, Table 10-3-B for 7-year property, and Table 10-3-C for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service in February. Your basis in the stove is \$300 and your basis in the refrigerator is \$500. Both are 5-year property. Using the half-year convention column in Table 10-3-A, you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is \$60 ($\$300 \times .20$) for the stove, and is \$100 ($\$500 \times .20$) for the refrigerator.

For the second tax year, you find your depreciation percentage is 32%. That year's depreciation deduction will be \$96 ($\$300 \times .32$) for the stove and \$160 ($\$500 \times .32$) for the refrigerator.

Example 2. Assume the same facts as in Example 1, except you buy the refrigerator in October instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis (\$500) is more than 40% of the total basis of all property placed in service during the year ($\$800 \times .40 = \320).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 10-3-A and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator is \$25 ($\$500 \times .05$).

Because you placed the stove in service in February, you use the first quarter column of Table 10-3-A and find that the depreciation percentage for year 1 is 35%. For that year, your depreciation deduction for the stove is \$105 ($\$300 \times .35$).

Table 10-3-D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Example. You purchased a single family rental house and placed it in service in February. Your basis in the house is \$80,000. Using Table 10-3-D, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is \$2,546 ($\$80,000 \times .03182$).

MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 10-2 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years and real property with no class life is depreciated using a recovery period of 40 years.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

Election. You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

Gain from disposition. If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain. See Publication 544, *Sales and Other Dispositions of Assets*.

Alternative minimum tax. If you use accelerated depreciation, you may have to file Form 6251. Accelerated depreciation includes

MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. However, you may be able to deduct rental losses without regard to whether you have income from other passive activities if you "materially" or "actively" participated in your rental activity. See *Passive Activity Limits*, later.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

Exception. If your rental losses are less than \$25,000 and you actively participated in the rental activity, the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities*, later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Dwelling Unit (Including Vacation Home)*.

At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925 for more information.

Passive Activity Limits

In general, rental activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Limits on passive activity deductions and credits. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

For a detailed discussion of these rules, see Publication 925.

You may have to complete **Form 8582** to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

Exception for real estate professionals. Rental activities in which you **materially participated** during the year are not passive activities if, during that year, you were a real estate professional because you met the requirements. For a detailed discussion of the requirements, see Publication 527. For a detailed discussion of material participation, see Publication 925.

Losses From Rental Real Estate Activities

If you or your spouse **actively participated** in a passive rental real estate activity, you can deduct up to \$25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to \$25,000 of nonpassive income after taking into account any losses allowed under this exception.

If you are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than \$12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot use the special allowance to reduce your nonpassive income or tax on nonpassive income.

The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than \$100,000 (\$50,000 if married filing separately).

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

More information. See Publication 925 for more information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity.

you normally report your rental income and expenses in Part I of Schedule E (Form 1040). However, do not use that schedule to report a not-for-profit activity. See *Not Rented for Profit*, earlier.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C-EZ, *Net Profit From Business (Sole Proprietorship)*. Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*. You also may have to pay self-employment tax on your rental income. See Publication 533, *Self-Employment Tax*.

Form 1098. If you paid \$600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, *Mortgage Interest Statement*, or similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E (Form 1040). Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E (Form 1040), next to line 13, write "See attached."

Schedule E (Form 1040)

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the "Totals" column on only one Schedule E. The figures in the "Totals" column on that Schedule E should be the combined totals of all Schedules E.

Page 2 of Schedule E is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

On page 1, line 20 of Schedule E, enter the depreciation you are claiming. You must com-

plete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 2001,
- Depreciation on any property that is listed property (such as a car), regardless of when it was placed in service, or
- Any car expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

Example. On January 1, Justin Cole bought a townhouse and placed it in service as residential rental property. He receives \$1,100 a month rental income. His rental expenses for the year are as follows:

Fire insurance (1-year policy)	\$200
Mortgage interest	5,000
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid	800

Justin's basis for depreciation of the townhouse is \$65,000. He is using MACRS with a 27.5-year recovery period. On April 1, Justin bought a new refrigerator for the rental property at a cost of \$425. He uses the MACRS method with a 5-year recovery period.

Justin uses the percentage for January in *Table 10-3-D* to figure his depreciation deduction for the townhouse. He uses the percentage under "Half-year convention" in *Table 10-3-A* to figure his depreciation deduction for the refrigerator. He must report the depreciation on Form 4562.

Justin figures his net rental income or loss for the townhouse as follows:

Total rental income received (\$1,100 × 12)	\$13,200
Minus Expenses:	
Fire insurance (1-year policy)	200
Mortgage interest	5,000
Rent collection fee	572
General repairs	175
Real estate taxes	800
Total expenses	6,747
Balance	\$6,453
Minus Depreciation:	
On townhouse (\$65,000 × 3.485%)	2,265
On refrigerator (\$425 × 20%)	85
Total depreciation	2,350
Net rental income for townhouse	\$4,103

How To Report Rental Income and Expenses

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc.,

11.

Retirement Plans, Pensions, and Annuities

Important Change

Required distributions. The IRS proposed new rules that simplify the calculation of required distributions. See the discussion on required distributions under *Tax on Excess Accumulation* in Publication 575, *Pension and Annuity Income*.

Important Reminder

5-year tax option repealed. The 5-year tax option for figuring the tax on lump-sum distributions from a qualified retirement plan has been repealed. However, a plan participant can continue to choose the 10-year tax option or capital gain treatment for a lump-sum distribution that qualifies for the special treatment.

Introduction

This chapter discusses the tax treatment of distributions you receive from:

- 1) An employee pension or annuity from a qualified plan,
- 2) A disability retirement, and
- 3) A purchased commercial annuity.

What is not covered in this chapter. The following topics are not discussed in this chapter:

- 1) **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans. If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for a qualified plan. For more information about the General Rule, see Publication 939.
- 2) **Civil service retirement benefits.** If you are retired from the federal government (either regular or disability retirement), see Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*. Publication 721 also covers the information that you need if you are the survivor or beneficiary of a federal employee or retiree who died.
- 3) **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an individual retirement arrangement (IRA), as well as

general information on traditional and Roth IRAs, is in chapter 18.

Useful Items

You may want to see:

Publication

- **575** Pension and Annuity Income
- **721** Tax Guide to U.S. Civil Service Retirement Benefits
- **939** General Rule for Pensions and Annuities

Form (and Instructions)

- **W-4P** Withholding Certificate for Pension or Annuity Payments
- **1099-R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- **4972** Tax on Lump-Sum Distributions
- **5329** Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

Employee Pensions and Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

Partly taxable payments. If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. Your annuity starting date (defined later) determines which method you must or may use.

If you contributed to your pension or annuity plan, you figure the tax-free and the taxable parts of your annuity payments under either the Simplified Method or the General Rule. If your annuity starting date is **after November 18, 1996**, and your payments are from a qualified plan, you **must** use the Simplified Method. Generally, you must use the General Rule only for nonqualified plans.

If your annuity starting date is **after July 1, 1986, but before November 19, 1996**, you **can** use either the General Rule or, if you qualify, the Simplified Method.

More than one program. If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must figure the taxable part of each separately. Make separate computations even if the benefits from both are included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule or the Simplified Method. Your former employer or the plan administrator should be able

to tell you if you have more than one pension or annuity contract.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated for tax purposes like social security benefits, and part is treated like an employee pension. For information about railroad retirement benefits treated as social security benefits, see Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*. For information about railroad retirement benefits treated as an employee pension, see *Railroad Retirement* in Publication 575.

Credit for the elderly or the disabled. If you receive a pension or annuity, you may be able to take the credit for the elderly or the disabled. See chapter 34.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers*, later. You make this choice by filing Form W-4P.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W-4P. If an eligible rollover distribution is paid directly to you, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers*, later. If you choose not to have tax withheld or you do not have enough tax withheld, you may have to pay estimated tax.

For more information, see *Pensions and Annuities* under *Withholding* in chapter 5.

Loans. If you borrow money from your qualified pension or annuity plan, tax-sheltered annuity program, government plan, or contract purchased under any of these plans, you may have to treat the loan as a nonperiodic distribution. This means that you may have to include in income all or part of the amount borrowed unless certain exceptions apply. Even if you do not have to treat the loan as a nonperiodic distribution, you may not be able to deduct the interest on the loan in some situations. For details, see *Loans Treated as Distributions* in Publication 575. For information on the deductibility of interest, see chapter 25.

Qualified plans for self-employed individuals. Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors, partnerships (but not a partner), and corporations. They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method. For more information about qualified plans, see Publication 560, *Retirement Plans for Small Business*.

Deferred compensation plans of state and local governments and tax-exempt organizations. If you participate in one of these non-

qualified plans (known as **section 457 plans**), you will not be taxed currently on your pay that is deferred under the plan. You or your beneficiary will be taxed on this deferred pay only when it is distributed or otherwise made available to either of you.

For information on the limits on deferrals under section 457 plans and how to treat excess deferrals, see *Retirement Plan Contributions under Employee Compensation* in Publication 525.

Distributions of deferred pay are not eligible for the 10-year tax option and rollover treatment (discussed later). Distributions are, however, subject to the tax for failure to make minimum distributions. See *Required distributions not made*, under *Tax on Excess Accumulation*, later.

For general information on these deferred compensation plans, see *Section 457 Deferred Compensation Plans* in Publication 575.

Cost (Investment in the Contract)

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost (your investment in the contract). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

Your **annuity starting date** is the later of the first day of the first period for which you received a payment, or the date the plan's obligation became fixed.

Your employer or the organization that pays you the benefits (plan administrator) should show your cost in Box 5 of your Form 1099-R.

Foreign employment contributions. If you worked in a foreign country and your employer contributed to your retirement plan, a part of those payments may be considered part of your cost. This applies to contributions that were made:

- 1) Before 1963,
- 2) After 1962 for work if you performed the services under a plan that existed on March 12, 1962, or
- 3) After 1996 if you performed the services of a foreign missionary.

Simplified Method

Under the Simplified Method, you figure the tax-free part of each monthly annuity payment by dividing your cost by the total number of expected monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, **and** you receive pension or annuity payments from a qualified plan or annuity, **unless** you were at least 75 years old and entitled to annuity payments from a qualified plan that are guaranteed for 5 years or more.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

- 1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
- 2) A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years.

You can use the General Rule for a qualified plan if your annuity starting date is before November 19, 1996 (but after July 1, 1986), and you do not qualify to use, or choose not to use, the Simplified Method.

You generally cannot use the General Rule for a qualified plan if your annuity starting date is after November 18, 1996. Complete information on the General Rule, including the tables you need, is contained in Publication 939.

TIP **If you are age 75 or older, and your annuity starting date is after November 18, 1996, you must use the General Rule if the payments are guaranteed for at least 5 years. You must use the Simplified Method if the payments are guaranteed for less than 5 years.**

Note. If you are not sure whether your retirement plan is a qualified plan (that meets certain Internal Revenue Code requirements), ask your employer or plan administrator.

Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to less than 5 years of guaranteed payments.

If you are the survivor of a deceased retiree, you can use the Simplified Method if the retiree used it.

Exclusion limit. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years.

If your annuity starting date is after 1986, your exclusion is limited to your cost. If it was before January 1, 1987, you can continue to take your monthly exclusion for as long as you receive your annuity.

If your annuity starting date is after 1986, any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

How to use it. Complete the Simplified Method Worksheet to figure your taxable annuity for 2001. If the annuity is payable only over your life, use your age at the birthday preceding your annuity starting date. For annuity starting dates beginning in 1998, if your annuity is payable over your life and the lives of other individuals, use your combined ages at the birthdays preceding the annuity starting date.



CAUTION **If your annuity starting date begins in 1998 and your annuity is payable over the lives of more than one annuitant, the total number of monthly annuity payments expected to be received is based on the combined ages of the annuitants at the annuity starting date. However, if your annuity starting date began before January 1, 1998, the total number of monthly annuity payments expected to be received is based on the primary annuitant's age at the annuity starting date.**



TIP **Be sure to keep a copy of the completed worksheet; it will help you figure your taxable annuity in later years.**

Example. Bill Kirkland, age 65, began receiving retirement benefits on January 1, 2001, under a joint and survivor annuity. Bill's annuity starting date is January 1, 2001. The benefits are to be paid for the joint lives of Bill and his wife, Kathy, age 65. Bill had contributed \$31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of \$1,200 a month, and Kathy is to receive a monthly survivor benefit of \$600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet is shown in Table 11-1.

Bill's tax-free monthly amount is \$100 (\$31,000 ÷ 310 as shown on line 4 of the worksheet). Upon Bill's death, if Bill has not recovered the full \$31,000 investment, Kathy will also exclude \$100 from her \$600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.



TIP **Had Bill's retirement annuity payments been from a nonqualified plan, he would have used the General Rule. He uses the Simplified Method Worksheet because his annuity payments are from a qualified plan.**

Survivors

If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the **Three-Year Rule**, include the total received in income. (The retiree's cost has already been recovered tax free.)

Table 11–1 Simplified Method Worksheet
(Keep for Your Records)

1. Enter the total pension or annuity payments received this year. Also, enter this amount on Form 1040, line 16a, or Form 1040A, line 12a	1.	14,400
2. Enter your cost in the plan at the annuity starting date plus any death benefit exclusion	2.	31,000
3. Enter the appropriate number from Table 1 below. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below	3.	310
4. Divide line 2 by the number on line 3	4.	100
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6	5.	1,200
6. Enter the amount, if any, recovered tax free in years after 1986	6.	–0–
7. Subtract line 6 from line 2	7.	31,000
8. Enter the smaller of line 5 or line 7	8.	1,200
9. Taxable amount. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total on Form 1040, line 16b, or Form 1040A, line 12b. If your Form 1099–R shows a larger amount, use the amount on this line instead of the amount from Form 1099–R	9.	13,200

TABLE 1 FOR LINE 3 ABOVE
AND your annuity starting date was—

IF the age at annuity starting date was...	before November 19, 1996, enter on line 3...	after November 18, 1996, enter on line 3...
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

TABLE 2 FOR LINE 3 ABOVE

IF the combined ages at annuity starting date were...	THEN enter on line 3...
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

If the retiree was reporting the annuity payments under the **General Rule**, apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree was reporting the annuity payments under the **Simplified Method**, the part of each payment that is tax free is the same as the tax-free amount figured by the retiree at the annuity starting date. See *Simplified Method*, earlier.

In any case, if the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost.

If you are the survivor of an employee, or former employee, who died before becoming entitled to any annuity payments, you must figure the taxable and tax-free parts of your annuity payments.

Estate tax. If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct, as a miscellaneous itemized deduction, the part of the total estate tax that was based on the annuity. This deduction is not subject to the 2%-of-

adjusted-gross-income limit. The deceased annuitant must have died after the annuity starting date. (For details, see section 1.691(d)-1 of the regulations.) This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

How To Report

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

If you file Form 1040A, report your total annuity on line 12a and the taxable part on line 12b. If your pension or annuity is fully taxable, enter it on line 12b; do not make an entry on line 12a.

More than one annuity. If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from **all** annuities on line 16a, Form 1040, or line 12a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 12b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 12b, Form 1040A.

Joint return. If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 12a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 12b, Form 1040A.

Lump-Sum Distributions

If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before 1936, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 10-year tax option, discussed later, to figure tax on the ordinary income part.



The 5-year tax option for figuring the tax on lump-sum distributions has been repealed.

Use Form 4972 to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on your other income. This may result in a smaller tax than you would pay by including the taxable amount of the distribution as ordinary income in figuring your regular tax.

Lump-sum distribution defined. A lump-sum distribution is the distribution or payment in 1 tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a section 457 deferred compensation plan of a state or local

government or tax-exempt organization) cannot qualify as a lump-sum distribution.

The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987. For more information about distributions that do not qualify as lump-sum distributions, see *Distributions that do not qualify* under *Lump-Sum Distributions* in Publication 575.

How to treat the distribution. If you receive a lump-sum distribution, you may have the following options for how you treat the taxable part.

- 1) Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income.
- 2) Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).
- 3) Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- 4) Roll over all or part of the distribution. See *Rollovers*, later. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- 5) Report the entire taxable part of the distribution as ordinary income on your tax return.

The first three options are explained in the following discussions.

Electing optional lump-sum treatment. You can choose to use the 10-year tax option or capital gain treatment only once after 1986 for any plan participant. If you make this choice, you cannot use either of these optional treatments for any future distributions for the participant.

Taxable and tax-free parts of the distribution. The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your **cost** in the lump sum and any **net unrealized appreciation (NUA)** in employer securities tax free.

Cost. In general, your cost is the total of:

- 1) The plan participant's nondeductible contributions to the plan,
- 2) The plan participant's taxable costs of any life insurance contract distributed,
- 3) Any employer contributions that were taxable to the plan participant, and
- 4) Repayments of any loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

NUA. The NUA in employer securities (box 6 of Form 1099-R) received as part of a lump-sum distribution is generally tax free until you sell or exchange the securities. (For more information, see *Distributions of employer securities* under *Taxation of Nonperiodic Payments*, in Publication 575.)

Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. You can elect this treatment only once for any plan participant, and only if the plan participant was born before 1936.

Complete Part II of Form 4972 to choose the 20% capital gain election. For more information, see *Capital Gain Treatment* under *Lump-Sum Distributions* in Publication 575.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. You pay the tax only once, for the year in which you receive the distribution, not over the next 10 years. You can elect this treatment only once for any plan participant, and only if the plan participant was born before 1936.

The ordinary income part of the distribution is the amount shown in box 2a of the Form 1099-R given to you by the payer, minus the amount, if any, shown in box 3. You also can treat the capital gain part of the distribution (box 3 of Form 1099-R) as ordinary income for the 10-year tax option if you do **not** choose capital gain treatment for that part.

Complete Part III of Form 4972 to choose the 10-year tax option. You must use the special tax rates shown in the instructions for Part III to figure the tax. Publication 575 illustrates how to complete Form 4972 to figure the separate tax.

Rollovers

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA.

For this purpose, a qualified retirement plan generally is:

- 1) A qualified employee plan, or
- 2) A qualified employee annuity.



This discussion applies only to traditional IRAs.

In general, the most you can roll over is the part that would be taxable if you did not roll it over. You cannot roll over your contributions, other than your deductible employee contributions. You do not pay tax on the amount that you roll over. This amount, however, is generally taxable later when it is paid to you or your survivor.

You must generally complete the rollover by the 60th day following the day on which you receive the distribution from your employer's plan. (This 60-day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) For all rollovers to an IRA, you must irrevocably elect rollover treatment by written notice to the trustee or issuer of the IRA.



The 60-day period may be extended for distributions made after 2001 in certain cases of casualty, disaster, or other events beyond your reasonable control.

Eligible rollover distributions. Generally, you can roll over any part of the taxable portion of most nonperiodic distributions from a qualified retirement plan, unless it is a required minimum distribution.

Hardship distributions. Hardship distributions from 401(k) plans and similar employer-sponsored retirement plans are no longer treated as eligible rollover distributions.

Direct rollover option. You can choose to have the administrator of your old plan transfer the distribution directly from your old plan to the new plan (if permitted) or traditional IRA. If you decide on a rollover, it is generally to your advantage to choose this direct rollover option. Under this option, the plan administrator would not withhold tax from your distribution.

Withholding tax. If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you. (See *Pensions and Annuities* under *Withholding* in chapter 5.)



If you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld.

The administrator must give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Deductible voluntary employee contributions. If you receive an eligible rollover distribution from your employer's qualified plan of a part of the balance of your accumulated deductible voluntary employee contributions, you can roll over tax free any part of this distribution. The rollover can be either to a traditional IRA or to certain other qualified plans.

Rollover by surviving spouse. You may be able to roll over tax free all or part of a distribution from a qualified retirement plan you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee except that you generally can roll over the distribution only into a traditional IRA.



You can roll over a distribution made after 2001 into a qualified retirement plan or a traditional IRA.

A beneficiary other than the employee's surviving spouse cannot roll over a distribution.

Alternate payee under qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified retirement plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse (not as a nonspousal beneficiary), the rollover rules apply to you as if you were the employee. You can roll over the

distribution from the plan into a traditional IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

Retirement bonds. If you redeem a retirement bond, you can defer the tax on the amount received by rolling it over to an IRA or qualified employer plan as discussed in Publication 590. **For more information** on the rules for rolling over distributions, see Publication 575.

Special Additional Taxes

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive, as explained earlier, and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- Early distributions, and
- Excess accumulation (not receiving minimum distributions).

These taxes are discussed in the following sections.

If you must pay either of these taxes, report them on **Form 5329**. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099-R shows a "1" in box 7. Instead, enter 10% of the taxable part of the distribution on line 55 of Form 1040 and write "No" on the dotted line next to line 55.

Even if you do not owe any of these taxes, you may have to complete Form 5329 and attach it to your Form 1040. This applies if you received an early distribution and your Form 1099-R does not show distribution code "2," "3," or "4" in box 7 (or the code shown is incorrect).

Tax on Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income.

For this purpose, a **qualified retirement plan** is:

- 1) A qualified employee plan,
- 2) A qualified employee annuity plan, or
- 3) A tax-sheltered annuity plan.



A state or local government section 457 deferred compensation plan is also treated as a qualified retirement plan to the extent that any distribution made after 2001 is attributable to amounts the plan received in a direct transfer or rollover from one of the plans listed above.

5% rate on certain early distributions from deferred annuity contracts. If an early withdrawal from a deferred annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply by 5% instead of 10%. Attach an explanation to your return.

Exceptions to tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to your early distribution, distribution code "2," "3," or "4" should be shown in box 7 of your Form 1099-R and you do not have to report the distribution on Form 5329. If an exception applies but distribution code "1" (early distribution, no known exception) is shown in box 7, you must file Form 5329. Enter the taxable amount of the distribution shown in box 2a of your Form 1099-R on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.



If distribution code "1" is incorrectly shown on your Form 1099-R for a distribution received when you were age 59½ or older, include that distribution on Form 5329. Enter exception number "11" on line 2.

The early distribution tax does not apply to any distribution that meets one of the following exceptions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified retirement plan, the payments must begin after your separation from service),
- Made because you are totally and permanently disabled, or
- Made on or after the death of the plan participant or contract holder.

Additional exceptions for qualified retirement plans. The tax does not apply to distributions that are:

- From a qualified retirement plan after your separation from service in or after the year you reached age 55,
- From a qualified retirement plan to an alternate payee under a qualified domestic relations order,
- From a qualified retirement plan to the extent you have deductible medical expenses (medical expenses that exceed 7.5% of your adjusted gross income), whether or not you itemize your deductions for the year,
- From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had separated from

service and had begun receiving payments under the election,

- From an employee stock ownership plan for dividends on employer securities held by the plan, or
- From a qualified retirement plan due to an IRS levy of the plan.

Additional exceptions for nonqualified annuity contracts. The tax does not apply to distributions that are:

- From a deferred annuity contract to the extent allocable to investment in the contract before August 14, 1982,
- From a deferred annuity contract under a qualified personal injury settlement,
- From a deferred annuity contract purchased by your employer upon termination of a qualified employee plan or qualified employee annuity plan and held by your employer until your separation from service, or
- From an immediate annuity contract (a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually).

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your **required beginning date** (defined next).

Unless the rule for 5% owners applies, **you must begin** to receive distributions from your qualified retirement plan by April 1 of the year that follows the **later** of:

- 1) The calendar year in which you reach age 70½, or
- 2) The calendar year in which you retire.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 70½, even if you have not retired.

For this purpose, a **qualified retirement plan** includes a:

- 1) Qualified employee plan,
- 2) Qualified employee annuity plan,
- 3) Section 457 deferred compensation plan, or
- 4) Tax-sheltered annuity plans (for benefits accruing after 1986).

Age 70½. You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday.

For example, if you are retired and your 70th birthday was on July 1, 2000, you were age 70½ on January 1, 2001. Your required beginning date is April 1, 2002. If your 70th birthday was on June 30, 2000, you were age 70½ on December 30, 2000, and your required beginning date is April 1, 2001, unless you had not yet retired.

5% owners. If you are a 5% owner of the company maintaining your qualified retirement plan, you must begin to receive distributions by April 1 of the calendar year that follows the year in which you reach age 70½, regardless of when you retire.

Required distributions. By the required beginning date, as explained above, you must either:

- 1) Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or
- 2) Begin receiving periodic distributions in annual amounts calculated to distribute your entire interest (for a tax-sheltered annuity, your entire benefit accruing after 1986) over your life or life expectancy or over the joint lives or joint life expectancies of you and a designated beneficiary (or over a shorter period).

Additional information. For more information on this rule and how to figure the required amount to be distributed, see *Tax on Excess Accumulation* in Publication 575.

Required distributions not made. If you do not receive required minimum distributions, you are subject to an additional excise tax. The tax equals 50% of the difference between the amount that must be distributed and the amount that was distributed during the tax year. You can get this excise tax waived if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

State insurer delinquency proceedings.

You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum due to these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the excise tax.

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

Disability Pensions

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

You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see chapter 34.

Beginning on the day after you reach minimum retirement age, payments you receive are

taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A.

For more information on how to report disability pensions, including military and certain government disability pensions, see chapter 6.

Purchased Annuities

If you privately purchased an annuity contract from a commercial organization, such as an insurance company, you generally must use the General Rule to figure the tax-free part of each annuity payment. For more information about the General Rule, get Publication 939. Also, see *Variable Annuities* in Publication 575 for the special provisions that apply to these annuity contracts.

Sale of annuity. Gain on the exchange of an annuity contract is ordinary income to the extent that the gain is due to interest accumulated on the contract and the exchange is for a life insurance or endowment contract. You do not recognize gain or loss on an exchange of an annuity contract solely for another annuity contract if the insured or annuitant remains the same. See *Transfers of Annuity Contracts* in Publication 575 for more information about exchanges of annuity contracts.

12.

Social Security and Equivalent Railroad Retirement Benefits

Introduction

This chapter explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits. It explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet (with examples),
- How to report your taxable benefits, and
- How to treat repayments that are more than the benefits you received during the year.

Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable.

Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

If you received these benefits during 2001, you should have received a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S or Form RRB-1042S if you are a nonresident alien). These forms show the amounts received and repaid, and taxes withheld for the year. You may receive more than one of these forms for the same year. You should add the amounts shown on all forms you receive for the year to determine the "total" amounts received and repaid, and taxes withheld for that year. See the Appendix at the end of Publication 915 for more information.

Note. When the term "benefits" is used in this chapter, it applies to both social security benefits and equivalent tier 1 railroad retirement benefits.



Legislation in 2000 removed the "earnings test" for social security recipients who work and are ages 65 through 70. This change has no effect on the federal income tax rules for social security benefits.

What is not covered in this chapter. This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

For information on these benefits, see Publication 575, *Pension and Annuity Income*.

This chapter also does not cover the tax rules for foreign social security or railroad retirement benefits. These benefits are taxable as annuities, unless they are exempt from U.S. tax under a treaty. For more information, see Publication 915.

Useful Items

You may want to see:

Publication

- 575** Pension and Annuity Income
- 590** Individual Retirement Arrangements (IRAs)
- 915** Social Security and Equivalent Railroad Retirement Benefits

Forms (and Instructions)

- 1040-ES** Estimated Tax for Individuals
- W-4V** Voluntary Withholding Request

Are Any of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the **base amount** for your filing status with the total of:

- 1) One-half of your benefits, plus
- 2) All your other income, including tax-exempt interest.

When making this comparison, do not reduce your other income by any **exclusions** for:

- Interest from qualified U.S. savings bonds,
- Employer-provided adoption benefits,
- Foreign earned income or foreign housing, or
- Income earned in American Samoa or Puerto Rico by bona fide residents.

Figuring total income. To figure the total of one-half of your benefits plus your other income, use the worksheet later in this discussion. If the total is more than your base amount, part of your benefits may be taxable.

If you are married and file a joint return for 2001, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.



If the only income you received during 2001 was your social security or the SSEB portion of tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable.

Base amount. Your base amount is:

- \$25,000 if you are single, head of household, or qualifying widow(er),
- \$25,000 if you are married filing separately and **lived apart** from your spouse for **all** of 2001,
- \$32,000 if you are married filing jointly, or
- \$-0- if you are married filing separately and **lived with** your spouse at any time during 2001.



Worksheet. You can use the following worksheet to figure the amount of income to compare with your base amount. This is a quick way to check whether some of your benefits may be taxable.

A. Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 2001, for 2001 and earlier years. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. _____

Note. If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.

B. Enter one-half of the amount on line A B. _____

C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total C. _____

D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income (listed earlier). D. _____

E. Add lines B, C, and D and write in the total E. _____

Note. Compare the amount on line E to your **base amount** for your filing status. If the amount on line E equals or is less than the **base amount** for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits may be taxable. You then need to complete Worksheet 1 in Publication 915 (or in your tax form instruction booklet).

Example. You and your spouse (both over 65) are filing a joint return for 2001, and you both received social security benefits during the year. In January 2002, you received a Form SSA-1099 showing net benefits of \$6,600 in box 5. Your spouse received a Form SSA-1099 showing net benefits of \$2,400 in box 5. You also received a taxable pension of \$17,000 and interest income of \$500. You did not have any tax-exempt interest income. Your benefits are **not** taxable for 2001 because your income, as figured in the following worksheet, is not more than your base amount (\$32,000) for married filing jointly.

Even though none of your benefits are taxable, you must file a return for 2001 because your

taxable gross income (\$17,500) exceeds the minimum filing requirement amount for your filing status.

- A. Write in the amount from **box 5** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 2001, for 2001 and earlier years. (If you received more than one form, combine the amounts from box 5 and write in the total.) A. \$ 9,000

Note. If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.

- B. Enter one-half of the amount on line A B. 4,500

- C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total C. 17,500

- D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income (listed earlier) D. -0-

- E. Add lines B, C, and D and write in the total E. \$22,000

Note. Compare the amount on line E to your **base amount** for your filing status. If the amount on line E equals or is less than the **base amount** for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your **base amount**, some of your benefits may be taxable. You then need to complete *Worksheet 1* in Publication 915 (or in your tax form instruction booklet).

Who is taxed. The person who has the legal right to receive the benefits must determine whether the benefits are taxable. For example, if you and your child receive benefits, but the check for your child is made out in your name, you must use only your part of the benefits to see whether any benefits are taxable to you. One-half of the part that belongs to your child must be added to your child's other income to see whether any of those benefits are taxable to your child.

Repayment of benefits. Any repayment of benefits you made during 2001 must be subtracted from the gross benefits you received in 2001. It does not matter whether the repayment was for a benefit you received in 2001 or in an earlier year. If you repaid more than the gross benefits you received in 2001, see *Repayments More Than Gross Benefits*, later.

Your gross benefits are shown in box 3 of Form SSA-1099 or RRB-1099. Your repayments are shown in box 4. The amount in box 5 shows your net benefits for 2001 (box 3 minus box 4). Use the amount in box 5 to figure whether any of your benefits are taxable.

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your social security benefits and/or the SSEB portion of your tier 1 railroad retirement benefits.

If you choose to do this, you must complete a Form W-4V. For 2002, you can choose withholding at 7%, 10%, 15%, or 27% of your total benefit payment.

If you do not choose to have income tax withheld, you may have to request additional withholding from other income or pay estimated tax during the year. For details, get Publication 505, *Tax Withholding and Estimated Tax*, or the instructions for Form 1040-ES.

How To Report Your Benefits

If part of your benefits are taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ.

Reporting on Form 1040. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 20a and the taxable part on line 20b. If you are married filing separately and you lived apart from your spouse for all of 2001, also enter "D" to the left of line 20a.

Reporting on Form 1040A. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 14a and the taxable part on line 14b. If you are married filing separately and you lived apart from your spouse for all of 2001, also enter "D" to the right of the word "benefits" on line 14a.

Benefits not taxable. If none of your benefits are taxable, do not report any of them on your tax return. But if you are married filing separately and you lived apart from your spouse for all of 2001, make the following entries. On Form 1040, enter "D" to the left of line 20a and "-0-" on line 20b. On Form 1040A, enter "D" to the right of the word "benefits" on line 14a and "-0-" on line 14b.

How Much Is Taxable?

If part of your benefits are taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations applies to you.

- 1) The total of one-half of your benefits and all your other income is more than \$34,000 (\$44,000 if you are married filing jointly).
- 2) You are married filing separately and **lived with your spouse** at any time during 2001.

Which worksheet to use. A worksheet to figure your taxable benefits is in the instructions for your Form 1040 or Form 1040A. You can use either that worksheet or *Worksheet 1* in Publication 915, unless any of the following situations applies to you.

- 1) You contributed to a traditional individual retirement arrangement (IRA) and your IRA deduction is limited because you or your spouse is covered by a retirement plan at work. In this situation you **must** use the special worksheets in Appendix B of Publication 590 to figure both your IRA deduction and your taxable benefits.
- 2) Situation (1) does not apply and you take an exclusion for interest from qualified U.S. savings bonds (Form 8815), for adoption benefits (Form 8839), for foreign earned income or housing (Form 2555 or Form 2555-EZ), or for income earned in American Samoa (Form 4563) or Puerto Rico by bona fide residents. In this situation, you **must** use *Worksheet 1* in Publication 915 to figure your taxable benefits.
- 3) You received a lump-sum payment for an earlier year. In this situation, also complete *Worksheet 2* or *3* and *Worksheet 4* in Publication 915. See *Lump-sum election*.

Lump-sum election. You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 2001 in your 2001 income, even if the payment includes benefits for an earlier year.

TIP This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

Generally, you use your 2001 income to figure the taxable part of the total benefits received in 2001. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

Making the election. If you received a lump-sum benefit payment in 2001 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

CAUTION Since the earlier year's taxable benefits are included in your 2001 income, no adjustment is made to the earlier year's return. **Do not** file an amended return for the earlier year.

Examples

The following are a few examples you can use as a guide to figure the taxable part of your benefits.

Example 1. George White is single and files Form 1040 for 2001. He received the following income in 2001:

Fully taxable pension	\$18,600
Wages from part-time job	9,400
Taxable interest income	990
Total	<u>\$28,990</u>

George also received social security benefits during 2001. The Form SSA-1099 he received in January 2002 shows \$5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here.

Worksheet 1. Figuring Your Taxable Benefits

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	5,980
--	-------

Note. If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.

2. Enter one-half of line 1	2,990
---------------------------------------	-------

3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10, 11b, 12b, and 13	28,990
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4. Form 1040A filers: Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 26).	
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Form 1040 filers: Enter the total of any exclusions/adjustments for:	
• Qualified U.S. savings bond interest (Form 8815, line 14),	
• Adoption benefits (Form 8839, line 26),	
• Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and	
• Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	-0-
5. Add lines 2, 3, and 4	31,980

6. Form 1040A filers: Enter the amount from Form 1040A, line 16	
--	--

Form 1040 filers: Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24	-0-
7. Subtract line 6 from line 5	31,980

8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 2001)	25,000
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9. Subtract line 8 from line 7. If zero or less, enter -0-	6,980
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Note. If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2001, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 14a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 14b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 2001)	9,000
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11. Subtract line 10 from line 9. If zero or less, enter -0-	-0-
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12. Enter the smaller of line 9 or line 10	6,980
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13. Enter one-half of line 12	3,490
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14. Enter the smaller of line 2 or line 13	2,990
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15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	-0-
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16. Add lines 14 and 15	2,990
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17. Multiply line 1 by 85% (.85)	5,083
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18. Taxable benefits. Enter the smaller of line 16 or line 17	2,990
• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 14a.	
• Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 14b.	

The amount on line 18 of George's worksheet shows that \$2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of \$5,980. On line 20b, he enters his taxable part of \$2,990.

Example 2. Ray and Alice Hopkins file a joint return on Form 1040A for 2001. Ray is retired and received a fully taxable pension of \$15,500. He also received social security benefits, and his Form SSA-1099 for 2001 shows net benefits of \$5,600 in box 5. Alice worked during the year and had wages of \$14,000. She made a deductible payment to her IRA account of \$1,000. Ray and Alice have two savings accounts with a total of \$250 in interest income. They complete Worksheet 1 and find that none of Ray's social security benefits are taxable. They leave lines 14a and 14b of their Form 1040A blank.

Worksheet 1. Figuring Your Taxable Benefits

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	5,600
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Note. If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.

2. Enter one-half of line 1	2,800
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3. Enter the total of the amounts from: Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21. Form 1040A: lines 7, 8a, 8b, 9, 10, 11b, 12b, and 13	29,750
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4. Form 1040A filers: Enter the total of any exclusion for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 26).	
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Form 1040 filers: Enter the total of any exclusions/adjustments for:

- Qualified U.S. savings bond interest (Form 8815, line 14),
- Adoption benefits (Form 8839, line 26),
- Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico

5. Add lines 2, 3, and 4	32,550
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6. Form 1040A filers: Enter the amount from Form 1040A, line 16	
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Form 1040 filers: Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24	1,000
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7. Subtract line 6 from line 5	31,550
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8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 2001)	32,000
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9. Subtract line 8 from line 7. If zero or less, enter -0-	-0-
--	-----

Note. If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2001, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 14a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 14b.) Otherwise, go on to line 10.

10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 2001)	
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11. Subtract line 10 from line 9. If zero or less, enter -0-	
--	--

12. Enter the smaller of line 9 or line 10	
---	--

13. Enter one-half of line 12	
---	--

14. Enter the smaller of line 2 or line 13	
---	--

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	
--	--

16. Add lines 14 and 15	
-----------------------------------	--

17. Multiply line 1 by 85% (.85)	
--	--

18. Taxable benefits. Enter the smaller of line 16 or line 17	
• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 14a.	
• Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 14b.	

Example 3. Joe and Betty Johnson file a joint return on Form 1040 for 2001. Joe is a retired railroad worker and in 2001 received the social security equivalent benefit (SSEB) portion of tier 1 railroad retirement benefits. Joe's Form RRB-1099 shows \$10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of \$38,000. They had \$2,300 in interest income plus interest of \$200 on a qualified U.S. savings bond. The savings bond interest qualified for the exclusion. Thus, they have a total income of \$40,300 (\$38,000 + \$2,300). They figure their taxable benefits by completing Worksheet 1.

**Worksheet 1.
Figuring Your Taxable Benefits**

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	10,000
<i>Note. If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.</i>	
2. Enter one-half of line 1	5,000
3. Enter the total of the amounts from:	
Form 1040: Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.	
Form 1040A: lines 7, 8a, 8b, 9, 10, 11b, 12b, and 13	40,300
4. Form 1040A filers: Enter the total of any exclusion for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 26).	
Form 1040 filers: Enter the total of any exclusions/adjustments for:	
• Qualified U.S. savings bond interest (Form 8815, line 14),	
• Adoption benefits (Form 8839, line 26),	
• Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and	
• Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	200
5. Add lines 2, 3, and 4	45,500
6. Form 1040A filers: Enter the amount from Form 1040A, line 16	
Form 1040 filers: Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24	-0-
7. Subtract line 6 from line 5	45,500
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 2001)	32,000
9. Subtract line 8 from line 7. If zero or less, enter -0-	13,500
<i>Note. If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2001, enter "D" to the left of line 20a, Form 1040, or to the right of the word "benefits" on line 14a, Form 1040A. Also enter -0- on Form 1040, line 20b or on Form 1040A, line 14b.) Otherwise, go on to line 10.</i>	
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time in 2001)	12,000
11. Subtract line 10 from line 9. If zero or less, enter -0-	1,500
12. Enter the smaller of line 9 or line 10	12,000
13. Enter one-half of line 12	6,000
14. Enter the smaller of line 2 or line 13	5,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	1,275

16. Add lines 14 and 15	6,275
17. Multiply line 1 by 85% (.85)	8,500
18. Taxable benefits. Enter the smaller of line 16 or line 17	6,275
• Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 14a.	
• Enter the amount from line 18 above on Form 1040, line 20b or on Form 1040A, line 14b.	

More than 50% of Joe's net benefits are taxable because the income on line 7 of the worksheet (\$45,500) is more than \$44,000. Joe and Betty enter \$10,000 on line 20a, Form 1040, and \$6,275 on line 20b, Form 1040.

Deductions Related to Your Benefits

You may be entitled to deduct certain amounts related to the benefits you receive.

Disability payments. You may have received disability payments from your employer or an insurance company that you included as income on your tax return in an earlier year. If you received a lump-sum payment from SSA or RRB, and you had to repay the employer or insurance company for the disability payments, you can take an itemized deduction for the part of the payments you included in gross income in the earlier year. If the amount you repay is more than \$3,000, you may be able to claim a tax credit instead. Claim the deduction or credit in the same way explained under *Repayments More Than Gross Benefits*, later.

Legal expenses. You can usually deduct legal expenses that you pay or incur to produce or collect taxable income or in connection with the determination, collection, or refund of any tax.

Legal expenses for collecting the **taxable** part of your benefits are deductible as a miscellaneous itemized deduction on line 22, Schedule A (Form 1040).

Repayments More Than Gross Benefits

In some situations, your Form SSA-1099 or Form RRB-1099 will show that the total benefits you repaid (box 4) are more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure (a figure in parentheses) and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year.

If you have any questions about this negative figure, contact your local SSA office or your local U.S. RRB field office.

Joint return. If you and your spouse file a joint return, and your Form SSA-1099 or RRB-1099 has a negative figure in box 5, but your spouse's does not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

Example. John and Mary file a joint return for 2001. John received Form SSA-1099 showing \$3,000 in box 5. Mary also received Form SSA-1099 and the amount in box 5 was (\$500). John and Mary will use \$2,500 (\$3,000 minus \$500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

Repayment of benefits received in an earlier year. If the total amount shown in box 5 of all of your Forms SSA-1099 and RRB-1099 is a negative figure, you can take an itemized deduction for the part of this negative figure that represents benefits you included in gross income in an earlier year.

If this deduction is \$3,000 or less, it is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions. Claim it on line 22, Schedule A (Form 1040).

If this deduction is more than \$3,000, you should figure your tax two ways:

- 1) Figure your tax for 2001 with the itemized deduction included on line 27 of Schedule A.
- 2) Figure your tax for 2001 in the following steps.
 - a) Figure the tax without the itemized deduction included on line 27 of Schedule A.
 - b) For each year after 1983 for which part of the negative figure represents a repayment of benefits, refigure your taxable benefits as if your total benefits for the year were reduced by that part of the negative figure. Then refigure the tax for that year.
 - c) Subtract the total of the refigured tax amounts in (b) from the total of your actual tax amounts.
 - d) Subtract the result in (c) from the result in (a).

Compare the tax figured in methods (1) and (2). Your tax for 2001 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 27, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 65 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 65. If both methods produce the same tax, deduct the repayment on line 27, Schedule A (Form 1040).

13.

Other Income

Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not subject to tax.

This chapter begins with discussions of the following income items.

- Bartering.
- Canceled debts.
- Life insurance proceeds.
- Partnership income.
- S Corporation income.
- Recoveries (including state income tax refunds).
- Rents from personal property.
- Repayments.
- Royalties.
- Unemployment benefits.
- Welfare and other public assistance benefits.

These discussions are followed by brief discussions of many income items arranged in alphabetical order.

You must include on your return all income you receive in the form of money, property, and services unless the tax law states that you do not include them. Some items, however, are only partly excluded from income.

Useful Items

You may want to see:

Publication

- 520** Scholarships and Fellowships
- 525** Taxable and Nontaxable Income
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value

of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Generally, you report this income on Schedule C, *Profit or Loss From Business*, or Schedule C-EZ, *Net Profit From Business* (Form 1040). But if the barter involves an exchange of something other than services, such as in *Example 3* below, you may have to use another form or schedule instead.

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

Example 2. You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in your income the value of the credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

Example 3. You own a small apartment building. In return for 6 months rent-free use of an apartment, an artist gives you a work of art she created. You must report as rental income on Schedule E, *Supplemental Income and Loss* (Form 1040), the fair market value of the artwork, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

Form 1099-B from barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange by January 31, 2002. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2001. The IRS will also receive a copy of Form 1099-B.

Canceled Debts

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040. If it is a business debt, report the amount on Schedule C or C-EZ (Form 1040) (or on Schedule F, *Profit or Loss From Farming* (Form 1040), if you are a farmer).

Form 1099-C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your income depends on whether the interest would be deductible if you paid it. See *Deductible debt*, under *Exceptions*, later.

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

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

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Exceptions

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

Nonrecourse debt. If you are not personally liable for the debt (nonrecourse debt), different rules apply. You may have a gain or loss if nonrecourse debt is canceled or forgiven in conjunction with the foreclosure or repossession of property to which the debt attaches. See Publication 544 for more information.

Student loans. Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers.

You do not have income if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

- 1) The federal government, a state or local government, or an instrumentality, agency, or subdivision thereof,
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
- 3) An educational institution:

- a) Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
- b) As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

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

Section 501(c)(3) organizations are defined in Publication 525.

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

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

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

- 1) The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, *Bankruptcy Tax Guide*.
- 2) The debt is canceled when you are insolvent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent. See Publication 908.
- 3) The debt is qualified farm debt and is canceled by a qualified person. See chapter 4 of Publication 225, *Farmer's Tax Guide*.
- 4) The debt is qualified real property business debt. See chapter 5 of Publication 334.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the

benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

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

More information. For more information, see *Life Insurance Proceeds* in Publication 525.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In general, your cost (or investment in the contract) is the total of premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income.

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

Endowment proceeds. Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, add the aggregate amount of premiums (or other consideration) paid for the contract and subtract any amount that you previously received under the contract and excluded from your income. Include the part of the lump sum payment that is more than your cost in your income.

Deceased public safety officers. If you are a survivor of a public safety officer who died in the line of duty, you may be able to exclude from income certain amounts you receive.

Bureau of Justice Assistance payments. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit paid to you by the Bureau of Justice Assistance.

Governmental plan annuity. If you receive a survivor annuity as the child or spouse (or former spouse) of a public safety officer who was killed in the line of duty after 1996, you generally do not have to include it in income. This exclusion applies to the amount of the annuity that is based on the officer's service as a public safety officer.



Beginning in 2002, this exclusion applies regardless of when the officer was killed.

For this purpose, the term **public safety officer** includes police and law enforcement officers, firefighters and rescue squad and ambu-

lance crews. See Publication 525 for more information.

Accelerated Death Benefits

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

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

Exclusion for terminal illness. Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts. For information on the limit and the definitions of **chronically ill individual** and **long-term care insurance contracts**, see *Long-Term Care Insurance Contracts* under *Sickness and Injury Benefits* in chapter 6.

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

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

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

Partnership Income

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

Schedule K-1 (Form 1065). Although a partnership generally pays no tax, it must file an information return on Form 1065, *U.S. Return of Partnership Income*, and send Schedule K-1 (Form 1065) to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K-1 (Form 1065)* to help each partner report his or her share of the partnership's income, deductions, credits, and tax preference items.



Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040.

For more information on partnerships, get Publication 541, *Partnerships*.

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are **passed through** to the shareholders.

Schedule K-1 (Form 1120S). An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation*, and send Schedule K-1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K-1 (Form 1120S)* to help each shareholder report his or her share of the S corporation's income, losses, credits, and deductions.



Keep Schedule K-1 (Form 1120S) for your records. Do not attach it to your Form 1040.

For more information on S corporations and their shareholders, see the instructions for Form 1120S.

Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year. For more information, get Publication 525.

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

State income tax refund. If you received a state or local income tax refund (or credit or offset) in 2001, you must include it in income if you deducted the tax in an earlier year. You should receive Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, from the payer by January 31, 2002. The IRS will also receive a copy of the Form 1099-G.

Mortgage interest refund. If you received a refund or credit in 2001 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, *Mortgage Interest Statement*. Do not subtract the refund amount from the interest you paid in 2001. You may have to include it in your income under the rules explained in the following discussions.

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

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

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which you paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525.

Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must generally include the full amount of the recovery in your income in the year you receive it.

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

Standard deduction limit. You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the smaller of:

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

Example. For 2000, you filed a joint return. Your taxable income was \$20,000 and you were not entitled to any tax credits. The standard

deduction that you could have claimed was \$7,350, and you had itemized deductions of \$9,000. In 2001, you received the following recoveries for amounts deducted on your 2000 return:

Medical expenses	\$200
State and local income tax refund	400
Refund of mortgage interest	325
Total recoveries	\$925

None of the recoveries were more than the deductions taken for 2000.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction (\$9,000 - 7,350 = \$1,650), you must include your total recoveries in your income for 2001. Report the state and local income tax refund of \$400 on line 10 of Form 1040 and the balance of your recoveries, \$525, on line 21 of Form 1040.

Standard deduction for earlier years. To determine if amounts recovered in 2001 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. Standard deduction amounts for 2000, 1999, and 1998 are in Publication 525.

Example. You filed a joint return for 2000 with taxable income of \$25,000. Your itemized deductions were \$8,700. The standard deduction that you could have claimed was \$7,350. In 2001 you recovered \$2,400 of your 2000 itemized deductions. None of the recoveries were more than the actual deductions for 2000. Include \$1,350 of the recoveries in your 2001 income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction (\$8,700 - 7,350 = \$1,350).

Recovery limited to deduction. You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

- 1) The amount deducted on Schedule A (Form 1040), or
- 2) The amount recovered.

Example. During 2000 you paid \$1,700 for medical expenses. From this amount you subtracted \$1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was \$200. In 2001, you received a \$500 reimbursement from your medical insurance for your 2000 expenses. The only amount of the \$500 reimbursement that must be included in your income for 2001 is \$200—the amount actually deducted.

Other recoveries. See *Recoveries* in Publication 525 if:

- 1) You have recoveries of items other than itemized deductions, or
- 2) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year.

Rents from Personal Property

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

- 1) Whether or not the rental activity is a business, and
- 2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

Reporting business income and expenses.

If you are in the business of renting personal property, report your income and expenses on Schedule C or C-EZ (Form 1040). The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on line 32 of Form 1040. Also enter the amount and "PPR" on the dotted line to the left of line 32.

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

Repayments

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than \$3,000, you may be able to take a credit against your tax for the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C or C-EZ (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040).

Repayment – \$3,000 or less. If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it. If you must deduct it as a miscellaneous itemized deduction, enter it on line 22 of Schedule A (Form 1040).

Repayment – over \$3,000. If the amount you repaid was more than \$3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if you included the income under a **claim of right**. This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

Method 1. Figure your tax for 2001 claiming a deduction for the repaid amount. If you must deduct it as a miscellaneous itemized deduction, enter it on line 27 of Schedule A (Form 1040).

Method 2. Figure your tax for 2001 claiming a credit for the repaid amount. Follow these steps.

- 1) Figure your tax for 2001 **without** deducting the repaid amount.
- 2) Refigure your tax from the earlier year without including in income the amount you repaid in 2001.
- 3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
- 4) Subtract the answer in (3) from the tax for 2001 figured without the deduction (Step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim a credit for the amount repaid on line 65 of Form 1040, and write "I.R.C. 1341" next to line 65.

An example of this computation can be found in Publication 525.

Repaid social security benefits. If you repaid social security benefits, see *Repayment of benefits* in chapter 12.

Royalties

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

You generally report royalties in Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C or Schedule C-EZ (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are ex-

tracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 10 of Publication 535, *Business Expenses*.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment of other interests in the property is ordinary income subject to a depletion allowance.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Unemployment Benefits

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

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

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

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.

- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a **substitute** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are **not** unemployment compensation. See chapter 6 for more information.)
- Trade readjustment allowances under the Trade Act of 1974.
- Benefits under the Airline Deregulation Act of 1978.
- Unemployment assistance under the Disaster Relief Act Amendments of 1974.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Repayment of unemployment compensation. If you repaid in 2001 unemployment compensation you received in 2001, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. On the dotted line next to your entry write "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2001 that you included in income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. For more information, see *Repayments*, earlier.

Tax withholding. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 15% of your payment.



If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. For more information on estimated tax, see chapter 5.

Supplemental unemployment benefits. Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax and social security and Medicare taxes. Report these payments on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

Repayment of benefits. You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040. (You cannot use Form 1040A or Form 1040EZ.) Include the repayment on line 32 of Form 1040, and write "Sub-Pay TRA" and the amount on the dotted line next to line 32. If the amount you repay in a later year is more than \$3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see *Repayments*, earlier.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages. Include them on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

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

Welfare and Other Public Assistance Benefits

Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare payments obtained fraudulently.

Alaska residents. Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in income on line 21 of Form 1040.

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

services to help mentally retarded persons do their work.

Disaster relief grants. Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Unemployment assistance payments under the Act are taxable unemployment compensation. See *Unemployment compensation*, earlier.

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

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

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

Other Income

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

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity is a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report and can be taken only if you itemize deductions on Schedule A (Form 1040). See *Not-for-Profit Activities* in chapter 1 of Publication 535 for information on whether an activity is considered carried on for a profit.

Advance payment of the rate reduction credit. If you received a check from the IRS during 2001 for the advance payment of the rate reduction credit, do not report it on your tax return. It is not taxable. For more information about the rate reduction credit, see chapter 38.

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

Alimony. Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 20.

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*. Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21 of Form 1040 in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

Example. You buy a new car for \$9,000 cash and receive a \$400 rebate check from the manufacturer. The \$400 is not income to you. Your cost is \$8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Casualty insurance and other reimbursements. You generally should not report these reimbursements on your return. Get Publication 547, *Casualties, Disasters, and Thefts*, for more information.

Child support payments. You should not report these payments on your return. Get Publication 504, *Divorced or Separated Individuals*, for more information.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. Include the following as ordinary income.

- 1) Interest on any award.
- 2) Compensation for lost wages or lost profits in most cases.
- 3) Punitive damages. It does not matter if they relate to a physical injury or physical sickness.
- 4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
- 5) Damages for:
 - a) Patent or copyright infringement,
 - b) Breach of contract, or
 - c) Interference with business operations.
- 6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Emotional distress. Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment dis-

crimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Credit card insurance. Generally, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

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

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income, whether or not you have actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

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

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

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

The fiduciary of the estate or trust must tell you the type of items making up your share of

the estate or trust income and any credits you are allowed on your individual income tax return.

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

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. (The grantor is the one who transferred property to the trust.) This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

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

- 1) A corporate director,
- 2) An executor or administrator of an estate,
- 3) A notary public, or
- 4) An election precinct official.

Nonemployee compensation. If you are **not an employee** and the fees for your services from the same payer total \$600 or more for the year, you may receive a Form 1099-MISC. You may need to report your fees as self-employment income. See *Self-Employed Persons*, in chapter 1, for a discussion of when you are considered self-employed.

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

Executor or administrator of an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on line 21 of Form 1040. If you provide the services as a trade or business, report them as self-employment income on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

Notary public. Report payments for these services on Schedule C (Form 1040) or Schedule C-EZ (Form 1040). These payments are **not** subject to self-employment tax. (See the separate instructions for Schedule C (Form 1040) for details.)

Election precinct official. You should receive a Form W-2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing care to qualified foster individuals in your home generally are not included in your income. However, you must include in your income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

A qualified foster individual is a person who:

- 1) Is living in a foster family home, and

2) Was placed there by:

- a) An agency of a state or one of its political subdivisions, or
- b) If the individual is under age 19, a tax-exempt child placement agency licensed by a state or one of its political subdivisions.

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

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

- 1) 10 qualified foster individuals under age 19, or
- 2) 5 qualified foster individuals age 19 or older.

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

Reporting taxable payments. If you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. Report the payments on Schedule C or Schedule C-EZ (Form 1040). Get Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers)*, to help you determine the amount you can deduct for the use of your home.

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

Gambling winnings. You must include your gambling winnings in income on line 21 of Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. See chapter 30 for information on recordkeeping.

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes.



If you win a state lottery prize payable in installments, see Publication 525 for more information.

Form W-2G. You may have received a Form W-2G, *Certain Gambling Winnings*, showing the amount of your gambling winnings and any tax taken out of them. Include the

amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 59 of Form 1040.

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

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See chapter 11 if you inherited a pension. See chapter 18 if you inherited an IRA.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.



If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct the loss.

Holocaust victims restitution. Under new law enacted in 2001, the federal tax treatment of payments received by Holocaust victims (or their heirs) as restitution for Nazi persecution has been clarified. Restitution payments received after December 31, 1999 (and interest earned on the payments, including interest earned on amounts held in certain escrow accounts or funds) are not taxable. You also do not include them in any computations in which you would ordinarily add excludable income to your adjusted gross income, such as the computation to determine the taxable part of social security benefits. If the payments are made in property, your basis in the property is its fair market value when you receive it.

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

Amending your 2000 return. If your treatment of restitution payments received in 2000 was different from the treatment described above and caused you to pay more tax, you should file an amended return for 2000 on Form 1040X, *Amended U.S. Individual Income Tax Return*. To claim a refund of tax, you should generally file the amended return by April 15, 2004. See the form instructions for more information.

Illegal income. Illegal income, such as stolen or embezzled funds, must be included in your income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Interest on frozen deposits. In general, you exclude from your income the amount of interest earned on a frozen deposit. See *Interest income on frozen deposits* in chapter 8.

Interest on qualified savings bonds. You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. For more information on this exclusion, see *Education Savings Bond Program under U.S. Savings Bonds* in chapter 8.

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

Jury duty. Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income. Include the amount you repay your employer on line 32 of Form 1040. Write "Jury Pay" and the amount on the dotted line next to line 32.

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

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

Medical savings accounts (MSAs). You do not generally include in income amounts you withdraw from your Archer MSA or Medicare+Choice MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040), *Itemized Deductions*. For more information about qualified medical expenses, see chapter 23. For more information about Archer MSAs or Medicare+Choice MSAs, see Publication 969, *Medical Savings Accounts (MSAs)*.



You cannot buy health insurance with distributions from your MSA unless you are receiving unemployment benefits, buying continuation coverage required by federal law, or buying long-term care insurance.

Taxable distributions and penalty. If you use the money from your MSA for any purpose besides qualified medical expenses, it will be taxable income that you must report on your tax return. In addition to the tax, you will be charged a 15% penalty for an early distribution. The penalty will not be charged if you are disabled, age 65, or die during the year.

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

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

Employee awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income. See *Bonuses and awards* in chapter 6.

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

- 1) You were selected without any action on your part to enter the contest or proceeding.
- 2) You are not required to perform substantial future services as a condition to receiving the prize or award.
- 3) The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you.

See Publication 525 for more information about the conditions that apply to the transfer.

Railroad retirement annuities. The following types of payments are treated as pension or annuity income and are taxable under the rules explained in chapter 12.

- 1) Tier 1 railroad retirement benefits that are more than the **social security equivalent benefit**.

- 2) Tier 2 benefits.
- 3) Vested dual benefits.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of a personal residence. See chapter 16.

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

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

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

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

Amounts used for room and board **do not** qualify. Get Publication 520 for more information on qualified scholarships and fellowship grants.

Payments for services. Payments you receive for services required as a condition of receiving a scholarship or fellowship grant must be included in your income, even if the services are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

For information about the rules that apply to a tax-free qualified tuition reduction provided to employees and their families by an educational institution, see Publication 520.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your income. These allowances are not considered scholarship or fellowship grants.

Scholarship prizes. Scholarship prizes won in a contest are not scholarships or fellow-

ships if you do not have to use the prizes for educational purposes. You must include these amounts in your income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.

State tuition programs. If you receive distributions from a qualified state tuition program, only the amount that is more than the amount contributed to the program is taxable.

Qualified state tuition programs are defined in Publication 970. For more information on a specific program, contact the state or agency that established and maintains it.

Transporting school children. Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). For more information, see *Union Dues and Expenses* in chapter 30.

Strike and lockout benefits. Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

Utility rebates. If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

- 1) A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

Part Three.

Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in chapter 27 in Part Five.

14.

Basis of Property

Introduction

This chapter discusses how to figure your basis in property. It is divided into the following sections.

- Cost basis.
- Adjusted basis.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure gain or loss on the sale, exchange, or other disposition of property. Also use it to figure deductions for depreciation, amortization, depletion, and casualty losses. You must keep accurate records of all items that affect the basis of property so you can make these computations.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

Useful Items

You may want to see:

Publication

- ❑ **15–B** Employer's Tax Guide to Fringe Benefits
- ❑ **523** Selling Your Home
- ❑ **525** Taxable and Nontaxable Income
- ❑ **535** Business Expenses
- ❑ **537** Installment Sales
- ❑ **544** Sales and Other Dispositions of Assets

- ❑ **550** Investment Income and Expenses
- ❑ **551** Basis of Assets
- ❑ **564** Mutual Fund Distributions
- ❑ **946** How To Depreciate Property

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items.

- Sales tax.
- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

In addition, the basis of real estate and business assets may include other items.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

For more information, see *Unstated Interest and Original Issue Discount* in Publication 537.

Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

If you buy buildings and the land on which they stand for a lump sum, allocate the basis among the land and the buildings so you can figure the allowable depreciation on the buildings. Land is not depreciable. Allocate the cost according to the fair market values of the land and buildings at the time of purchase.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, who both have reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Assumption of mortgage. If you buy property and assume (or buy subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs you pay for buying the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.) You cannot include fees and costs for getting a loan on the property.

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs you **cannot** include in the basis of property.

- 1) Casualty insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services related to occupancy of the property before closing.
- 4) Fees for refinancing a mortgage.
- 5) Charges connected with getting a loan. The following are examples of these charges.

- a) Points (discount points, loan origination fees).
- b) Mortgage insurance premiums.
- c) Loan assumption fees.
- d) Cost of a credit report.
- e) Fees for an appraisal required by a lender.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information on how to deduct points, see *Points* in chapter 5 of Publication 535.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by any seller-paid points. For more information, see *Points* in chapter 25.

Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

Improvements. Add the cost of improvements to your basis in the property if they increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Add assessments for improvements such as streets and sidewalks to the basis of the prop-

Table 14–1. Examples of Adjustments to Basis

<u>Increases to Basis</u>	<u>Decreases to Basis</u>
<ul style="list-style-type: none"> • Capital improvements: <ul style="list-style-type: none"> – Putting an addition on your home – Replacing an entire roof – Paving your driveway – Installing central air conditioning – Rewiring your home • Assessments for local improvements: <ul style="list-style-type: none"> – Water connections – Sidewalks – Roads • Costs of restoring damaged property after a casualty loss • Legal fees for defending and perfecting a title • Zoning costs 	<ul style="list-style-type: none"> • Exclusion from income of subsidies for energy conservation measures. • Casualty or theft loss deductions and insurance reimbursements • Credit for qualified electric vehicles • Section 179 deduction • Depreciation • Deduction for clean-fuel vehicles and clean-fuel refueling property • Nontaxable corporate distributions

erty if they increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes assessments for maintenance, repairs, or interest charges on the improvements.

Example. Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

Decreases to Basis

The following items reduce the basis of your property.

- The section 179 deduction.
- The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- Nontaxable corporate distributions (see chapter 9).
- Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
- Exclusion of subsidies for energy conservation measures (see *Energy conservation subsidies* in chapter 13).
- Credit for qualified electric vehicles.
- Postponed gain from the sale of your home.
- Casualty and theft losses and insurance reimbursements.
- Certain canceled debt excluded from income.

- Rebates received from a manufacturer or seller.
- Easements.
- Gas-guzzler tax.
- Adoption tax benefits.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance.

You must increase your basis in the property by the amount you spend on repairs that substantially prolong the life of the property, increase its value, or adapt it to a different use. To make this determination, compare the repaired property to the property before the casualty.

For more information on casualty and theft losses, see chapter 27.

Easements. The amount you receive for granting an easement is generally considered to be from the sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

If the gain is on a capital asset, see chapter 17 for information about how to report it. If the gain is on property used in a trade or business, see Publication 544 for information about how to report it.

Depreciation and section 179 deduction. Decrease the basis of your qualifying business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

For more information about depreciation and the section 179 deduction, see Publication 946.

Credit for qualified electric vehicles. If you claim the credit for a qualified electric vehicle, you must reduce your basis in that vehicle by the lesser of the following amounts.

- \$4,000.
- 10% of the vehicle's cost.

This basis reduction rule applies even if the credit allowed is less than the reduction. For more information on this credit, see chapter 12 in Publication 535.

Deduction for clean-fuel vehicle and refueling property. If you take the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, decrease the basis of the property by the amount taken. For more information about these deductions, see chapter 12 in Publication 535.

Exclusion of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you received the subsidy by the excluded amount. For more information about this subsidy, see chapter 13.

Postponed gain from sale of home. If you postponed gain from the sale of your main home before May 7, 1997, you must reduce the basis of your new home by the amount of the postponed gain. For more information on the rules for the sale of a home, see Publication 523.

Example

You owned a duplex used as rental property that cost you \$40,000, of which \$35,000 was allocated to the building and \$5,000 to the land. You added an improvement to the duplex that cost \$10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of \$23,000. You sold some salvaged material for \$1,300 and collected \$19,700 from your insurance company. You deducted a casualty loss of \$1,000 on your income tax return for last year. You spent \$19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. You must use the duplex's adjusted basis after the restoration to determine depreciation for the rest of the property's recovery period. Figure the adjusted basis of the duplex as follows:

Original cost of duplex	.....	\$35,000
Addition to duplex	.....	10,000
Total cost of duplex	.....	\$45,000
Minus: Depreciation	.....	23,000
Adjusted basis before casualty	.....	\$22,000
Minus: Insurance proceeds	.....	19,700
Deducted casualty loss	.....	1,000
Salvage proceeds	.....	1,300
Adjusted basis after casualty	.....	\$-0-
Add: Cost of restoring duplex	.....	19,000
Adjusted basis after restoration	.....	\$19,000

Your basis in the land is its original cost of \$5,000.

Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of the property can be used. Fair market value (FMV) and adjusted basis were discussed earlier.

Property Received for Services

If you receive property for your services, include its FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. However, this rule does not apply if you make an election to include in income the FMV of the property at the time it is transferred to you, less any amount you paid for it. Property becomes substantially vested when your rights in the property or the rights of any person to whom you transfer the property are not subject to a substantial risk of forfeiture. For more information, see *Restricted Property* in Publication 525.

Bargain purchases. A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Employee Discounts* in Publication 15-B.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Involuntary Conversions

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you can figure the basis of the replacement property using the basis of the converted property.

Similar or related property. If you receive property similar or related in service or use to the converted property, the replacement property's basis is the same as the converted property's basis on the date of the conversion, with the following adjustments.

- 1) Decrease the basis by the following.

- a) Any loss you recognize on the conversion.
- b) Any money you receive that you do not spend on similar property.

2) Increase the basis by the following.

- a) Any gain you recognize on the conversion.
- b) Any cost of acquiring the replacement property.

Money or property not similar or related. If you receive money or property not similar or related in service or use to the converted property, and you buy replacement property similar or related in service or use to the converted property, the basis of the replacement property is its cost decreased by the gain not recognized on the conversion.

Example. The state condemned your property. The adjusted basis of the property was \$26,000 and the state paid you \$31,000 for it. You realized a gain of \$5,000 (\$31,000 – \$26,000). You bought replacement property similar in use to the converted property for \$29,000. You recognize a gain of \$2,000 (\$31,000 – \$29,000), the unspent part of the payment from the state. Your unrecognized gain is \$3,000, the difference between the \$5,000 realized gain and the \$2,000 recognized gain. The basis of the replacement property is figured as follows:

Cost of replacement property	.....	\$29,000
Minus: Gain not recognized	.....	3,000
Basis of replacement property	.....	\$26,000

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred. See *Nontaxable Trades* in chapter 15.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To qualify as a like-kind exchange, the property traded and the property received must be both of the following.

- 1) Qualifying property.
- 2) Like-kind property.

The basis of the property you receive is generally the same as the basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the basis of the property you gave up increased by the money you paid.

Qualifying property. In a like-kind exchange, you must hold for investment or for productive

use in your trade or business both the property you give up and the property you receive.

Like-kind property. There must be an exchange of like property. The exchange of real estate for real estate or personal property for similar personal property is an exchange of like property.

Example. You trade in an old truck used in your business with an adjusted basis of \$1,700 for a new one costing \$6,800. The dealer allows you \$2,000 on the old truck, and you pay \$4,800. This is a like-kind exchange. The basis of the new truck is \$6,500 (the adjusted basis of the old one, \$1,700, plus the amount you paid, \$4,800).

If you sell your old truck to a third party for \$2,000 instead of trading it in and then buy a new one from the dealer, you have a taxable gain of \$300 on the sale (\$2,000 sale price minus \$1,700 basis). The basis of the new truck is the price you pay the dealer.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the basis of the property you gave up, with the following adjustments.

- 1) Decrease the basis by the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.
- 2) Increase the basis by the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.

Allocation of basis. Allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like property.

More information. See *Like-Kind Exchanges* in chapter 1 of Publication 544 for more information.

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse that is incident to divorce. However, adjust your basis for any gain recognized by your spouse or former spouse on property transferred in trust. This rule applies only to a transfer of property in trust in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred to you is a series E, series EE, or series I U.S. savings bond, the transferor must include in income the interest accrued to the date of transfer. Your basis in the bond immediately after the transfer is equal to the transferor's basis increased by the interest

income includible in the transferor's income. For more information on these bonds, see chapter 8.

The transferor must give you, at the time of the transfer, the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information about the transfer of property from a spouse, see chapter 15.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

Example. You received an acre of land as a gift. At the time of the gift, the land had an FMV of \$8,000. The donor's adjusted basis was \$10,000. After you received the property, no events occurred to increase or decrease your basis. If you later sell the property for \$12,000, you will have a \$2,000 gain because you must use the donor's adjusted basis at the time of the gift (\$10,000) as your basis to figure gain. If you sell the property for \$7,000, you will have a \$1,000 loss because you must use the FMV at the time of the gift (\$8,000) as your basis to figure loss.

If the sales price is between \$8,000 and \$10,000, you have neither gain nor loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift, explained later.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

Gift received before 1977. If you received a gift before 1977, increase your basis in the gift (the donor's adjusted basis) by any gift tax paid on it. However, do not increase your basis above the FMV of the gift at the time it was given to you.

Gift received after 1976. If you received a gift after 1976, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

Example. In 2001, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$40,000 (\$50,000 minus the \$10,000 annual exclusion). She paid a gift tax of \$9,000 on the property. Your basis is \$26,750, figured as follows:

Fair market value	\$50,000
Minus: Adjusted basis	-20,000
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$9,000
Multiplied by (\$30,000 ÷ \$40,000)	× .75
Gift tax due to net increase in value	<u>\$6,750</u>
Adjusted basis of property to your mother	+20,000
Your basis in the property	<u>\$26,750</u>

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
- 3) The value under the special-use valuation method for real property used in farming or another closely held business, if chosen for estate tax purposes.
- 4) The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

For more information, see the instructions to Form 706, *U.S. Estate Tax Return*.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former personal residence.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- 1) The FMV of the property on the date of the change.
- 2) Your adjusted basis on the date of the change.

Example. Several years ago, you paid \$160,000 to have your house built on a lot that cost \$25,000. Before changing the property to rental use last year, you paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction for damage to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was \$178,000 (\$160,000 + \$20,000 – \$2,000). On the same date, your property had an FMV of \$180,000, of which \$15,000 was for the land and \$165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of the change (\$165,000) because it is less than your adjusted basis (\$178,000).

Sale of property. If you later sell or dispose of the property, the basis you use will depend on whether you are figuring gain or loss.

Gain. The basis for figuring a gain is your adjusted basis when you sell the property.

Example. Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of \$37,500. The basis for figuring gain is \$165,500 (\$178,000 + \$25,000 (land) – \$37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use, as discussed earlier under *Adjusted Basis*, to arrive at a basis for loss.

Example. Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of \$37,500. In this case, you would start with the FMV on the date of the change to rental use (\$180,000), because it is less than the adjusted basis of \$203,000 (\$178,000 + \$25,000) on that date. Reduce that amount (\$180,000) by the depreciation deductions to arrive at a basis for loss of \$142,500 (\$180,000 – \$37,500).

Stocks and Bonds

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, divide the adjusted basis of the old stock by the number of shares of old and new stock. This rule applies only when the additional stock received is identical to the stock held. Also reduce your basis when you receive nontaxable distributions. They are a return of capital.

Example. In 1999 you bought 100 shares of XYZ stock for \$1,000 or \$10 a share. In 2000 you bought 100 shares of XYZ stock for \$1,600 or \$16 a share. In 2001 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of \$5 a share and 200 shares with a basis of \$8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them. For detailed information, see

Stocks and Bonds under Basis of Investment Property in chapter 4 of Publication 550.

Identifying stocks or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. For more information about identifying securities you sell, see *Stocks and Bonds under Basis of Investment Property* in chapter 4 of Publication 550.

Mutual fund shares. If you sell mutual funds you acquired at various times and prices, you can choose to use an average basis. For more information, see *Average Basis* in Publication 564.

Bond premium. If you buy a taxable bond at a premium and choose to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. See *Bond Premium Amortization* in chapter 3 of Publication 550 for more information. Although you cannot deduct the premium on a tax-exempt bond, you must amortize the premium each year and reduce your basis in the bond by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the OID you include in income for that instrument. See *Original Issue Discount* in chapter 8.

Tax-exempt bonds. OID on tax-exempt bonds is generally not taxable. However, there are special rules for figuring the basis of these bonds issued after September 3, 1982, and acquired after March 1, 1984. See chapter 4 of Publication 550.

15.

Sale of Property

Important Reminder

Foreign income. If you are a U.S. citizen with investment property from sources outside the United States, you must report all gains and losses from the sale of that property on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- When you have a nontaxable trade,
- What to do with a related party transaction,
- Whether the property you sell is a capital asset or a noncapital asset,
- Whether you have a capital or ordinary gain or loss from the sale of property,
- How to determine your holding period, and
- When you can make a tax-free rollover of a gain from selling certain securities.

Sales not discussed in this publication. Certain sales or trades of property are discussed in other publications.

Installment sales are covered in Publication 537, *Installment Sales*.

Transfers of property at death are covered in Publication 559, *Survivors, Executors, and Administrators*.

Transactions involving business property are covered in Publication 544, *Sales and Other Dispositions of Assets*.

Dispositions of an interest in a passive activity are covered in Publication 925, *Passive Activity and At-Risk Rules*.

Sales of a main home are covered in chapter 16.

Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses)*, provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Useful Items

You may want to see:

Publication

- **504** Divorced or Separated Individuals
- **550** Investment Income and Expenses
- **564** Mutual Fund Distributions

Form (and Instructions)

- **Schedule D (Form 1040)** Capital Gains and Losses
- **8824** Like-Kind Exchanges

Sales and Trades

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a **Form 1099-B, Proceeds From Broker and Barter Exchange Transactions**, or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B (or an equivalent statement received from your broker) to complete Schedule D of Form 1040.

What is a Sale or Trade?

This section explains what is a sale or trade. It also explains certain transactions and events that are treated as sales or trades.

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money. A trade is a transfer of property for other property or services and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Nontaxable Trades*, later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- 1) The redemption is not essentially equivalent to a dividend (see chapter 9),
- 2) There is a substantially disproportionate redemption of stock,
- 3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 4) The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Worthless securities. Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long-term or short-term. See *Holding Period*, later.

If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

How to report loss. Report worthless securities on line 1 or line 8 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), write "Worthless." Enter the amount of your loss in parentheses in column (f).

Filing a claim for refund. If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. You must use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See chapter 14 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated

interest will reduce the amount realized. For more information, see Publication 537.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other debt instruments you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of debt instruments.

Example. You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 minus \$7,000). If you also receive a note for \$6,000 that has a discount value of \$4,000, your gain is \$7,000 (\$10,000 plus \$4,000 minus \$7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example. You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000 plus \$8,000). Your gain is \$22,000 (\$28,000 minus \$6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Basis Other Than Cost* in chapter 14.

Nontaxable Trades

This section discusses trades that generally do not result in a taxable gain or deductible loss. For more information on nontaxable trades, see chapter 1 of Publication 544.

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

- 1) The property must be business or investment property. You must hold both the property you trade and the property you

receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.

- 2) The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
- 3) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule, as discussed later.
- 4) There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property is a trade of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property. Also, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.
- 5) The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
- 6) The property to be received must be received by the earlier of:
 - a) The 180th day after the date on which you transfer the property given up in the trade, or
 - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter. Also, see chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

Partially nontaxable exchange. If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If conditions (1) - (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Basis of property received. To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 14.

How to report. You must report the trade of like property on **Form 8824**. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on **Form 4797, Sales of Business Property**, whichever applies.

For information on using Form 4797, see chapter 4 of Publication 544.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is part of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of non-voting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Additional information. For more information on trades of stock, see *Nontaxable Trades* in chapter 4 of Publication 550.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

- 1) A life insurance contract for another life insurance contract or for an endowment or annuity contract,
- 2) An endowment contract for an annuity contract or for another endowment contract that provides for regular payments

beginning at a date not later than the beginning date under the old contract, or

- 3) An annuity contract for another annuity contract.

The insured or annuitant must be the same under both contracts. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

Demutualization of life insurance companies. If you received stock or cash in exchange for your equity interest as a policyholder or an annuitant, you generally will not have a recognized gain or loss. See *Demutualization of Life Insurance Companies* in Publication 550.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues designated by the Secretary of the Treasury, with no gain or loss recognized.

Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it. See chapter 2 of Publication 544 for more information.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades*.

This rule also applies to trades of property between related parties, defined next under

Losses on sales or trades of property. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following **related parties**.

- 1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- 3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock. (See *Constructive ownership of stock*, later.)
- 4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

- 1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- 2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
- 4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- 5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
- 8) Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
- 9) Two partnerships if the same persons own, directly or indirectly, more than 50%

of the capital interests or the profit interests in both partnerships.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Constructive ownership of stock. In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules described in chapter 4 of Publication 550 under *Wash Sales*.

Example 1. Your brother sells you stock for \$7,600. His cost basis is \$10,000. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 — the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

Example 2. If, in *Example 1*, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 (your \$7,600 basis minus \$6,900). You cannot deduct the loss that was not allowed to your brother.

Capital Gains and Losses

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify your qualified 5-year gain and any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains. Reporting capital gains and losses is explained in chapter 17.

Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a **capital asset**. Some examples are:

- Stocks or bonds held in your personal account,
- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

Any property you own is a capital asset, except the following **noncapital assets**.

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers.
- 2) **Depreciable property** used in your trade or business, even if fully depreciated.
- 3) **Real property** used in your trade or business.

4) **A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property:**

- a) Created by your personal efforts,
- b) Prepared or produced for you as a letter, memorandum, or similar property, or
- c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.

5) **Accounts or notes receivable** acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).

6) **U.S. Government publications** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

7) **Certain commodities derivative financial instruments** held by commodities derivatives dealers.

8) **Hedging transactions**, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into.

9) **Supplies** of a type you regularly use or consume in the ordinary course of your trade or business.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or trade is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Section 1244 (Small Business) Stock and Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Personal use property. Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue.

Acquisition discount is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted Debt Instruments* in chapter 4 of Publication 550.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1 of Publication 550.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Redeemed before maturity. If a state or local bond that was issued **before June 9, 1980**, is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued **after June 8, 1980**, is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain.

Example. On July 1, 1990, the date of issue, you bought a 20-year, 6% municipal bond for \$800. The face amount of the bond was \$1,000. The \$200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was

callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 1, 2001) for its face amount of \$1,000 plus accrued annual interest of \$60. The OID earned during the time you held the bond, \$73, is not taxable. The \$60 accrued annual interest also is not taxable. However, you must report the unearned part of the OID (\$127) as a capital gain.

Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). If you sell, trade, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the OID at the time of the sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter.

Long-term debt instruments issued after May 27, 1969 (or after July 1, 1982, if a government instrument). If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in that debt instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in chapter 8 for information about the OID that you must report on your tax return.

If you sell or trade the debt instrument before maturity, your gain is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is a capital gain.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. The rest of the gain is capital gain. See *Market Discount Bonds* in chapter 1 of Publication 550.

A different rule applies to market discount bonds issued before July 19, 1984, and purchased by you before May 1, 1993. See chapter 4 of Publication 550.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Notes of individuals. If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

- 1) The lender is not in the business of lending money.
- 2) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less.
- 3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of the OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a qualified financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss in one of three ways.

- 1) Ordinary loss,
- 2) Casualty loss, or
- 3) Nonbusiness bad debt (short-term capital loss).

Ordinary loss or casualty loss. If you can reasonably estimate your loss, you can choose to treat the estimated loss as either an ordinary loss or a casualty loss in the current year. Either way, you claim the loss as an itemized deduction.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is \$20,000 (\$10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2%-of-adjusted-gross-income limit. You cannot choose to claim an ordinary loss if any of the deposit is federally insured.

If you claim a casualty loss, attach **Form 4684, *Casualties and Thefts***, to your return. Each loss must be reduced by \$100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

You cannot choose either of these methods if:

- 1) You own at least 1% of the financial institution,
- 2) You are an officer of the institution, or
- 3) You are related to such an owner or officer. You are related if you and the owner or officer are "related parties," as defined earlier under *Related Party Transactions*, or if you are the aunt, uncle, nephew, or niece of the owner or officer.

If the actual loss that is finally determined is more than the amount you deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed. See *Recov-*

eries in Publication 525, *Taxable and Nontaxable Income*.

Nonbusiness bad debt. If you choose to treat the loss as a bad debt, see *How to report bad debts*, later.

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (as most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040).

In Part I, line 1 of Schedule D, enter the name of the debtor and "statement attached" in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

- 1) A description of the debt, including the amount, and the date it became due,
- 2) The name of the debtor, and any business or family relationship between you and the debtor,
- 3) The efforts you made to collect the debt, and
- 4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the

year the debt became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

Additional information. For more information, see *Nonbusiness Bad Debts* in Publication 550. For information on business bad debts, see chapter 11 of Publication 535, *Business Expenses*.

Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Report the loss on **Form 4797**, line 10. Any gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See *Losses on Section 1244 (Small Business) Stock* in chapter 4 of Publication 550.

Losses on Small Business Investment Company Stock

See *Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

Long term or short term. If you hold investment property **more than 1 year**, any capital gain or loss is a **long-term** capital gain or loss. If you hold the property **1 year or less**, any capital gain or loss is a **short-term** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example. If you bought investment property on February 5, 2000 and sold it on February 5, 2001, your holding period is not more than 1 year and you will have a short-term capital gain or loss. If you sold it on February 6, 2001, your holding period is more than 1 year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.



Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.

Example. You are a cash method, calendar year taxpayer. You sold stock at a gain on December 28, 2001. According to the rules of the stock exchange, the sale was closed by delivery of the stock three trading days after the sale, on

January 3, 2002. You received payment of the sales price on that same day. Report your gain on your 2001 return, even though you received the payment in 2002. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 28. If you had sold the stock at a loss, you would also report it on your 2001 return.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Loss on mutual fund or REIT stock held 6 months or less. If you hold stock in a mutual fund or real estate investment trust (REIT) for 6 months or less and then sell it at a loss, special rules may apply. See chapter 4 of Publication 550.

Automatic investment service. In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on the day after the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same

day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Rollover of Gain From Publicly Traded Securities

You may qualify for a tax-free rollover of certain gains from the sale of publicly traded securities. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property*, later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

- 1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

Amount of gain recognized. If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain.

Limit on gain postponed. The amount of gain you can postpone each year is limited to the smaller of:

- 1) \$50,000 (\$25,000 if you are married and file a separate return), or
- 2) \$500,000 (\$250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of your replacement property.

How to report and postpone gain. See chapter 4 of Publication 550 for details on how to report and postpone the gain.

16.

Selling Your Home

Important Reminders

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address. (Addresses for the Service Centers are on the back of the form.)

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in chapter 25.

Introduction

This chapter explains the tax rules that apply when you sell your main home. Generally, your main home is the one in which you live most of the time.

Gain. If you have a gain from the sale of your main home, you may be able to exclude up to \$250,000 of the gain from your income (\$500,000 on a joint return in most cases). Any gain not excluded is taxable.

Loss. You cannot deduct a loss from the sale of your main home.

Worksheets. Publication 523, *Selling Your Home*, includes worksheets to help you figure the adjusted basis of the home you sold, the gain (or loss) on the sale, and the amount of the gain that you can exclude.

Reporting the sale. Do not report the sale of your main home on your tax return unless you have a gain and at least part of it is taxable. Report any taxable gain on Schedule D (Form 1040). You may also have to include Form 4797, *Sales of Business Property*. See *Reporting the Gain* in chapter 2 of Publication 523.

Who may need to read chapter 3 in Publication 523. Chapter 3 of Publication 523 explains the rules that applied to sales before May 7, 1997. You may still need to know those rules, but only if you sold your main home at a gain before May 7, 1997, and all three of the following statements are true.

- 1) You postponed the gain on the sale.
- 2) The 2-year period you had to replace that home (your replacement period) was suspended while you either:
 - a) Served in the Armed Forces, or
 - b) Lived and worked outside the United States.

- 3) You have not already reported to the IRS your purchase of a new home within your replacement period, or a taxable gain resulting from the end of your replacement period.

If all three statements are true or you have questions, see chapter 3 of Publication 523.

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 530** Tax Information for First-Time Homeowners

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8822** Change of Address
- 8828** Recapture of Federal Mortgage Subsidy

Main Home

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land.

Example. On March 2, 2001, you sell the land on which your main home is located. You buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot exclude tax on any gain on the sale of the land.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income the gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

Example 1. You own and live in a house in the city. You also own a beach house, which you use during summer months. The house in the city is your main home.

Example 2. You own a house, but you live in another house that you rent. The rented house is your main home.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Property used partly as your home and partly for business or rental during the year of sale* under *Business Use or Rental of Home*, later.

How To Figure Gain or Loss

To figure the gain or loss on the sale of your main home, you must know the **selling price**, the **amount realized**, and the **adjusted basis**.

Selling price. The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do **not** include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it in your gross income as wages on line 7 of Form 1040.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

Form 1099-S. If you received Form 1099-S, *Proceeds From Real Estate Transactions*, box 2 (gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked.

If you can exclude the entire gain, the person responsible for closing the sale generally will not have to report it on Form 1099-S. You will use sale documents and other records to figure the total amount you received for your home.

Amount realized. The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or "points."

Adjusted basis. While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home. For information on how to figure your home's adjusted basis, see *Basis* later.

Amount of gain or loss. To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

Loss on sale. 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.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home that had an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new home priced at \$80,000. This is treated as a sale of your old home for \$50,000 with a gain of \$9,000 (\$50,000 – \$41,000).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, your sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a sale.

You figure the gain or loss from the sale in generally the same way as gain or loss from any sale. But the amount of your gain or loss depends, in part, on whether you were personally liable for repaying the debt secured by the home. Get Publication 523 for more information.

Form 1099–A and Form 1099–C. Generally, you will receive Form 1099–A, *Acquisition or Abandonment of Secured Property*, from your lender. This form will have the information you need to determine the amount of your gain or loss and any ordinary income from cancellation of debt. If your debt is canceled, you may receive Form 1099–C, *Cancellation of Debt*.

Abandonment. If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which you are personally liable and the debt is canceled, you have ordinary income equal to the amount of the canceled debt. Get Publication 523 for more information.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain

or loss. This is true even if you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

More information. If you need more information, see *Transfer to spouse* in Publication 523 and *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

Basis

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), its basis is either its fair market value when you got it or the adjusted basis of the person you got it from.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's **adjusted basis**, which is used to figure gain or loss on the sale of your home.

You can find more information on basis and adjusted basis in chapter 14 of this publication and in Publication 523.

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you paid for buying the home. You cannot include in your basis the fees and costs for getting a mortgage loan. A fee for buying the home is any fee you would have had to pay even if you paid cash for the home.

Chapter 14 lists some of the settlement fees and closing costs that you can include in the basis of property, including your home. It also lists some settlement costs that cannot be included in basis.

In addition to the items listed in chapter 14, you **cannot** include in basis:

- 1) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994), and
- 2) VA funding fees.

Adjusted Basis

Adjusted basis is your basis **increased** or **decreased** by certain amounts.

Increases to basis. These include any:

- 1) Additions and other improvements that have a useful life of more than 1 year,
- 2) Special assessments for local improvements, and
- 3) Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

- 1) Gain you postponed from the sale of a previous home before May 7, 1997,
- 2) Deductible casualty losses,
- 3) Insurance payments you received or expect to receive for casualty losses,

- 4) Payments you received for granting an easement or right-of-way,
- 5) Depreciation allowed or allowable if you used your home for business or rental purposes,
- 6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
- 7) Adoption credit you claimed for improvements added to the basis of your home,
- 8) Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
- 9) First-time homebuyer credit (allowed to certain first-time buyers of a home in the District of Columbia), and
- 10) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Examples. Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a garage, is also an improvement.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Recordkeeping. You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if you sold a home before May 7, 1997, and postponed tax on any gain, the basis of that home affects the basis of the new home you bought. Keep records proving the basis of both homes as long as they are needed for tax purposes.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses,
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,



- Any worksheets you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain,
- Any Form 2119 that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the *Adjusted Basis of Home Sold Worksheet* or the *Capital Improvements Worksheet* from the Form 2119 instructions.

Excluding the Gain

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Maximum Amount of Exclusion*, next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you must include in income your entire gain.

Maximum Amount of Exclusion

You can exclude the entire gain on the sale of your main home up to:

- 1) \$250,000, or
- 2) \$500,000 if all of the following are true.
 - a) You are married and file a joint return for the year.
 - b) Either you or your spouse meets the ownership test.
 - c) Both you and your spouse meet the use test.
 - d) During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

Reduced Maximum Exclusion

You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if either of the following is true.

- 1) You did not meet the ownership and use tests, but you sold the home due to:
 - a) A change in place of employment,
 - b) Health, or
 - c) Unforeseen circumstances, to the extent provided in regulations (as discussed later).
- 2) Your exclusion would have been disallowed because of the rule described in *More Than One Home Sold During 2-Year*

Period, later, except that you sold the home due to:

- a) A change in place of employment,
- b) Health, or
- c) Unforeseen circumstances, to the extent provided in regulations (as discussed next).

Use *Worksheet 3* in Publication 523 to figure your reduced maximum exclusion.

Unforeseen circumstances. The IRS has not issued regulations defining unforeseen circumstances. You cannot claim an exclusion based on unforeseen circumstances until the IRS issues final regulations or other appropriate guidance.

More Than One Home Sold During 2-Year Period

You cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and excluded all or part of that gain. If you cannot exclude the gain, you must include it in your income.

However, you can still claim an exclusion if you sold the home due to:

- 1) A change in place of employment,
- 2) Health, or
- 3) Unforeseen circumstances, to the extent provided in regulations (as discussed earlier).

The maximum amount you can exclude is reduced. See *Reduced Maximum Exclusion*, earlier.

Ownership and Use Tests

To claim the exclusion, you must meet the ownership and use tests. This means that during the **5-year period** ending on the date of the sale, you must have:

- 1) **Owned** the home for at least **2 years** (the ownership test), **and**
- 2) **Lived in** the home as your main home for at least **2 years** (the use test).

Exception. If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can claim will be reduced. See *Reduced Maximum Exclusion*, earlier.

Period of ownership and use. The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 × 2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent the property during the absences, are counted as periods of use. See

Ownership and use tests met at different times, later.

Example. Professor Paul Beard, who is single, bought and moved into a house on August 28, 1998. He lived in it as his main home continuously until January 5, 2000, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On January 5, 2001, he sold the house at a gain.

Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, unless he sold the house due to a change in place of employment or health, as explained under *Reduced Maximum Exclusion*, earlier. Even if he did sell the house due to a change in place of employment or health, he cannot exclude the part of the gain equal to the depreciation he claimed while renting the house. See *Depreciation for business use after May 6, 1997*, later.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 1992, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 1998. In 1999, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 2001, while still living in her daughter's home, she sold her apartment.

Helen can exclude gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 1996, to July 10, 2001, the date she sold the apartment. She owned her apartment from December 1, 1998, to July 10, 2001 (over 2 years). She lived in the apartment from July 11, 1996 (the beginning of the 5-year period), to April 14, 1999 (over 2 years).

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

- 1) Owned the stock for at least 2 years, and
- 2) Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if during the 5-year period before the sale of your home:

- 1) You become physically or mentally unable to care for yourself, and
- 2) You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Gain postponed on sale of previous home. For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home because of buying the home on which you wish to exclude gain.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the **same** home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Maximum Amount of Exclusion*, earlier.)

Example 1 – one spouse sells a home. Emily sells her home in June 2001. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to \$250,000 of gain on a separate or joint return for 2001.

Example 2 – each spouse sells a home. The facts are the same as in *Example 1* except that Jamie also sells a home. He meets the ownership and use tests on his home. Emily and Jamie can each exclude up to \$250,000 of gain.

Death of spouse before sale. If your spouse died before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

- 1) You owned it, and
- 2) Your spouse or former spouse is allowed to live in it under a divorce or separation instrument.

Business Use or Rental of Home

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1. On May 30, 1995, Amy bought a house. She moved in on that date and lived in it until May 31, 1997, when she moved out of the

house and put it up for rent. The house was rented from June 1, 1997, to March 31, 1999. Amy moved back into the house on April 1, 1999, and lived there until she sold it on January 31, 2001. During the 5-year period ending on the date of the sale (February 1, 1996 – January 31, 2001), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five Year Period	Used as Home	Used as Rental
2/1/96 – 5/31/97	16 months	
6/1/97 – 3/31/99		22 months
4/1/99 – 1/31/01	22 months 38 months	22 months

Amy can exclude gain up to \$250,000. But she cannot exclude the part of the gain equal to the depreciation she claimed for renting the house, as explained after *Example 2*.

Example 2. William owned and used a house as his main home from 1995 through 1998. On January 1, 1999, he moved to another state. He rented his house from that date until April 30, 2001, when he sold it. During the 5-year period ending on the date of sale (May 1, 1996 – April 30, 2001), William owned and lived in the house for 32 months (more than 2 years). He can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed for renting the house, as explained next.

Depreciation for business use after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. If you can show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the smaller figure.

Example. Ray sold his main home in 2001 at a \$30,000 gain. He meets the ownership and use tests to exclude the gain from his income. However, he used part of the home for business in 2000 and claimed \$500 depreciation. He can exclude \$29,500 (\$30,000 – \$500) of his gain. He has a taxable gain of \$500.

Property used partly as your home and partly for business or rental during the year of sale. In the year of sale you may have used part of your property as your home and part of it for business or to produce income. Examples are:

- A working farm on which your house was located,
- An apartment building in which you lived in one unit and rented out the others,
- A store building with an upstairs apartment in which you lived, or
- A home with a room used for business (home office) or to produce income.

If you sell the entire property you should consider the transaction as the sale of two properties. The sale of the part of your property used

for business or rental is reported on Form 4797. For more information, see *Property used partly as your home and partly for business or rental during the year of sale* under *Business Use or Rental of Home* in chapter 2 of Publication 523.

Special Situations

The situations that follow may affect your exclusion.

Expatriates. You cannot claim the exclusion if the expatriation tax applies to you. The expatriation tax applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency) if one of their principal purposes was to avoid U.S. taxes. See chapter 4 of Publication 519, *U.S. Tax Guide for Aliens*, for more information about expatriation tax.

Home destroyed or condemned. If your home was destroyed or condemned, any gain (for example, because of insurance proceeds you received) qualifies for the exclusion.

Any part of the gain that cannot be excluded (because it is more than the limit) may be postponed under the rules explained in:

- Publication 547, *Casualties, Disasters, and Thefts*, in the case of a home that was destroyed, or
- Chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*, in the case of a home that was condemned.

Sale of remainder interest. Subject to the other rules in this chapter, you can choose to exclude gain from the sale of a remainder interest in your home. If you make this choice, you cannot choose to exclude gain from your sale of any other interest in the home that you sell separately.

Exception for sales to related persons. You cannot exclude gain from the sale of a remainder interest in your home to a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

Reporting the Gain

Do **not** report the 2001 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it, or
- You have a gain and you choose not to exclude it.

If you have any taxable gain on the sale of your main home that cannot be excluded, report the entire gain realized on Schedule D (Form 1040). Report it on line 1 or line 8 of Schedule D, depending on how long you owned the home. If you qualify for an exclusion, show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss (in parentheses).

If you used the home for business or to produce rental income during the year of sale, you must use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental in that year). See *Business Use or Rental of Home* in chapter 2 of Publication 523.

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called “installment sales.” If you finance the buyer’s purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, *Installment Sale Income*, to report the sale. Enter your exclusion on line 15 of Form 6252.

Seller-financed mortgage. If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her SSN and you must give the buyer your SSN. Failure to meet these requirements may result in a \$50 penalty for each failure. If you or the buyer does not have and is not eligible to get an SSN, see *Social Security Number* in chapter 1.

More information. For more information on installment sales, see Publication 537, *Installment Sales*.

qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. You may have to pay this recapture tax even if you can exclude your gain from income; that exclusion does not affect the recapture tax.

Loans subject to recapture rules. The recapture applies to loans that:

- 1) Came from the proceeds of qualified mortgage bonds, or
- 2) Were based on mortgage credit certificates.

The recapture also applies to assumptions of these loans.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet **both** of the following conditions.

- 1) You sell or otherwise dispose of your home:
 - a) At a gain, and
 - b) During the first 9 years after the date you closed your mortgage loan.
- 2) Your income for the year of disposition is more than that year’s adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

When recapture does not apply. The recapture does **not** apply if any of the following situations apply to you:

- Your mortgage loan was a qualified home improvement loan of not more than \$15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the end of the tax year when the destruction happened, or
- You refinance your mortgage loan (unless you later meet all of the conditions listed previously under *When the recapture applies*).

Notice of amounts. At or near the time of settlement of your mortgage loan, you should receive a notice that provides the federally subsidized amount and other information you will need to figure your recapture tax.

How to figure and report the recapture. The recapture tax is figured on Form 8828, *Recapture of Federal Mortgage Subsidy*. If you sell your home and your mortgage is subject to recapture rules, you must file Form 8828 even if you do not owe a recapture tax. Attach Form 8828 to your Form 1040. For more information, see Form 8828 and its instructions.

Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt

17.

Reporting Gains and Losses

Important Change

8% capital gain rate. Beginning in 2001, the 10% capital gain rate is lowered to 8% for qualified 5-year gain. For more information, see *Capital Gain Tax Rates*, later.

Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the lower tax rates on a net capital gain, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, *Sales and Other Dispositions of Assets*, before completing Schedule D.

Useful Items

You may want to see:

Publication

- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 4797** Sales of Business Property
- 6252** Installment Sale Income
- 8582** Passive Activity Loss Limitations

Schedule D

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate.

Include all these transactions even if you did not receive a Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions*, or Form 1099–S, *Proceeds From Real Estate Transactions* (or substitute statement). You can use Schedule D–1 as a continuation schedule to report more transactions.

Installment sales. You cannot use the installment method to report a gain from the sale of stock or securities traded on an established securities market. You must report the entire gain in the year of sale (the year in which the trade date occurs).

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on **Form 8582**. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099–B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099–B or equivalent statement from the broker. Use the Form 1099–B or the equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099–B as the **gross sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that **net sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

Form 1099–S transactions. If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099–S showing the gross proceeds.

“Reportable real estate” is defined as any present or future ownership interest in any of the following:

- 1) Improved or unimproved land, including air space,
- 2) Inherently permanent structures, including any residential, commercial, or industrial building,
- 3) A condominium unit and its accessory fixtures and common elements, including land, and
- 4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A “real estate reporting person” could include the buyer’s attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer’s broker, or the person acquiring the biggest interest in the property.

Your Form 1099–S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on line 1 or 8 as appropriate.

Reconciling Forms 1099 with Schedule D.

Add the following amounts reported to you for 2001 on Forms 1099–B and 1099–S (or on substitute statements):

- 1) Proceeds from transactions involving stocks, bonds, and other securities, and
- 2) Gross proceeds from real estate transactions (other than the sale of your main home if you had no taxable gain) not reported on another form or schedule.

If this total is more than the total of lines 3 and 10 of Schedule D, attach a statement to your return explaining the difference.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write “Various” in column (b) for the “Date acquired.” See the *Comprehensive Example* later in this chapter.

Sale expenses. Add to your cost or other basis any expense of sale such as brokers’ fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see chapter 14.



Property held for personal use only, rather than for investment, is a capital asset and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. If the amount in column (f) is a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

- 1) Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),
- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
- 3) All capital gain distributions from mutual funds and REITs not reported directly on line 10 of Form 1040A or line 13 of Form 1040, and
- 4) Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 16 of Schedule D).

28% rate gain or loss. Enter in column (g) the amount, if any, from column (f) that is a 28% rate gain or loss. Enter any loss in parentheses. A 28% rate gain or loss is:

- Any collectibles gain or loss, or
- The part of your gain on qualified small business stock that is equal to the section 1202 exclusion.

For more information, see *Capital Gain Tax Rates*, later.

Capital gain distributions only. You do not have to file Schedule D if **all** of the following are true.

- 1) The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099-DIV (or substitute statement).
- 2) You do not have an amount in box 2b, 2c, 2d, or 2e of any Form 1099-DIV (or substitute statement).
- 3) You do not file Form 4952 or, if you do, the amount on line 4e of that form is not more than zero.

If all the above statements are true, report your capital gain distributions directly on line 13 of Form 1040 and check the box on that line. Also, use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

You can report your capital gain distributions on line 10 of Form 1040A, instead of on Form 1040, if both of the following are true.

- 1) None of the Forms 1099-DIV (or substitute statements) you received have an amount in box 2b, 2c, 2d, or 2e.
- 2) You do not have to file Form 1040 for any other capital gains or any capital losses.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 16). Enter the result on line 17, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses*, next. If both lines 16 and 17 are gains and line 39 of Form 1040 is more than zero, see *Capital Gain Tax Rates*, later.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or
- 2) Your total net loss as shown on line 17 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

Capital loss carryover. If you have a total net loss on line 17 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

- 1) Your allowable capital loss deduction for the year, or
- 2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 2001 that you can carry over to 2002.

Example. Bob and Gloria sold securities in 2001. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. Their taxable income was \$26,000. On their joint 2001 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 - \$3,000), can be carried over to 2002.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

Capital Gain Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

The maximum capital gain rate can be 8%, 10%, 20%, 25%, or 28%. See *Table 17-1* for details.

The maximum capital gain rate does not apply if it is higher than your regular tax rate.

Example. You have a net capital gain from selling collectibles, so the capital gain rate would be 28%. Because you are single and your taxable income is \$25,000, your regular tax rate is 15%. All your taxable income will be taxed at the 15% rate. The 28% rate does not apply.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on lines 21-23 of Schedule D. For more information about the limit on investment interest, see chapter 3 of Publication 550.

8% rate. Beginning in 2001, the 10% capital gain rate is lowered to 8% for "qualified 5-year gain."

Qualified 5-year gain. This is long-term capital gain from the sale of property that you held for more than 5 years and that would otherwise be subject to the 10% capital gain rate.

Table 17–1. What Is Your Maximum Capital Gain Rate?

IF your net capital gain is from ...	THEN your maximum capital gain rate is ...
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain, ¹ and the regular tax rate that would apply is 27.5% or higher	20%
Other gain, ¹ and the regular tax rate that would apply is lower than 15%	8% or 10% ²

¹ "Other gain" means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.

² The rate is 8% only for qualified 5–year gain.

Collectibles gain or loss. This is gain or loss from the sale or trade of a work of art, rug, antique, metal (such as gold, silver, and platinum bullion), gem, stamp, coin, or alcoholic beverage held more than 1 year.

Gain on qualified small business stock. If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude one-half of your gain from income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Gains on Qualified Small Business Stock* in chapter 4 of Publication 550.

Unrecaptured section 1250 gain. Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Publication 544.

Using Schedule D. You apply these rules by using Part IV of Schedule D (Form 1040) to figure your tax. Use Part IV if both of the following are true.

- 1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains. (Line 16 is your net long-term capital gain or loss. Line 17 is your net long-term capital gain or loss combined with any net short-term capital gain or loss.)
- 2) Your taxable income on Form 1040, line 39, is more than zero.

If you have any collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain, you may have to use the *Schedule D Tax Worksheet* in the Schedule D instructions to figure your tax. See the directions below line 19 of Schedule D.

See the *Comprehensive Example*, later, for an example of how to figure your tax on Schedule D using the capital gain rates.

Using Capital Gain Tax Worksheet. If you have capital gain distributions but do not have to file Schedule D (Form 1040), figure your tax using the *Capital Gain Tax Worksheet* in the instructions for Form 1040A or Form 1040. For more information, see *Capital gain distributions only*, earlier.

New 18% rate beginning in 2006. Beginning in 2006, the 20% maximum capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000. See chapter 4 of Publication 550 for more information.

Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from stocks and other securities. For the 2001 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D is shown in this chapter.

Capital gains and losses — Schedule D. Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had bought in February. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. In July, she sold 25 shares of Computer Co. stock that she bought in June. She had an adjusted basis in the stock of \$2,500 and she sold it for \$2,000, for a loss of \$500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. In February, she sold 60 shares of Car Co. for \$2,100. She had inherited the Car Co. stock from her father. Its fair market

value at the time of his death was \$2,500, which became her basis. Her loss on the sale is \$400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. She enters the loss in column (f) of line 8.

In June, she sold 500 shares of Furniture Co. stock for \$14,000. She had bought 100 of those shares in 1990, for \$1,000. She had bought 100 more shares in 1992 for \$2,200, and an additional 300 shares in 1995 for \$1,500. Her total basis in the stock is \$4,700. She has a \$9,300 (\$14,000 – \$4,700) gain on this sale, which she enters in column (f) of line 8. Because she held all 500 shares for more than 5 years, the entire gain is qualified 5-year gain.

In December, she sold 20 shares of Toy Co. for \$4,100. This was qualified small business stock that she had bought in September 1996. Her basis is \$1,100, so she has a \$3,000 gain which she enters in column (f) of line 8. Because she held the stock more than 5 years, she has a \$1,500 section 1202 exclusion. She enters that amount in column (g) as a 28% rate gain and claims the exclusion on the line below by entering \$1,500 as a loss in column (f).

She received a Form 1099–B (not shown) from her broker for each of these transactions.

Capital loss carryover from 2000. Emily has a capital loss carryover to 2001 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D.

She kept the completed *Capital Loss Carryover Worksheet* in her 2000 Schedule D instructions (not shown), so she could properly report her loss carryover for the 2001 tax year without refiguring it.

Tax computation. Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she goes to Part IV of Schedule D to figure her tax. But because line 15 of Schedule D is more than zero (due to her section 1202 gain from selling qualified small business stock), she must use the *Schedule D Tax Worksheet* to figure her tax instead. She must also complete the *Qualified 5-Year Gain Worksheet* (not shown) in her Schedule D instructions.

After entering the gain from line 17 on line 13 of her Form 1040, she completes the rest of Form 1040 through line 39. She enters the amount from that line, \$30,000, on line 1 of the Schedule D Tax Worksheet. After filling out the worksheet and the rest of that worksheet, she figures her tax is \$4,235. This is less than the \$4,876 tax she would have figured without the capital gain tax rates.

Reconciliation of Forms 1099–B. Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099–B she received from her broker. For 2001, the total of each is \$23,100.

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2001

Attachment
Sequence No. **12**

Name(s) shown on Form 1040

Emily Jones

Your social security number

111 00 1111

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	
1 100 sh Trucking Co.	2-12-01	6-12-01	900	650	250	
25 sh Computer Co.	6-29-01	7-30-01	2,000	2,500	(500)	
2 Enter your short-term totals, if any, from Schedule D-1, line 2						
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)			2,900			
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824						
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1						
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2000 Capital Loss Carryover Worksheet					(300)	
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f).					(550)	

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-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8 60 sh Car Co.	INHERITED	2-3-01	2,100	2,500	(400)	
500 sh Furniture Co.	VARIOUS	6-27-01	14,000	4,700	9,300	
20 sh Toy Co.	9-20-96	12-15-01	4,100	1,100	3,000	1,500
Section 1202 exclusion					(1,500)	
9 Enter your long-term totals, if any, from Schedule D-1, line 9						
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			20,200			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824						
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1.						
13 Capital gain distributions. See page D-1 of the instructions						
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet					(500)	(500)
15 Combine lines 8 through 14 in column (g)						1,000
16 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) Next: Go to Part III on the back.					9,900	

* **28% rate gain or loss** includes all "collectibles gains and losses" (as defined on page D-6 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page D-4 of the instructions).

Part III Taxable Gain or Deductible Loss

<p>17 Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39</p> <p>Next: • If both lines 16 and 17 are gains and Form 1040, line 39, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.</p>	17	9,350	
<p>18 If line 17 is a loss, enter here and on Form 1040, line 13, the smaller of (a) that loss or (b) (\$3,000) (or, if married filing separately, (\$1,500)). Then complete Form 1040 through line 37</p> <p>Next: • If the loss on line 17 is more than the loss on line 18 or if Form 1040, line 37, is less than zero, skip Part IV below and complete the Capital Loss Carryover Worksheet on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip Part IV below and complete the rest of Form 1040.</p>	18	()	

Part IV Tax Computation Using Maximum Capital Gains Rates

<p>19 Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions</p> <p>If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.</p>	19	-0-	
<p>20 Enter your taxable income from Form 1040, line 39</p>	20		
<p>21 Enter the smaller of line 16 or line 17 of Schedule D</p>	21		
<p>22 If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-</p>	22	-0-	
<p>23 Subtract line 22 from line 21. If zero or less, enter -0-</p>	23		
<p>24 Subtract line 23 from line 20. If zero or less, enter -0-</p>	24		
<p>25 Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies</p>	25		
<p>26 Enter the smaller of:</p> <ul style="list-style-type: none"> • The amount on line 20 or • \$45,200 if married filing jointly or qualifying widow(er); \$27,050 if single; \$36,250 if head of household; or \$22,600 if married filing separately <p>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</p>	26		
<p>27 Enter the amount from line 24</p>	27		
<p>28 Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34</p>	28		
<p>29 Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8</p>	29	9,300	
<p>30 Enter the smaller of line 28 or line 29</p>	30		
<p>31 Multiply line 30 by 8% (.08)</p>	31		
<p>32 Subtract line 30 from line 28</p>	32		
<p>33 Multiply line 32 by 10% (.10)</p> <p>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</p>	33		
<p>34 Enter the smaller of line 20 or line 23</p>	34		
<p>35 Enter the amount from line 28 (if line 28 is blank, enter -0-)</p>	35		
<p>36 Subtract line 35 from line 34</p>	36		
<p>37 Multiply line 36 by 20% (.20)</p>	37		
<p>38 Add lines 25, 31, 33, and 37</p>	38		
<p>39 Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies</p>	39		
<p>40 Tax on all taxable income (including capital gains). Enter the smaller of line 38 or line 39 here and on Form 1040, line 40</p>	40	4,235	



Complete this worksheet only if line 15 or line 19 of Schedule D is more than zero. Otherwise, complete Part IV of Schedule D to figure your tax. **Exception: Do not** use Schedule D, Part IV, or this worksheet to figure your tax if line 16 or line 17 of Schedule D or Form 1040, line 39, is zero or less; instead, see the instructions for Form 1040, line 40.

1.	Enter your taxable income from Form 1040, line 39	1.	<u>30,000</u>
2.	Enter the smaller of line 16 or line 17 of Schedule D	2.	<u>9,350</u>
3.	If you are claiming investment interest expense on Form 4952, enter the amount from line 4e. Otherwise, enter -0-. Also enter this amount on Schedule D, line 22	3.	<u>-0-</u>
4.	Subtract line 3 from line 2. If zero or less, enter -0-	4.	<u>9,350</u>
5.	Combine lines 7 and 15 of Schedule D. If zero or less, enter -0-	5.	<u>450</u>
6.	Enter the smaller of line 5 above or Schedule D, line 15, but not less than zero	6.	<u>450</u>
7.	Enter the amount from Schedule D, line 19	7.	<u>-0-</u>
8.	Add lines 6 and 7	8.	<u>450</u>
9.	Subtract line 8 from line 4. If zero or less, enter -0-	9.	<u>8,900</u>
10.	Subtract line 9 from line 1. If zero or less, enter -0-	10.	<u>21,100</u>
11.	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 1 or • \$45,200 if married filing jointly or qualifying widow(er); \$27,050 if single; \$36,250 if head of household; or \$22,600 if married filing separately 	11.	<u>27,050</u>
12.	Enter the smaller of line 10 or line 11	12.	<u>21,100</u>
13.	Subtract line 4 from line 1. If zero or less, enter -0-	13.	<u>20,650</u>
14.	Enter the larger of line 12 or line 13	▶ 14.	<u>21,100</u>
15.	Figure the tax on the amount on line 14. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	15.	<u>3,169</u>
If lines 11 and 12 are the same, skip lines 16 through 21 and go to line 22. Otherwise, go to line 16.			
16.	Subtract line 12 from line 11	▶ 16.	<u>5,950</u>
17.	Enter your qualified 5-year gain, if any, from the worksheet on page D-8. Also enter this amount on Schedule D, line 29	17.	<u>9,300</u>
18.	Enter the smaller of line 16 above or line 17 above	18.	<u>5,950</u>
19.	Multiply line 18 by 8% (.08)	19.	<u>476</u>
20.	Subtract line 18 from line 16	20.	<u>-0-</u>
21.	Multiply line 20 by 10% (.10)	21.	<u>-0-</u>
If lines 1 and 11 are the same, skip lines 22 through 34 and go to line 35. Otherwise, go to line 22.			
22.	Enter the smaller of line 1 or line 9	22.	<u>8,900</u>
23.	Enter the amount from line 16. If blank, enter -0-	23.	<u>5,950</u>
24.	Subtract line 23 from line 22	▶ 24.	<u>2,950</u>
25.	Multiply line 24 by 20% (.20)	25.	<u>590</u>
If line 7 is zero, skip lines 26 through 31 and go to line 32. Otherwise, go to line 26.			
26.	Enter the smaller of line 4 or line 7	26.	<u> </u>
27.	Add lines 4 and 14	27.	<u> </u>
28.	Enter the amount from line 1 above	28.	<u> </u>
29.	Subtract line 28 from line 27. If zero or less, enter -0-	29.	<u> </u>
30.	Subtract line 29 from line 26. If zero or less, enter -0-	▶ 30.	<u> </u>
31.	Multiply line 30 by 25% (.25)	31.	<u> </u>
If line 6 is zero, skip lines 32 through 34 and go to line 35. Otherwise, go to line 32.			
32.	Add lines 14, 16, 24, and 30	32.	<u>30,000</u>
33.	Subtract line 32 from line 1	33.	<u>-0-</u>
34.	Multiply line 33 by 28% (.28)	34.	<u>-0-</u>
35.	Add lines 15, 19, 21, 25, 31, and 34	35.	<u>4,235</u>
36.	Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies	36.	<u>4,876</u>
37.	Tax on all taxable income (including capital gains). Enter the smaller of line 35 or line 36. Also enter this amount on Schedule D, line 40, and Form 1040, line 40	37.	<u>4,235</u>

Part Four.

Adjustments to Income

The three chapters in this part discuss three of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:

- *Contributions you make to traditional individual retirement arrangements (IRAs) — chapter 18,*
- *Moving expenses you pay — chapter 19, and*
- *Alimony you pay — chapter 20.*

Other adjustments to income are discussed in other parts of this publication or in other publications and instructions. They are deductions for:

- *Interest paid on student loans — instructions for Form 1040, line 24, or Form 1040A, line 17,*
 - *Contributions to an Archer MSA— chapter 23,*
 - *Self-employment tax — chapter 24,*
 - *Self-employed health insurance — chapter 23,*
 - *Payments to self-employed SEP, SIMPLE, and qualified plans — Publication 560, Retirement Plans for Small Business,*
 - *Penalty on early withdrawal of savings — chapter 8,*
 - *Amortization of the costs of reforestation — chapter 9 of Publication 535, Business Expenses,*
 - *Contributions to Internal Revenue Code section 501(c)(18) pension plans — Publication 525, Taxable and Nontaxable Income,*
 - *Expenses from the rental of personal property — chapter 13,*
 - *Expenses of fee-basis officials or certain performing artists — chapter 28,*
 - *Certain required repayments of supplemental unemployment benefits (sub-pay) — chapter 13,*
 - *Foreign housing deduction — chapter 4 of Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad,*
 - *Jury duty pay given to your employer — chapter 13,*
 - *Part of the cost of qualified clean-fuel vehicle property — chapter 12 of Publication 535, Business Expenses, and*
 - *Contributions by certain chaplains to Internal Revenue Code section 403(b) plans— Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers.*
-

18.

Individual Retirement Arrangements (IRAs)

Important Changes for 2001

Coverdell education savings accounts (formerly education IRAs). Education IRAs have been renamed Coverdell education savings accounts. Coverdell education savings accounts are no longer covered in this chapter. They are now covered in Publication 970, *Tax Benefits for Higher Education*.

Modified AGI limit for traditional IRAs. For 2001, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (AGI) is between:

- \$53,000 and \$63,000 for a married couple filing a joint return or a qualifying widow(er),
- \$33,000 and \$43,000 for a single individual or head of household, or
- \$-0- and \$10,000 for a married individual filing a separate return.

For all filing statuses other than married filing a separate return, the upper and lower limits of the phaseout range increased by \$1,000. For more information, see *How Much Can I Deduct?* under *Traditional IRAs*.

Simplified rules for minimum required distributions. New rules which became effective in 2001 simplify how minimum required distributions are figured. For most people, the new simplified rules result in lower minimum required distributions. For more information, see *When Must I Withdraw IRA Assets? (Required Distributions)* in chapter 1 of Publication 590, *Individual Retirement Arrangements (IRAs)*.

Important Changes for 2002

Increased traditional IRA contribution and deduction limit. The most that can be contributed to your traditional IRA for 2002 is the smaller of the following amounts:

- Your compensation that you must include in income for the year, or

- **\$3,000** (up from \$2,000).

If you are 50 years of age or older in 2002, the most that can be contributed to your traditional IRA for 2002 is the smaller of the following amounts:

- Your compensation that you must include in income for the year, or
- **\$3,500** (up from \$2,000).

For more information, see *How Much Can Be Contributed?* under *Traditional IRAs*.

Besides being able to contribute a larger amount in 2002, you may be able to deduct a larger amount. See *How Much Can I Deduct?* under *Traditional IRAs*.

Modified AGI limit for traditional IRA contributions increased. For 2002, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (AGI) is between:

- \$54,000 and \$64,000 for a married couple or a qualifying widow(er) filing a joint return,
- \$34,000 and \$44,000 for a single individual or head of household, or
- \$-0- and \$10,000 for a married individual filing a separate return.

For all filing statuses other than married filing a separate return, the upper and lower limits of the phaseout range increased by \$1,000. See *How Much Can I Deduct?* under *Traditional IRAs*.

Credit for IRA contributions. For tax years beginning after December 31, 2001, if you are an eligible individual, you may be able to claim a credit for a percentage of your qualified retirement savings contributions, such as contributions to your traditional or Roth IRA. To be eligible, you must be at least 18 years old as of the end of the year, and you cannot be a student or an individual for whom someone else claims a personal exemption. Also, your adjusted gross income (AGI) must be below a certain amount.

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Rollovers from traditional IRAs into qualified plans. For distributions after December 31, 2001, you can roll over, tax free, a distribution from your IRA into a qualified plan. The part of the distribution that you can roll over is the part that would otherwise be taxable (includible in your income). Qualified plans may, but are not required to, accept such rollovers. Rules applicable to other rollovers, such as the 60-day time limit, apply. For more information, see *Rollovers* under *Traditional IRAs*.

Rollovers of distributions from employer plans. For distributions after December 31, 2001, you can rollover both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA. If you have both deductible and nondeductible contributions in your IRA, you will have to keep track of your basis so you will be able to determine the taxable amount once distributions from the IRA begin.

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Rollovers of deferred compensation plans of state and local governments (section 457 plans) into traditional IRAs. Before 2002, you could not roll over, tax free, an eligible rollover distribution from a governmental deferred compensation plan into a traditional IRA.

Beginning with distributions after December 31, 2001, if you participate in an eligible deferred compensation plan of a state or local government, you may be able to roll over part of your account tax free into an eligible retirement plan such as a traditional IRA. The most that you can roll over is the amount that would be taxed if the rollover were not an eligible rollover distribution. You cannot roll over any part of the distribution that would not be taxable. The rollover may be either direct or indirect.

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Rollovers of traditional IRAs into deferred compensation plans of state and local governments (section 457 plans). Before 2002, you could not roll over tax free a distribution from a traditional IRA into a governmental deferred compensation plan.

Beginning with distributions after December 31, 2001, if you participate in an eligible deferred compensation plan of a state or local government, you may be able to roll over a distribution from your traditional IRA into a deferred compensation plan of a state or local government. Qualified plans may, but are not required to, accept such rollovers.

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Rollovers of traditional IRAs into tax-sheltered annuities (section 403(b) plans). Before 2002, you could not roll over tax free a distribution from a traditional IRA into a tax-sheltered annuity.

Beginning with distributions after December 31, 2001, you may be able to roll over distributions tax free from a traditional IRA into a tax-sheltered annuity. You cannot roll over any amount that would not have been taxable.

Although a tax-sheltered annuity is allowed to accept such a rollover, it is not required to do so.

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Participants born before 1936. If you were born before 1936, you may be able to use capital gain and averaging treatment on certain lump-sum distributions from qualified plans, but you will lose the opportunity to use capital gain or averaging treatment on distributions from a qualified plan if you roll over IRA contributions to that plan. You can retain such treatment if the rollover is from a conduit IRA. For more information on conduit IRAs, see *IRA as a holding account (conduit IRA) for rollovers to other eligible plans* in chapter 1 of Publication 590.

No rollovers of hardship distributions into IRAs. For distributions made after December 31, 2001, no hardship distribution can be rolled over into an IRA. For more information about what can be rolled over, see *Rollover From Employer's Plan Into an IRA* under *Traditional IRAs*.

Hardship exception to the 60-day rollover rule. Generally, a rollover is tax free only if you

make the rollover contribution by the 60th day after the day you receive the distribution. Beginning with distributions after December 31, 2001, the IRS may waive the 60-day requirement where it would be against equity or good conscience not to do so.

For more information, see *Time Limit for Making a Rollover Contribution under Traditional IRAs*.

Increased Roth IRA contribution limit. If contributions on your behalf are made only to Roth IRAs, your contribution limit for 2002 generally is the lesser of:

- **\$3,000** (up from \$2,000), or
- Your taxable compensation.

If you are 50 years of age or older in 2002 and contributions on your behalf are made only to Roth IRAs, your contribution limit for 2002 generally is the lesser of:

- **\$3,500** (up from \$2,000), or
- Your taxable compensation.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced. For more information, see *How Much Can Be Contributed?* under *Roth IRAs*.

Contributions to both traditional and Roth IRAs for same year. If contributions are made on your behalf to both a Roth IRA and a traditional IRA, your contribution limit for 2002 is the lesser of:

- **\$3,000 (\$3,500** if you are 50 years of age or older in 2002) (up from \$2,000) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced. For more information, see *How Much Can Be Contributed?* under *Roth IRAs*.

Important Reminders

IRA interest. Although interest earned from your IRA is generally not taxed in the year earned, it is **not tax-exempt** interest. **Do not** report this interest on your tax return as tax-exempt interest.

Form 8606. If you make nondeductible contributions to a traditional IRA and you do not file Form 8606, *Nondeductible IRAs and Coverdell ESAs*, with your tax return, you may have to pay a \$50 penalty.

Spousal IRAs. In the case of a married couple filing a joint return, up to \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if 50 or older) can be contributed to IRAs (other than SIMPLE IRAs) on behalf of each spouse, even if one spouse

has little or no compensation. See *Spousal IRA limit* under *How Much Can Be Contributed?* and under *Can I contribute to a Roth IRA for my spouse?* under *Roth IRAs*, later.



Employer contributions under a SEP plan are not counted when figuring the limits just discussed. SEP plans are discussed in chapter 3 of Publication 590.

Spouse covered by employer plan. If you are not covered by an employer retirement plan and you file a joint return, you may be able to deduct all of your contributions to a traditional IRA, even if your spouse is covered by a plan. See *How Much Can I Deduct?* under *Traditional IRAs*.

Distributions for higher education expenses. You can take distributions from your traditional IRA or Roth IRA for qualified higher education expenses without having to pay the 10% additional tax on early distributions. For more information, see Publication 590.

Distributions for first home. You can take distributions of up to \$10,000 from your traditional or Roth IRA to buy, build, or rebuild a first home without having to pay the 10% additional tax on early distributions. For more information, see Publication 590.

Roth IRA. You cannot claim a deduction for any contributions to a Roth IRA. But, if you satisfy the requirements, all earnings are tax free and neither your nondeductible contributions nor any earnings on them are taxable when you withdraw them. See *Roth IRAs*, later.

Introduction

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement.

This chapter discusses:

- 1) The rules for a **traditional IRA** (those that are not Roth or SIMPLE IRAs), and
- 2) The **Roth IRA**, which features nondeductible contributions and tax-free distributions.

Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs) are not discussed in this chapter. For more information on these plans and employees' SEP-IRAs and SIMPLE IRAs that are part of these plans, see Publication 590.

Useful Items

You may want to see:

Publication

- 590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- 5329** Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts
- 8606** Nondeductible IRAs and Coverdell ESAs

Traditional IRAs

In this chapter the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA." Two advantages of a traditional IRA are:

- 1) You may be able to deduct some or all of your contributions to it, depending on your circumstances, and,
- 2) Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

What Is a Traditional IRA?

A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA.

Who Can Set Up a Traditional IRA?

You can set up and make contributions to a traditional IRA if:

- 1) You (or, if you file a joint return, your spouse) received taxable compensation during the year, and
- 2) You were not age 70½ by the end of the year.

What is compensation? Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (*Wages, tips, other compensation*) of Form W-2, *Wage and Tax Statement*, provided that amount is reduced by any amount properly shown in box 11 (*Nonqualified plans*). Scholarship and fellowship payments are compensation for this purpose only if shown in box 1 of Form W-2. Compensation also includes commissions and taxable alimony and separate maintenance payments.

Self-employment income. If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the total of:

- 1) The deduction for contributions made on your behalf to retirement plans, and
- 2) The deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs. See Publication 533, *Self-Employment Tax*, for more information.

What is not compensation? Compensation does **not** include any of the following items.

- Earnings and profits from property, such as rental income, interest income, and dividend income.
- Pension or annuity income.

- Deferred compensation received (compensation payments postponed from a past year).
- Income from a partnership for which you do not provide services that are a material income-producing factor.
- Any amounts you exclude from income, such as foreign earned income and housing costs.

When and How Can a Traditional IRA Be Set Up?

You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. See *When Can Contributions Be Made*, later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Kinds of traditional IRAs. Your traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

How Much Can Be Contributed?

There are limits and other rules that affect the amount that can be contributed and the amount you can deduct. These limits and other rules are explained below.

Community property laws. Except as discussed later under *Spousal IRA limit*, each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws.

Brokers' commissions. Brokers' commissions paid in connection with your traditional IRA are subject to the contribution limit.

Trustees' fees. Trustees' administrative fees are not subject to the contribution limit.



Contributions to your traditional IRAs reduce the limit for contributions to Roth IRAs. (See Roth IRAs, later.)

General limit. The most that can be contributed to your traditional IRA is **the smaller of** the following amounts:

- 1) Your compensation (defined earlier) that you must include in income for the year, or
- 2) \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if you are 50 or older).

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See *Nondeductible Contributions*, later.)

Example 1. Betty, who is single, earned \$24,000 in 2001. Her IRA contributions for 2001 are limited to \$2,000.

Example 2. John, a college student working part time, earned \$1,500 in 2001. His IRA contributions for 2001 are limited to \$1,500, the amount of his compensation.

Spousal IRA limit. If you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

- 1) \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if you are 50 or older), or
- 2) The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following two amounts.
 - a) Your spouse's contribution for the year to a traditional IRA.
 - b) Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as \$4,000 for 2001 (\$6,000 for 2002, or \$6,500 for 2002 if only one of you is 50 or older, or \$7,000 for 2002 if both of you are 50 or older).

When Can Contributions Be Made?

As soon as you set up your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions must be made by due date. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, **not** including extensions. For most people, this means that contributions for 2001 must be made by April 15, 2002.

Age 70½ rule. Contributions cannot be made to your traditional IRA for the year in which you reach age 70½ or for any later year.

Designating year for which contribution is made. If an amount is contributed to your traditional IRA between January 1 and April 15, you should tell the sponsor to which year (the current year or the previous year) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. However, the contribution must be made by the due date of your return, **not** including extensions.

Contributions not required. You do not have to contribute to your traditional IRA for every tax year, even if you can.

How Much Can I Deduct?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit (or the spousal IRA limit, if it applies).

However, if you or your spouse was covered by an employer retirement plan, you may not be able to deduct this amount. See *Limit if Covered by Employer Plan*, later.

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040). See chapter 30.

Brokers' commissions. Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits.

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of:

- 1) \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if you are 50 or older), or
- 2) 100% of your compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

Spousal IRA. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

- 1) \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if 50 or older), or
- 2) The total compensation includible in the gross income of both spouses for the year reduced by the following two amounts.
 - a) The IRA deduction for the year of the spouse with the greater compensation.
 - b) Any contributions for the year to a Roth IRA on behalf of the spouse with more compensation.

This limit is reduced by any contributions to a 501(c)(18) plan on behalf of the spouse with less compensation.

Note. If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions to your spouse's IRA. After a divorce or legal separation, you can deduct only contributions to your own IRA and your deductions are subject to the rules for single individuals.

Covered by an employer retirement plan. If you or your spouse was covered by an employer retirement plan at any time during the year for which contributions were made, your deduction may be further limited. This is discussed later under *Limit If Covered by Employer Plan*. Limits on the amount you can deduct do not affect the amount that can be contributed. See *Nondeductible Contributions*, later.

Table 18–1. Effect of Modified AGI¹ on Deduction if Covered by Retirement Plan at Work

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is ...	AND your modified adjusted gross income (modified AGI) is ...	THEN you can take ...
Single or Head of Household	Less than \$33,000	A full deduction
	At least \$33,000 but less than \$43,000	A partial deduction
	\$43,000 or more	No deduction
Married Filing Jointly or Qualifying Widow(er)	Less than \$53,000	A full deduction
	At least \$53,000 but less than \$63,000	A partial deduction
	\$63,000 or more	No deduction
Married Filing Separately²	Less than \$10,000	A partial deduction
	\$10,000 or more	No deduction

¹ Modified AGI (adjusted gross income). See *Modified adjusted gross income*.

² If you did not live with your spouse at any time during the year, your filing status is considered *Single* for this purpose (therefore, your IRA deduction is determined under the “Single” column).

Are You Covered by an Employer Plan?

The Form W–2 you receive from your employer has a box used to indicate whether you were covered for the year. The “Retirement plan” box should be checked if you were covered.

Reservists and volunteer firefighters should also see *Situations in Which You Are Not Covered*, later.

If you are not certain whether you were covered by your employer’s retirement plan, you should ask your employer.

Federal judges. For purposes of the IRA deduction, federal judges are covered by an employer retirement plan.

For Which Year(s) Are You Covered?

Special rules apply to determine the tax years for which you are covered by an employer plan. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

Tax year. Your tax year is the annual accounting period you use to keep records and report income and expenses on your income tax return. For most people, the tax year is the calendar year.

Defined contribution plan. Generally, you are covered by a defined contribution plan for a tax year if amounts are contributed or allocated to your account for the plan year that ends with or within that tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Defined benefit plan. If you are eligible to participate in your employer’s defined benefit plan for the plan year that ends within your tax year, you are covered by the plan. This rule applies even if you:

- Declined to participate in the plan,

- Did not make a required contribution, or
- Did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Types of defined benefit plans include pension plans and annuity plans.

No vested interest. If you accrue a benefit for a plan year, you are covered by that plan even if you have no vested interest in (legal right to) the account or the accrual.

Situations in Which You Are Not Covered

Unless you are covered under another employer plan, you are not covered by an employer plan if you are in one of the situations described below.

Social security or railroad retirement. Coverage under social security or railroad retirement is not coverage under an employer retirement plan.

Benefits from a previous employer’s plan. If you receive retirement benefits from a previous employer’s plan, you are not covered by that plan.

Reservists. If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be covered by the plan. You are not covered by the plan if **both** of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
 - a) The United States,
 - b) A state or political subdivision of a state, or
 - c) An instrumentality of either (a) or (b) above.
- 2) You did not serve more than 90 days on active duty during the year (not counting duty for training).

Volunteer firefighters. If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be covered by the plan. You are not covered by the plan if **both** of the following conditions are met.

- 1) The plan you participate in is established for its employees by:
 - a) The United States,
 - b) A state or political subdivision of a state, or
 - c) An instrumentality of either (a) or (b) above.
- 2) Your accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

Limit if Covered by Employer Plan

If either you or your spouse was covered by an employer retirement plan, you may be entitled to only a partial (reduced) deduction or no deduction at all, depending on your income and your filing status.

Your deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on your filing status.

To determine if your deduction is subject to phaseout, you must determine your modified adjusted gross income (AGI) and your filing status. Then use *Table 18–1* or *18–2* to determine if the phaseout applies.

Social security recipients. Instead of using *Table 18–1* or *18–2*, use the worksheets in *Appendix B* of Publication 590 if, for the year, **all** of the following apply.

- You received social security benefits.
- You received taxable compensation.
- Contributions were made to your traditional IRA.

Table 18–2. Effect of Modified AGI¹ on Deduction if NOT Covered by Retirement Plan at Work

If you are not covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is ...	AND your modified adjusted gross income (modified AGI) is ...	THEN you can take ...
Single, Head of Household, or Qualifying Widow(er)	Any amount	A full deduction
Married Filing Jointly or Separately with a spouse who <i>is not</i> covered by a plan at work	Any amount	A full deduction
Married Filing Jointly with a spouse who <i>is</i> covered by a plan at work	Less than \$150,000	A full deduction
	At least \$150,000 but less than \$160,000	A partial deduction
	\$160,000 or more	No deduction
Married Filing Separately with a spouse who <i>is</i> covered by a plan at work ²	Less than \$10,000	A partial deduction
	\$10,000 or more	No deduction

¹ Modified AGI (adjusted gross income). See *Modified adjusted gross income*.

² You are entitled to the full deduction if you did not live with your spouse at any time during the year.

- You or your spouse was covered by an employer retirement plan.

Use those worksheets to figure your IRA deduction, your nondeductible contribution, and the taxable portion, if any, of your social security benefits.

Deduction phaseout. If you were covered by an employer retirement plan, your IRA deduction may be reduced or eliminated depending on your filing status and modified AGI as shown in Table 18–1.

TIP For 2002, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified AGI is between:

- \$34,000 and \$44,000 for a single individual (or head of household),
- \$54,000 and \$64,000 for a married couple (or a qualifying widow(er)) filing a joint return, or
- \$–0– (no increase) and \$10,000 for a married individual filing a separate return.

For all filing statuses other than married filing a separate return, the upper and lower limits of the phaseout range will increase by \$1,000.

If your spouse is covered. If you are not covered by an employer retirement plan, but your spouse is, and you did not receive any social security benefits, your IRA deduction is reduced or eliminated entirely depending on your filing status and modified AGI as shown in Table 18–2.

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see chapter 2.

Lived apart from spouse. If you did not live with your spouse at any time during the year and you file a separate return, your filing status, for this purpose, is single.

Modified adjusted gross income (AGI). How you figure your modified AGI depends on whether you are filing Form 1040 or Form 1040A. If you made contributions to your IRA for 2001 and received a distribution from your IRA in 2001, see Publication 590.



Do not assume that your modified AGI is the same as your compensation. Your modified AGI may include income in addition to your compensation (discussed earlier), such as interest, dividends, and income from IRA distributions.

Form 1040. If you file Form 1040, refigure the amount on page 1 “adjusted gross income” line without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.
- Foreign earned income exclusion.
- Foreign housing exclusion or deduction.
- Exclusion of qualified savings bond interest shown on Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses)*.
- Exclusion of employer-paid adoption expenses shown on Form 8839, *Qualified Adoption Expenses*.

This is your modified AGI.

Form 1040A. If you file Form 1040A, refigure the amount on page 1 “adjusted gross income” line without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.
- Exclusion of qualified savings bond interest shown on Form 8815.
- Exclusion of employer-paid adoption expenses shown on Form 8839.

This is your modified AGI.

Both contributions for 2001 and distributions in 2001. If all three of the following oc-

curred, any IRA distributions you received in 2001 may be partly tax free and partly taxable.

- 1) You received distributions in 2001 from one or more traditional IRAs.
- 2) You made contributions to a traditional IRA for 2001.
- 3) Some of those contributions may be nondeductible contributions depending on whether your IRA deduction for 2001 is reduced.

If all three of the above occurred, you must figure the taxable part of the traditional IRA distribution before you can figure your modified AGI. To do this, you can use *Worksheet 1–1, Figuring the Taxable Part of Your IRA Distribution* in Publication 590.

If at least one of the above did *not* occur, figure your modified AGI using *Worksheet 18–1* in this chapter.

How to figure your reduced IRA deduction. You can figure your reduced IRA deduction for either Form 1040 or Form 1040A by using the worksheets in chapter 1 of Publication 590. Also, the instructions for Form 1040 and Form 1040A include similar worksheets that you may be able to use instead.

Reporting Deductible Contributions

If you file Form 1040, enter your IRA deduction on line 23 of that form. If you file Form 1040A, enter your IRA deduction on line 16. You cannot deduct IRA contributions on Form 1040EZ.

Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated, contributions can be made to your IRA up to the general limit (\$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if 50 or older) or 100% of compensation, whichever is less) or the spousal IRA limit (if it applies). The difference between your total per-

Worksheet 18–1. Figuring Your Modified AGI

Use this worksheet to figure your modified adjusted gross income for traditional IRA purposes.

1.	Enter your adjusted gross income (AGI) shown on line 19, Form 1040A, or line 33, Form 1040 figured without taking into account line 16, Form 1040A, or line 23, Form 1040	1.	_____
2.	Enter any <i>Student loan interest deduction</i> from line 17, Form 1040A, or line 24, Form 1040	2.	_____
3.	Enter any <i>Foreign earned income exclusion</i> from line 18, Form 2555–EZ, or line 40, Form 2555	3.	_____
4.	Enter any <i>Foreign housing exclusion</i> from line 34, Form 2555, or <i>Foreign housing deduction</i> from line 48, Form 2555	4.	_____
5.	Enter any <i>Excluded qualified savings bond interest</i> shown on line 3, Schedule 1, Form 1040A, or line 3, Schedule B, Form 1040 (from line 14, Form 8815)	5.	_____
6.	Enter any <i>Exclusion of employer-paid adoption expenses</i> shown on line 26, Form 8839	6.	_____
7.	Add lines 1 through 6. This is your Modified AGI for traditional IRA purposes	7.	_____

mitted contributions and your IRA deduction, if any, is your nondeductible contribution.

Example. Martin Jones is single. In 2001, he was covered by a retirement plan at work. His salary was \$52,312. His modified AGI was \$55,000. Martin made a \$2,000 IRA contribution for 2001. Because he was covered by a retirement plan and his modified AGI was over \$43,000, he cannot deduct his \$2,000 IRA contribution. However, he can choose to designate this contribution as a nondeductible contribution, as explained next.

Form 8606. To designate contributions as nondeductible, you must file Form 8606.

You do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Failure to report nondeductible contributions. If you do not report nondeductible contributions, all of the contributions to your traditional IRA will be treated as deductible. All distributions from your IRA will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. If you overstate the amount of nondeductible contributions on your Form 8606 for any tax year, you must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause.

Penalty for failure to file Form 8606. You will have to pay a \$50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

Tax on earnings on nondeductible contributions. As long as contributions are within the contribution limits, none of the earnings or gains on those contributions (deductible or nondeductible) will be taxed until they are distributed. See *When Can I Withdraw or Use IRA Assets*, later.

Cost basis. You will have a cost basis in your IRA if there are nondeductible contributions. Your cost basis is the sum of the nondeductible contributions to your IRA minus any withdrawals or distributions of nondeductible contributions.

Inherited IRAs

If you inherit a traditional IRA, that IRA becomes subject to special rules.

If you inherit a traditional IRA from your deceased spouse, you can choose to treat it as your own by making contributions (including rollover contributions) to it.

If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that contributions (including rollover contributions) cannot be made to the IRA and you cannot roll over any amounts out of the inherited IRA.

If you inherit a traditional IRA from your deceased spouse, you can generally roll it over into another traditional IRA established for you or you can choose to treat the inherited IRA as your own.

For more information, see the discussion of inherited IRAs under *Rollover From One IRA Into Another*, later.

Can I Move Retirement Plan Assets?

Traditional IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. The rules permit the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

Transfers to Roth IRAs. Under certain conditions, you can move assets from a traditional IRA to a Roth IRA. See *Can I Move Amounts Into a Roth IRA?* under *Roth IRAs*, later.

Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is **not a rollover**. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers, discussed

later under *Rollover From One IRA Into Another*. For information about direct transfers to IRAs from retirement plans other than IRAs, see Publication 590.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

Note. The amount you roll over tax free is generally taxable when the new plan distributes that amount to you or your beneficiary.

Kinds of rollovers to an IRA. There are two kinds of rollover contributions to a traditional IRA.

- 1) You put amounts you receive from one traditional IRA into the same or another traditional IRA.
- 2) You put amounts you receive from an employer's qualified retirement plan for its employees into a traditional IRA.

Distributions after December 31, 2001, can be rolled over into a traditional IRA from:

- 1) A deferred compensation plan of a state or local government (section 457 plan), or
- 2) A tax-sheltered annuity (section 403(b)).

For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

Treatment of rollovers. You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return as discussed later under *Reporting rollovers from IRAs* and under *Reporting rollovers from employer plans*.

Kinds of rollovers from an IRA. For distributions after December 31, 2001, you can roll over, tax free, a distribution from your IRA into a qualified plan, including a deferred compensation plan of a state or local government (section 457 plan) and a tax-sheltered annuity (section 403(b) plan). The part of the distribution that you can roll over is the part that would otherwise be taxable (including in your income). Qualified plans may, but are not required to, accept such

rollovers. Rules applicable to other rollovers, such as the 60-day time limit, apply.

Time limit for making a rollover contribution. You, generally, must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA or your employer's plan.

For distributions made after December 31, 2001, the IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as a casualty, disaster, or other event beyond your reasonable control.

Extension of rollover period. If an amount distributed to you from a traditional IRA or a qualified employer retirement plan is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period. For more information, get Publication 590.

Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

Waiting period between rollovers. If you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

Example. If you have two traditional IRAs, IRA-1 and IRA-2, and you make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3), you can also make a tax-free rollover of a distribution from IRA-2 into IRA-3 (or into any other traditional IRA) within 1 year of the distribution from IRA-1. These can both be tax-free rollovers because you have not received more than one distribution from either IRA within 1 year. However, you cannot, within the 1-year period, make a tax-free rollover of any distribution from IRA-3 into another traditional IRA.

Exception. There is an exception to the rule that amounts rolled over tax free into an IRA cannot be rolled over tax free again within the 1-year period beginning on the date of the original distribution. The exception applies to a distribution which meets **all three** of the following requirements.

- 1) It is made from a failed financial institution by the Federal Deposit Insurance Corporation (FDIC) as receiver for the institution.
- 2) It was **not** initiated by either the custodial institution or the depositor.
- 3) It was made because:

- a) The custodial institution is insolvent, and
- b) The receiver is unable to find a buyer for the institution.

Partial rollovers. If you withdraw assets from a traditional IRA, you can roll over part of the withdrawal tax free and keep the rest of it. The amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions, discussed later under *Early Distributions*.

Required distributions. Amounts that must be distributed during a particular year under the required distribution rules (discussed later) **are not eligible for rollover** treatment.

Inherited IRAs. If you inherit a traditional IRA from your spouse, you generally can roll it over into a traditional IRA established for you, or you can choose to make the inherited IRA your own.

For distributions after December 31, 2001, your rollover options increase. You may still roll over your spouse's IRA into your traditional IRA, but to the extent a distribution is taxable, you can roll it over into your qualified plan, your qualified employee annuity (section 403(a) annuity), your tax-sheltered annuity (section 403(b) annuity), or your deferred compensation plan of your state or local government (section 457 plan).

Not inherited from spouse. If you inherit a traditional IRA from someone other than your spouse, you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, see Publication 590.

Reporting rollovers from IRAs. Report any rollover from one traditional IRA to the same or another traditional IRA on lines 15a and 15b, Form 1040 or lines 11a and 11b, Form 1040A.

Enter the total amount of the distribution on line 15a, Form 1040 or line 11a, Form 1040A. If the total amount on line 15a, Form 1040 or line 11a, Form 1040A was rolled over, enter zero on line 15b, Form 1040 or line 11b, Form 1040A. Otherwise, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040 or line 11b, Form 1040A.

Rollover From Employer's Plan Into an IRA

If you receive an **eligible rollover distribution** from your (or your deceased spouse's) employer's qualified pension, profit-sharing or stock bonus plan, annuity plan, or tax-sheltered annuity plan (403(b) plan), you can roll over all or part of it into a traditional IRA.

For distributions made after December 31, 2001, if you receive an eligible rollover distribution from your (or your deceased spouse's) governmental deferred compensation plan (section 457 plan), you can roll over all or part of it into a traditional IRA.

Eligible rollover distribution. Generally, an eligible rollover distribution is the taxable part of any distribution of all or part of the balance to your credit in a qualified retirement plan **except:**

- 1) A minimum required distribution,

- 2) Hardship distributions from 401(k) plans and certain 403(b) plans, or
- 3) Any of a series of substantially equal periodic distributions paid at least once a year over:
 - a) Your lifetime or life expectancy,
 - b) The lifetimes or life expectancies of you and your beneficiary, or
 - c) A period of 10 years or more.

The taxable parts of most other distributions are eligible rollover distributions. See Publication 575, *Pension and Annuity Income*, for additional exceptions.

For distributions made after December 31, 2001, no hardship distribution is an eligible rollover distribution.

Maximum rollover. The most that you can roll over is the taxable part of any eligible rollover distribution (defined earlier). All of the distribution you receive generally will be taxable unless you have made nondeductible employee contributions to the plan.

Reporting rollovers from employer plans. To report a rollover from an employer retirement plan to a traditional IRA, use lines 16a and 16b, Form 1040, or lines 12a and 12b, Form 1040A. Do not use lines 15a or 15b, Form 1040, or lines 11a or 11b, Form 1040A.

More Information on Rollovers

For more information on rollovers, get Publication 590.

Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from your spouse or former spouse to you by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. **The transfer is tax free.** For detailed information, see Publication 590.

When Can I Withdraw or Use IRA Assets?

There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of violation. See *What Acts Result in Penalties*.

Age 59½ rule. Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59½ are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Exceptions. There are several exceptions to the age 59½ rule. Even if you receive a distribution before you are age 59½, you may not have to pay the 10% additional tax if you are in one of the following situations.

- You have **unreimbursed medical expenses** that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your **medical insurance**.
- You are **disabled**.
- You are the **beneficiary** of a deceased IRA owner.
- You are receiving distributions in the form of an **annuity**.
- The distributions are not more than your qualified **higher education expenses**.
- You use the distributions to buy, build, or rebuild a **first home**.
- The distribution is due to an **IRS levy** of the qualified plan.

Most of these exceptions are explained in Publication 590.

Note. Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and therefore not subject to the 10% additional tax. (See *Excess contributions withdrawn after due date of return*, later.) This also applies to transfers incident to divorce, as discussed earlier.

Contributions returned before the due date. If you made IRA contributions for 2001, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You can do this if, for each contribution you withdraw, **both** of the following conditions apply.

- You did not take a deduction for the contribution.
- You also withdraw any interest or other income earned on the contribution. You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

Note. If the trustee of your IRA is unable to calculate the amount you must withdraw, get IRS Notice 2000-39. The notice explains the IRS-approved method of calculating the amount you must withdraw. This notice can be found in many libraries and IRS offices.

You must include in income any earnings on the contributions you withdraw. Include the earnings in income for the year in which you made the contributions, not in the year in which you withdraw them.



Generally, except for any part of a withdrawal that is a return of nondeductible contributions (basis), any withdrawal of your contributions after the due date (or extended due date) of your return will be treated as a taxable distribution. Another exception is the return of an excess contribution as discussed under What Acts Result in Penalties, later.

Early distributions tax. The 10% additional tax on distributions made before you reach age 59½ does not apply to these tax-free withdrawals of your contributions. However, the distribution of interest or other income must be reported on Form 5329 and, unless the distribution qualifies as an exception to the age 59½ rule, it will be subject to this tax.

When Must I Withdraw IRA Assets? (Required Distributions)

You cannot keep funds in your traditional IRA indefinitely. Eventually they **must** be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required. See *Excess Accumulations (Insufficient Distributions)*, later. The requirements for distributing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Required distributions not eligible for rollover. Amounts that must be distributed (required distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, by April 1 of the year following the year in which you reach age 70½, you must either:

- 1) Receive the entire balance in your IRA, or
- 2) Start receiving periodic distributions from your IRA.

April 1 of the year following the year in which you reach age 70½ is referred to as the **required beginning date**.

Periodic distributions. If you do not receive the entire balance in your traditional IRA by the required beginning date, you must start to receive periodic distributions over one of the following periods:

- 1) Your life,
- 2) The lives of you and your **designated beneficiary**,
- 3) A period that does not extend beyond your life expectancy, or
- 4) A period that does not extend beyond the joint life and last survivor expectancy of you and your designated beneficiary.

Distributions after the required beginning date. The minimum required distribution for any year after your 70½ year must be made by December 31 of that later year.

Beneficiaries. If you are the beneficiary of a decedent's traditional IRA, the requirements for distributions from that IRA depend on whether distributions that satisfy the minimum distributions requirement have begun.

More information. For more information, including how to figure your minimum required distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, see Publication 590.

Are Distributions Taxable?

In general, distributions from a traditional IRA are taxable in the year you receive them.

Exceptions. Exceptions to this general rule are rollovers and tax-free withdrawals of contributions, discussed earlier, and the return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable*.



Although a conversion of a traditional IRA is considered a rollover for Roth IRA purposes, it is not an exception to the general rule for distributions from a traditional IRA. Conversion distributions are includable in your gross income subject to these rules and the special rules for conversions explained in chapter 2 of Publication 590.

Ordinary income. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the 10-year tax option or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

Distributions Fully or Partly Taxable

Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have **no basis** in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return*, later.

Partly taxable. If you made nondeductible contributions to any of your traditional IRAs, you have a **cost basis** (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is tax free. If nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of your basis has been distributed, each distribution is partly nontaxable and partly taxable.

Form 8606. You must complete Form 8606 and attach it to your return if you receive a distribution from a traditional IRA and have ever made nondeductible contributions to any of your traditional IRAs. Using the form, you will figure the nontaxable distributions for 2001 and your total IRA basis for 2001 and earlier years.

Note. If you are required to file Form 8606, but you are not required to file an income tax return, you still **must** file Form 8606. Send it to the IRS at the time and place you would otherwise file an income tax return.

Distributions reported on Form 1099–R. If you receive a distribution from your traditional IRA, you will receive Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.*, or a similar statement. IRA distributions are shown in boxes 1 and 2 of Form 1099–R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

Withholding. Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. See chapter 5.

IRA distributions delivered outside the United States. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on distributions from your traditional IRA.

Reporting taxable distributions on your return. Report fully taxable distributions, including early distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 11b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040, or line 11a, Form 1040A, and the taxable part on line 15b, Form 1040, or line 11b, Form 1040A. You cannot report distributions on Form 1040EZ.

What Acts Result in Penalties?

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for the following activities.

- Investing in collectibles.
- Making excess contributions.
- Taking early distributions.
- Allowing excess amounts to accumulate (failing to take required distributions).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a Form 8606, if required.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.
- Selling property to it.
- Receiving unreasonable compensation for managing it.
- Using it as security for a loan.

- Buying property for personal use (present or future) with IRA funds.

Effect on an IRA account. Generally, if you or your beneficiary engages in a prohibited transaction in connection with your traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

Effect on you or your beneficiary. If you or your beneficiary engage in a prohibited transaction with your traditional IRA account at any time during the year, you (or your beneficiary) must include the fair market value of all of the IRA assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may have to pay the 10% additional tax on early distributions, discussed later.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

More information. For more information on prohibited transactions, get Publication 590.

Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on early distributions, discussed later.

Collectibles. These include:

- Art works,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins,
- Alcoholic beverages, and
- Certain other tangible personal property.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Excess Contributions

Generally, an excess contribution is the amount contributed to your traditional IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if 50 or older).

Tax on excess contributions. In general, if the excess contribution for a year and any earnings on it are not withdrawn by the date your return for the year is due (including extensions), you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your traditional IRA at the end of your tax year. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

Excess contributions withdrawn by due date of return. You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year **and** you also withdraw interest or other income earned on the excess contribution. You must complete your withdrawal by the date your tax return for that year is due, including extensions.

How to treat withdrawn contributions. Do not include in your gross income an excess contribution that you withdraw from your traditional IRA before your tax return is due if **both** the following conditions are met.

- 1) No deduction was allowed for the excess contribution.
- 2) You withdraw the interest or other income earned on the excess contribution.

You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

How to treat withdrawn interest or other income. You must include in your gross income the interest or other income that was earned on the excess contribution. Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early distributions, discussed later.

Excess contributions withdrawn after due date of return. In general, you must include all distributions (withdrawals) from your traditional IRA in your gross income. However, if the following conditions are met, you can withdraw excess contributions from your IRA and not include the amount withdrawn in your gross income.

- 1) Total contributions (other than rollover contributions) for 2001 to your IRA were not more than \$2,000.
- 2) You did not take a deduction for the excess contribution being withdrawn.

The withdrawal can take place at any time, even after the due date, including extensions, for filing your tax return for the year.

Excess contribution deducted in an earlier year. If you deducted an excess contribution in an earlier year for which the total contributions were \$2,000 or less, you can still remove the excess from your traditional IRA and not include

it in your gross income. To do this, file Form 1040X, *Amended U.S. Individual Income Tax Return*, for that year and do not deduct the excess contribution on the amended return. Generally, you can file an amended return within 3 years after you filed your return, or 2 years from the time the tax was paid, whichever is later.

Excess due to incorrect rollover information. If an excess contribution in your traditional IRA is the result of a rollover and the excess occurred because the information the plan was required to give you was incorrect, you can withdraw the excess contribution. The limits mentioned above are increased by the amount of the excess that is due to the incorrect information. You will have to amend your return for the year in which the excess occurred to correct the reporting of the rollover amounts in that year. Do not include in your gross income the part of the excess contribution caused by the incorrect information.

Early Distributions

You must include early distributions of taxable amounts from your traditional IRA in your gross income. Early distributions are also subject to an **additional 10% tax**. See the discussion of Form 5329 under *Reporting Additional Taxes*, later, to figure and report the tax.

Early distributions defined. Early distributions are amounts distributed from your traditional IRA account or annuity before you are age 59½.

Exceptions. In certain situations, you may not have to pay the 10% additional tax even if amounts are distributed from your IRA before you are age 59½. These situations are listed below.

- You have **unreimbursed medical expenses** that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your **medical insurance**.
- You are **disabled**.
- You are the **beneficiary** of a deceased IRA owner.
- You are receiving distributions in the form of an **annuity**.
- The distributions are not more than your qualified **higher education expenses**.
- You use the distributions to buy, build, or rebuild a **first home**.
- The distribution is due to an **IRS levy** of the qualified plan.

Most of these exceptions are explained in Publication 590.

Note. Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions are also tax free and not subject to the 10% additional tax (as explained earlier under *Excess Contributions*). This also applies to transfers incident to divorce, as discussed

under *Can I Move Retirement Plan Assets*, earlier.

Additional 10% tax. The additional tax on early distributions is 10% of the amount of the early distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

Nondeductible contributions. The tax on early distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

More information. For more information on early distributions, see Publication 590.

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your traditional IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½ (your 70½ year). The minimum required distribution for any year after your 70½ year must be made by December 31 of that later year.

Tax on excess. If distributions are less than the minimum required distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to excuse the tax. If the excess accumulation is due to reasonable error, and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused.

If you believe you qualify for this relief, do the following.

- 1) File Form 5329 with your Form 1040.
- 2) Pay any tax you owe on excess accumulations.
- 3) Attach a letter of explanation.

If the IRS approves your request, it will refund the excess accumulations tax you paid.

Exemption from tax. If you are unable to make required distributions because you have a traditional IRA invested in a contract issued by an insurance company that is in state insurer delinquency proceedings, the 50% excise tax does not apply if the conditions and requirements of Revenue Procedure 92–10 are satisfied.

More information. For more information on excess accumulations, see Publication 590.

Reporting Additional Taxes

Generally, you must use Form 5329 to report the tax on excess contributions, early (premature) distributions, and excess accumulations.

Filing Form 1040. If you file Form 1040, complete Form 5329 and attach it to your Form 1040. Enter the total amount of IRA tax due on line 55, Form 1040.

Note. If you have to file an individual income tax return and Form 5329, you must use Form 1040.

Not filing Form 1040. If you do not have to file a Form 1040 but do have to pay one of the IRA taxes mentioned earlier, file the completed Form 5329 with the IRS at the time and place you would have filed your Form 1040. Be sure to include your address on page 1 and your signature and date on page 2. Enclose, but do not attach, a check or money order payable to the United States Treasury for the tax you owe, as shown on Form 5329. Write your social security number and “2001 Form 5329” on your check or money order.

Form 5329 not required. You do not have to use Form 5329 if **any** of the following conditions exist.

- Distribution code 1 (early distribution) is shown in box 7 of Form 1099–R. If you do not owe any other additional tax on a distribution, multiply the taxable part of the early distribution by 10% and enter the result on line 55 of Form 1040. Write “No” next to line 55 to indicate that you do not have to file Form 5329. However, if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- You qualify for an exception to the additional tax on early distributions. You do not have to report the exception if distribution code 2, 3, or 4 is shown in box 7 of Form 1099–R. However, if one of those codes is not shown, or the code shown is incorrect, you must file Form 5329 to report the exception.
- You properly rolled over all distributions you received during the year.

Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

TIP You can make contributions for 2001 by the due date (not including extensions) for filing your 2001 tax return. This means that most people can make contributions for 2001 by April 15, 2002.

Contributions not reported. You do not have to report Roth IRA contributions on your return.

What Is a Roth IRA?

A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA (defined below). It can be either an account or an annuity. Individual retirement accounts and annuities are described in Publication 590.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be

Table 18–3. Effect of Modified AGI on Roth IRA Contribution

This table shows whether your contribution to a Roth IRA is affected by the amount of your modified adjusted gross income (modified AGI).

IF you have taxable compensation and your filing status is ...	AND your modified AGI is ...	THEN ...
Married Filing Jointly	Less than \$150,000	You can contribute up to \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if age 50 or older).
	At least \$150,000 but less than \$160,000	The amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> .
	\$160,000 or more	You cannot contribute to a Roth IRA.
Married Filing Separately and you lived with your spouse at any time during the year	Zero (-0-)	You can contribute up to \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if 50 or older).
	More than zero (-0-) but less than \$10,000	The amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> .
	\$10,000 or more	You cannot contribute to a Roth IRA.
Single, Head of Household, Qualifying Widow(er), or Married Filing Separately and you did not live with your spouse at any time during the year	Less than \$95,000	You can contribute up to \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if age 50 or older).
	At least \$95,000 but less than \$110,000	The amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> .
	\$110,000 or more	You cannot contribute to a Roth IRA.

made to your Roth IRA after you reach age 70½ and you can leave amounts in your Roth IRA as long as you live.

Traditional IRA. A traditional IRA is any IRA that is not a Roth IRA or SIMPLE IRA.

Can I Contribute to a Roth IRA?

Generally, you can contribute to a Roth IRA if you have taxable **compensation** (defined later) and your **modified AGI** (defined later) is less than:

- \$160,000 for married filing jointly,

- \$10,000 for married filing separately and you lived with your spouse at any time during the year, and
- \$110,000 for single, head of household, qualifying widow(er) or married filing separately and you did not live with your spouse at any time during the year.

- \$160,000 for married filing jointly,
- \$10,000 for married filing separately and you lived with your spouse at any time during the year, and
- \$110,000 for married filing separately and you did not live with your spouse at any time during the year.

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can I contribute to a Roth IRA for my spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit (discussed in *How Much Can Be Contributed?* under *Traditional IRAs*) and your modified AGI is less than:

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, and taxable alimony and separate maintenance payments.

Worksheet 18–2. Modified Adjusted Gross Income for Roth IRA Purposes

Use this worksheet to figure your modified adjusted gross income for Roth IRA purposes.

1. Enter your adjusted gross income (Form 1040, line 33 or Form 1040A, line 19)	1. _____
2. Enter any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA	2. _____
3. Subtract line 2 from line 1	3. _____
4. Enter any traditional IRA deduction (Form 1040, line 23 or Form 1040A, line 16)	4. _____
5. Enter any student loan interest deduction (Form 1040, line 24 or Form 1040A, line 17)	5. _____
6. Enter any foreign earned income exclusion (Form 2555, line 40 or Form 2555–EZ, line 18)	6. _____
7. Enter any foreign housing exclusion or deduction (Form 2555, line 34 or 48)	7. _____
8. Enter any exclusion of bond interest (Form 8815, line 14)	8. _____
9. Enter any exclusion of employer-paid adoption expenses (Form 8839, line 26)	9. _____
10. Add the amounts on line 3 through 9. This is your modified adjusted gross income for Roth IRA purposes	10. _____

Modified AGI. Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return modified as follows.

- 1) **Subtract** any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA (conversion income).
- 2) **Add** the following deductions and exclusions:
 - a) Traditional IRA deduction,
 - b) Student loan interest deduction,
 - c) Foreign earned income exclusion,
 - d) Foreign housing exclusion or deduction,
 - e) Exclusion of qualified savings bond interest shown on Form 8815, and
 - f) Exclusion of employer-paid adoption expenses shown on Form 8839.

You can use *Worksheet 18-2* to figure your modified AGI.

How Much Can Be Contributed?

The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of:

- \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if you are 50 or older), or
- Your taxable compensation.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced*.

Roth IRAs and traditional IRAs. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

This means that your contribution limit is the lesser of:

- \$2,000 for 2001 (\$3,000 for 2002 or \$3,500 for 2002 if you are 50 or older) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced*.

Simplified employee pensions (SEPs) are discussed in chapter 3 of Publication 590. Savings

incentive match plans for employees (SIMPLE) are discussed in chapter 4 of Publication 590.

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use *Table 18-3* to determine if this reduction applies to you.

Figuring the reduction. If the amount you can contribute to your Roth IRA is reduced, see Publication 590 for how to figure the reduction.

When Can I Make Contributions?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

What If I Contribute Too Much?

A 6% excise tax applies to any **excess contribution** to a Roth IRA.

Excess contributions. These are the contributions to your Roth IRAs for a year that equal the **total** of:

- 1) Amounts contributed for the tax year to your Roth IRAs (other than amounts properly and timely rolled over from a Roth IRA or properly converted from a traditional IRA, as described later) that are more than your contribution limit for the year, plus
- 2) Any excess contributions for the preceding year, reduced by the total of:
 - a) Any distributions out of your Roth IRAs for the year, plus
 - b) Your contribution limit for the year minus your contributions to all your IRAs for the year.

Withdrawal of excess contributions. For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing your tax return for the year is treated as an amount not contributed. This treatment applies only if any earnings on the contributions are also withdrawn and are reported as income earned and receivable in the year the contribution was made.

Applying excess contributions. If contributions to your Roth IRA for a year were more than the limit, you can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year.

Can I Move Amounts Into a Roth IRA?

You may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from one Roth IRA to another Roth IRA.

Conversions

You can convert a traditional IRA or a SIMPLE IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers, described under *Rollover From One IRA Into Another* under *Traditional IRAs*, earlier, apply to these rollovers. However, the 1-year waiting period does not apply.

Conversion methods. You can convert amounts from a traditional IRA to a Roth IRA in **any** of the following three ways.

- 1) **Rollover.** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
- 2) **Trustee-to-trustee transfer.** You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
- 3) **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Converting from any traditional IRA. You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, **both** of the following requirements are met.

- 1) Your modified AGI (explained earlier) is not more than \$100,000.
- 2) You are not a married individual filing a separate return. (See *Lived apart from spouse* under *Filing status*, earlier.)

Required distributions. Amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70½) under the required distribution rules (discussed under *Traditional IRAs*, earlier) cannot be converted.

Inherited IRAs. If you inherited a traditional IRA from someone other than your spouse, you cannot convert it to a Roth IRA.

Income. You must include in your gross income distributions from a traditional IRA that you would have to include in income if you had not converted them into a Roth IRA. You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed earlier under *Traditional IRAs*.

If you must include any amount in your gross income, you may have to make estimated tax payments. See chapter 5.

How to treat 1998 conversions. If you converted amounts from a traditional IRA in 1998 to a Roth IRA, any amount you had to include in income as a result of the distribution is generally included ratably over a 4-year period, beginning with 1998. This means you included one-quarter

of the amount in income in 1998, 1999, 2000, and must include the final one-quarter in 2001.

Death of Roth IRA owner during 4-year period. If a Roth IRA owner who is including amounts ratably over the 4-year period died in 2001, any amounts not included must generally be included in the owner's (decedent's) gross income for 2001.

Note. You may have elected to include the entire amount in income in 1998. If you did, this discussion does not apply to you.

Converting from a SIMPLE IRA. Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting from any traditional IRA*.

However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date you first participated in any SIMPLE IRA plan maintained by your employer.

More information. For more detailed information on conversions, see Publication 590.

Rollover From a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers explained under *Rollover From One IRA Into Another* under *Traditional IRAs*, earlier, apply to these rollovers.

Failed Conversions

If, when you converted amounts from a traditional IRA or SIMPLE IRA (including a transfer by redesignation) into a Roth IRA, you expected to have modified AGI of less than \$100,000 and a filing status other than married filing separately, but events changed these facts, you have made a failed conversion.

Adverse consequences. If the converted amount (contribution) is not recharacterized (explained later), the contribution will be treated as a regular contribution to the Roth IRA and subject to the following tax consequences.

- 1) A 6% excise tax per year will apply to any excess contribution not withdrawn from the Roth IRA.
- 2) The distributions from the traditional IRA must be included in your gross income.
- 3) The 10% additional tax on early distributions may apply to any distribution.

How to avoid. You must move the amount converted (including all earnings from the date of conversion) into a traditional IRA by the due date (including extensions) for your tax return for the year during which you made the conversion to the Roth IRA. You do not have to include this distribution (withdrawal) in income. See *Recharacterizations*, next, for more information.

Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution. More detailed information is in Publication 590.

No deduction allowed. No deduction is allowed for the contribution to the first IRA and any net income transferred with the recharacterized contribution is treated as earned in the second IRA.

How to recharacterize a contribution. To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. It will be treated as having been made to the second IRA on the same date that it was actually made to the first IRA.

Required notifications. To recharacterize a contribution, you must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA that you have elected to treat, for federal tax purposes, the contribution as having been made to the second IRA rather than the first. You must make the notifications by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notification(s) must include all of the following information.

- The type and amount of the contribution to the first IRA that is to be recharacterized.
- The date on which the contribution was made to the first IRA and the year for which it was made.
- A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income allocable to the contribution to the trustee of the second IRA. If there was a loss while the contribution was in the first IRA, the net income that must be transferred may be a negative amount.
- The name of the trustee of the first IRA and the name of the trustee of the second IRA.
- Any additional information needed to make the transfer.

Note. If the trustee of your first IRA is unable to calculate the amount of net income you must transfer, get IRS Notice 2000-39. The notice explains the IRS-approved method of calculating the amount you must transfer.

Reporting a recharacterization. If you elect to recharacterize a contribution to one IRA as a contribution to another IRA, you must report the recharacterization on your tax return as directed by Form 8606 and its instructions. You must treat the contribution as having been made to the second IRA.

Are Distributions From My Roth IRA Taxable?

You do not include in your gross income **qualified distributions** or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for distributions*, later.

What are qualified distributions? A qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements.

- 1) It is made after the 5-taxable-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
- 2) The payment or distribution is:
 - a) Made on or after the date you reach age 59½,
 - b) Made because you are disabled,
 - c) Made to a beneficiary or to your estate after your death, or
 - d) To pay certain qualified first-time homebuyer amounts discussed in Publication 590.

Additional tax on distributions of conversion contributions within 5-year period. If, within the 5-year period starting with the year in which you made a conversion contribution of an amount from a traditional IRA to a Roth IRA, you take a distribution from a Roth IRA of an amount attributable to the portion of the conversion contribution that you had to include in income, you generally must pay the 10% additional tax on early distributions. (See *Ordering Rules for Distributions*, later, to determine the amount, if any, of the distribution that is attributable to the conversion contribution.) The 5-year period is separately determined for each conversion contribution.

Additional tax on other early distributions. The taxable part of other distributions from your Roth IRA(s) that are not qualified distributions is subject to the additional tax on early distributions. See Publication 590 for more information.

Ordering rules for distributions. If you receive a distribution from your Roth IRA that is **not** a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Regular contributions are distributed first. See Publication 590 for more information.

Am I required to take distributions when I reach age 70½? You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

More information. For more detailed information on Roth IRAs, see Publication 590.

19.

Moving Expenses

Important Change

Standard mileage rate. The standard mileage rate for moving expenses has been increased to 12 cents a mile. See *Travel by car* under *Deductible Moving Expenses*.

Important Reminder

Change of address. If you change your mailing address, be sure to notify the IRS using **Form 8822, Change of Address**. Mail it to the Internal Revenue Service Center for your old address. Addresses for the Service Centers are on the back of the form.

Introduction

This chapter explains the deduction of certain expenses of moving to a new home because you changed job locations or started a new job. This includes the following topics.

- Who can deduct moving expenses.
- What moving expenses are deductible.
- What moving expenses are not deductible.
- How to report moving expenses.

You may qualify for the moving expense deduction whether you are self-employed or an employee. However, you must meet the requirements explained under *Who Can Deduct Moving Expenses*.

Moves to locations outside the United States. This chapter does not discuss moves outside the United States. If you are a United States citizen or resident alien who moved outside the United States or its possessions because of your job or business, see Publication 521, *Moving Expenses*, for special rules that apply to your move.

Useful Items

You may want to see:

Publication

- 521 Moving Expenses

Form (and Instructions)

- 3903 Moving Expenses

Who Can Deduct Moving Expenses

You can deduct your allowable moving expenses if your move is closely related to the start of work. You also must meet the distance test and the time test. These two tests are discussed later. After you have read the distance and time test rules, you may want to use *Figure 19–B* to help you decide if your move qualifies.

Related to Start of Work

Your move must be closely related, both in time and in place, to the start of work at your new job location.

Closely related in time. You can generally consider moving expenses incurred within 1 year from the date you first reported to work at the new location as closely related in time to the start of work. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within 1 year of the date you begin work, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

Example. Your family moved more than a year after you started work at a new location. You delayed the move for 18 months to allow your child to complete high school. You can deduct your allowable moving expenses.

Closely related in place. You can generally consider your move closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement may qualify if you can show that:

- 1) You are required to live at that home as a condition of your employment, or
- 2) You will spend less time or money commuting from your new home to your new job location.

Retirees or survivors. You may be able to deduct the expenses of moving to the United States or its possessions even if the move is not related to the start of work at a new job location. You must have worked outside the United States or be a survivor of someone who did. See *Retirees or Survivors Who Move to the United States*, later.

Home defined. Your *home* means your main home (residence). It can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. It does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home,

such as a summer beach cottage. Your *former home* means your home before you left for your new job location. Your *new home* means your home within the area of your new job location.

Distance Test

Your move will meet the distance test if your new main job location is **at least 50 miles** farther from your former home than your old main job location was from your former home. For example, if your old main job location was 3 miles from your former home, your new main job location must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not take into account the location of your new home. See *Figure 19–A*.

Example. You moved to a new home less than 50 miles from your former home because you changed main job locations. Your old main job location was 3 miles from your former home. Your new main job location is 60 miles from that home. Because your new main job location is 57 miles farther from your former home than the distance from your former home to your old main job location, you meet the distance test.

First job or return to full-time work. If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

Exception for Armed Forces. If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces*, later.

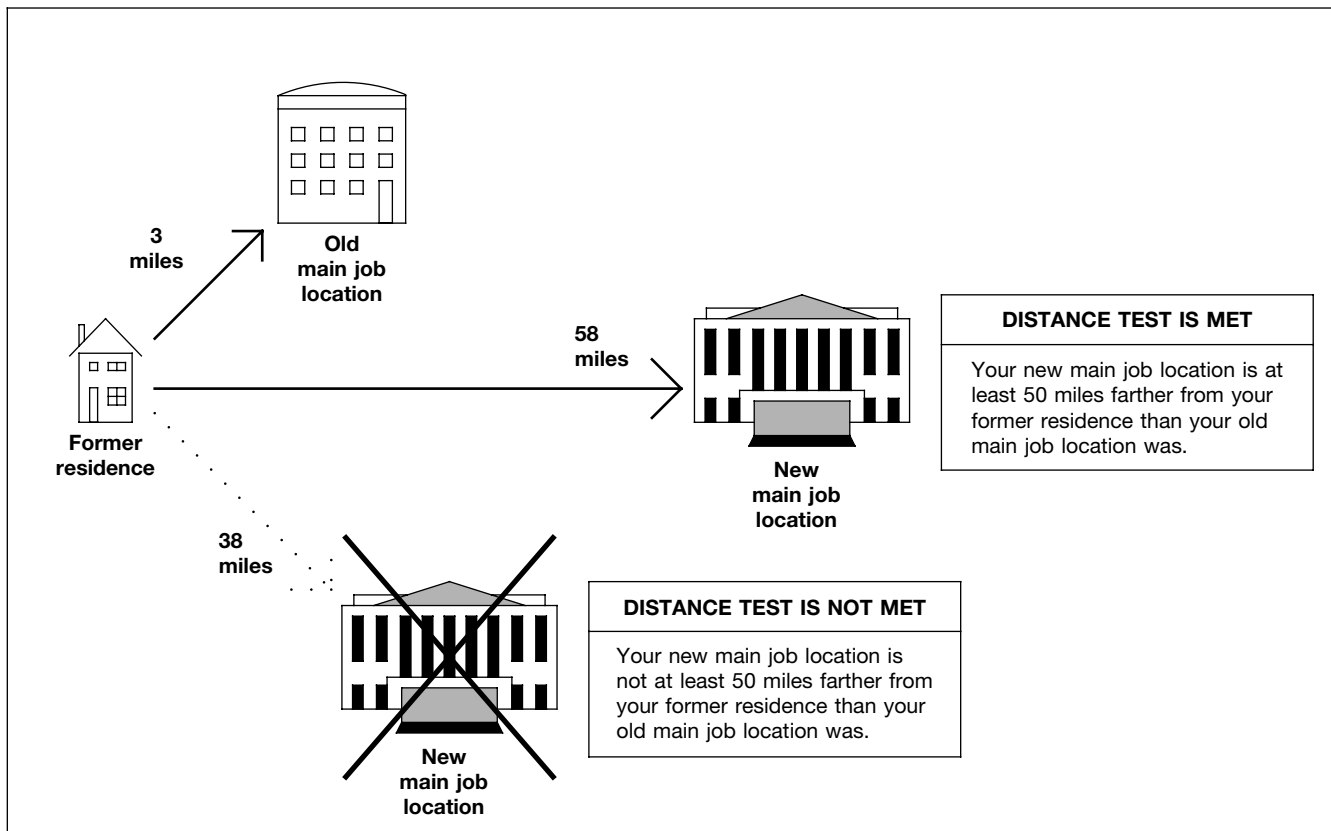
Main job location. Your main job location is usually the place where you spend most of your working time. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered, such as where you report for work or are otherwise required to “base” your work.

Union members. If you work for several employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

More than one job. If you have more than one job at any time, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- How much money you earn at each place.

Figure 19–A. Illustration of Distance Test



Time Test

To deduct your moving expenses, you also must meet one of the following two time tests.

- 1) The time test for employees.
- 2) The time test for self-employed persons.

See *Table 19–1* for a summary of these tests.

Time test for employees. If you are an employee, you must work full time for at least **39 weeks during the first 12 months** after you arrive in the general area of your new job location. Full-time employment depends on what is usual for your type of work in your area.

For purposes of this test, the following four rules apply.

- 1) You count only your full-time work as an employee, not any work you do as a self-employed person.
- 2) You do not have to work for the same employer for all 39 weeks.
- 3) You do not have to work 39 weeks in a row.
- 4) You must work full time within the same general commuting area for all 39 weeks.

Temporary absence from work. You are considered to have worked full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes. You are also considered to have worked full time during any week you are absent from work for leave or vacation provided for in your work contract or agreement.

Seasonal work. If your work is seasonal, you are considered to be working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered to have worked full time for the entire 12 months.

Time test for self-employed persons. If you are self-employed, you must work full time for at least **39 weeks during the first 12 months AND** for a total of at least **78 weeks during the first 24 months** after you arrive in your new job

location. For purposes of this test, the following three rules apply.

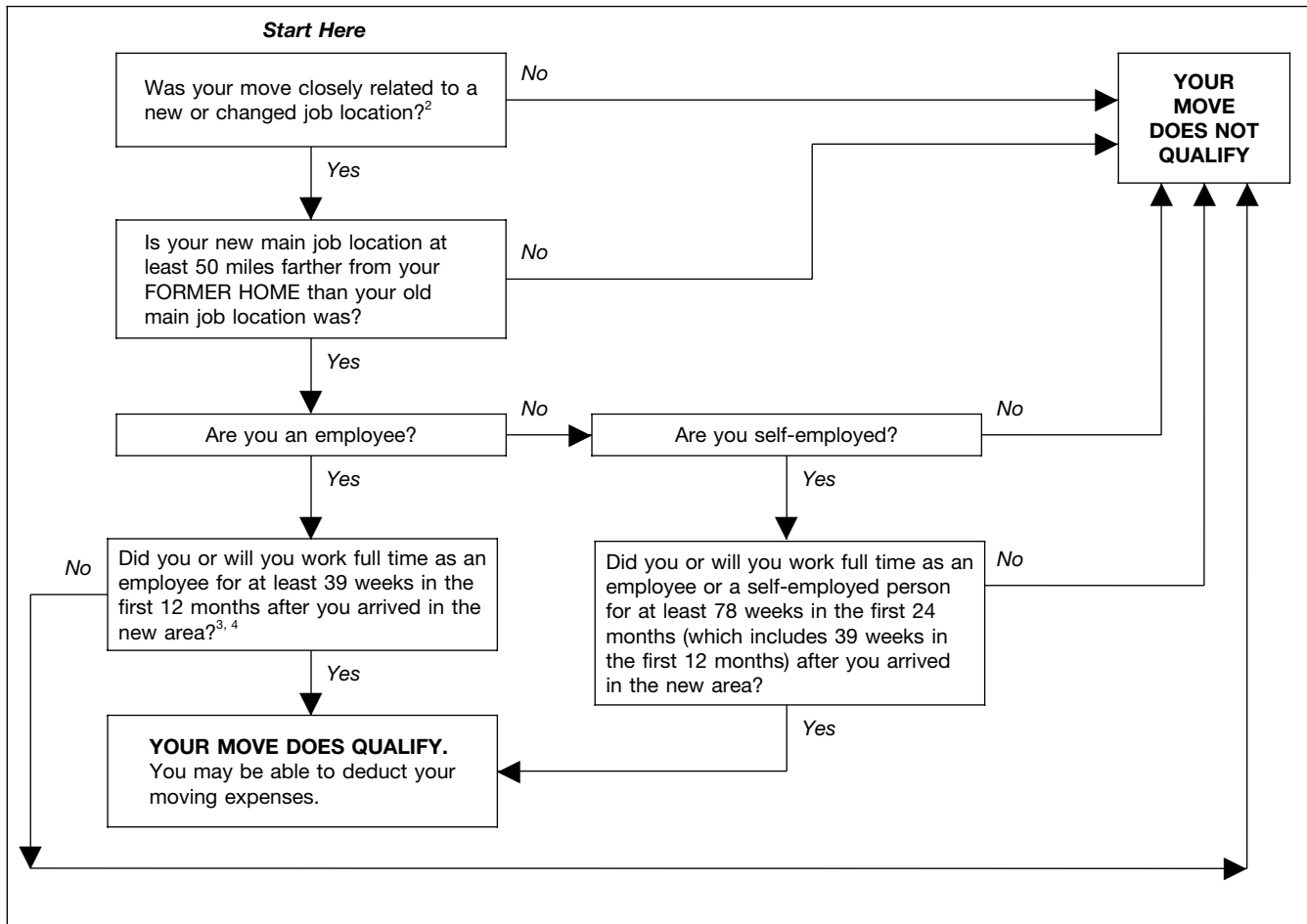
- 1) You count any full-time work you do either as an employee or as a self-employed person.
- 2) You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.
- 3) You must work within the same general commuting area for all 78 weeks.

If you were both an employee and self-employed, see *Table 19–1* for the requirements.

Table 19–1. Satisfying the Time Test for Employees and Self-Employed Persons

IF you are...	THEN you satisfy the time test by meeting...
An employee	The 39–week test for employees.
Self-employed and an employee but unable to satisfy the 39–week test for employees	The 78–week test for self-employed persons.
Both self-employed and an employee at the same time	The 78–week test for a self-employed person or the 39–week test for an employee based on your principal place of work.
Self-employed	The 78–week test for self-employed persons.

Figure 19–B. **Qualifying Moves Within the United States (Non-Military)**¹



¹Military persons should see *Members of the Armed Forces* for special rules that apply to them.

²Your move must be closely related to the start of work at your new job location. See *Related to Start of Work*.

³If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See *Time test not yet met*.

⁴If you become self-employed during the first 12 months, answer YES if your combined time as a full-time employee and self-employed person equals or will equal at least 78 weeks in the first 24 months (including 39 weeks in the first twelve months) after you arrived in the new area.

Self-employment. You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, are a part-time student, or work only a few hours each week.

Full-time work. You can count only those weeks during which you work full time as a week of work. Whether you work full time during any week depends on what is usual for your type of work in your area.

For more information, see *Time test for self-employed persons* in Publication 521.

Joint return. If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.

Time test not yet met. You can deduct your moving expenses on your 2001 tax return even if you have not yet met the time test by the date your 2001 return is due. You can do this if you expect to meet the 39-week test in 2002, or the 78-week test in 2002 or 2003. If you deduct

moving expenses but do not meet the time test in 2002 or 2003, you must either:

- 1) Report your moving expense deduction as other income on your Form 1040 for the year you cannot meet the test, or
- 2) Amend your 2001 return.

Use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return.

If you do not deduct your moving expenses on your 2001 return and you later meet the time test, you can file an amended return for 2001 to take the deduction.

Exceptions to the Time Test

You do not have to meet the time test if one of the following applies.

- 1) You are in the Armed Forces and you moved because of a permanent change of station. See *Members of the Armed Forces*, later.
- 2) You moved to the United States because you retired. See *Retirees or Survivors Who Move to the United States*, later.

3) You are the survivor of a person whose main job location at the time of death was outside the United States. See *Retirees or Survivors Who Move to the United States*, later.

4) Your job at the new location ends because of death or disability.

5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment and you must have expected to meet the test at the time you started the job.

Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the **distance and time tests**, discussed earlier. You can deduct your unreimbursed allowable moving expenses.

A permanent change of station includes:

- 1) A move from your home to your first post of active duty,

- 2) A move from one permanent post of duty to another, and
- 3) A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within 1 year of ending your active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces dies, is imprisoned, or deserts, a permanent change of station for the spouse or dependent includes a move to:

- The place of enlistment,
- The member's, spouse's, or dependent's home of record, or
- A nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

More information. For more information on moving expenses for members of the Armed Forces, and instructions for completing Form 3903, see *Members of the Armed Forces* in Publication 521.

Retirees or Survivors Who Move to the United States

If you are a retiree who was working abroad or a survivor of a decedent who was working abroad and you move to the United States or one of its possessions, you do not have to meet the **time test**, discussed earlier. However, you must meet the requirements discussed below under *Retirees who were working abroad* or *Survivors of decedents who were working abroad*.

United States defined. For this section of the chapter, the term "United States" includes the possessions of the United States.

Retirees who were working abroad. You can deduct moving expenses for a move to a new home in the United States when you permanently retire. However, both your former main job location and your former home must have been outside the United States.

Permanently retired. You are considered permanently retired when you cease gainful full-time employment or self-employment. If, at the time you retire, you intend your retirement to be permanent, you will be considered retired though you later return to work. Your intention to retire permanently may be determined by:

- 1) Your age and health,
- 2) The customary retirement age for people who do similar work,
- 3) Whether you are receiving retirement payments from a pension or retirement fund, and
- 4) The length of time before you return to full-time work.

Survivors of decedents who were working abroad. If you are the spouse or the depen-

dent of a person whose main job location at the time of death was outside the United States, you can deduct moving expenses if the following five requirements are met.

- 1) The move is to a home in the United States.
- 2) The move begins within 6 months after the decedent's death. (When a move begins is described later.)
- 3) The move is from the decedent's former home.
- 4) The decedent's former home was outside the United States.
- 5) The decedent's former home was also your home.

When a move begins. A move begins when one of the following events occurs.

- 1) You contract for your household goods and personal effects to be moved to your home in the United States, but only if the move is completed within a reasonable time.
- 2) Your household goods and personal effects are packed and on the way to your home in the United States.
- 3) You leave your former home to travel to your new home in the United States.

Deductible Moving Expenses

If you meet the requirements discussed earlier under *Who Can Deduct Moving Expenses*, you can deduct the reasonable expenses of:

- 1) Moving your household goods and personal effects (including in-transit or foreign-move storage expenses), and
- 2) Traveling (including lodging but not meals) to your new home.



You cannot deduct any expenses for meals.

Reasonable expenses. You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you stop over, or make side trips for sightseeing, the additional expenses for your stopover or side trips are not deductible as moving expenses.

Travel by car. If you use your car to take yourself, members of your household, or your personal effects to your new home, you can figure your expenses by deducting either:

- 1) Your **actual expenses**, such as gas and oil for your car, if you keep an accurate record of each expense, or

- 2) The **standard mileage rate** of 12 cents a mile.

Whether you use actual expenses or the standard mileage rate to figure your expenses, you can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

Member of household. You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you can claim that person as a dependent.

Location of move. There are different rules for moving within or to the United States than for moving outside the United States. This chapter only discusses moves within or to the United States. The rules for moves outside the United States can be found in Publication 521.

Household Goods and Personal Effects

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car*, earlier. You can include the cost of storing and insuring household goods and personal effects within **any period of 30 consecutive days** after the day your things are moved from your former home and before they are delivered to your new home.

You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving your household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.



You cannot deduct the cost of moving furniture you buy on the way to your new home.

Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive.

You can include any lodging expenses you had in the area of your former home within one day after you could no longer live in your former home because your furniture had been moved.

You can deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together or at the same time. If you use your own car, see *Travel by car*, earlier.

Nondeductible Expenses

You cannot deduct the following items as moving expenses.

- Any part of the purchase price of your new home.
- Car tags.
- Driver's license.
- Expenses of buying or selling a home.
- Expenses of getting or breaking a lease.
- Home improvements to help sell your home.
- Loss on the sale of your home.
- Losses from disposing of memberships in clubs.
- Meal expenses.
- Mortgage penalties.
- Pre-move househunting expenses.
- Real estate taxes.
- Refitting of carpets and draperies.
- Security deposits (including any given up due to the move).
- Storage charges except those incurred in transit and for foreign moves.
- Temporary living expenses.

No double deduction. You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must decide if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work may be deductible as business expenses if you are con-

sidered away from home on business. Generally, your work at a single location is considered temporary if it is realistically expected to last (and does in fact last) for 1 year or less. See *Temporary Assignment or Job* in chapter 28 for information on deducting your expenses.

How To Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

Form 3903. Use Form 3903 to report your moving expenses.

Where to deduct. Deduct your moving expenses on line 26 of Form 1040. The amount of moving expenses you can deduct is shown on line 5 of Form 3903.



You cannot deduct moving expenses on Form 1040EZ or Form 1040A.

Reimbursements. If you received a reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

When To Deduct Expenses

If you were not reimbursed, deduct your allowable moving expenses either in the year you incurred them or in the year you paid them.

Example. In December 2000, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving

expenses. In 2000, you paid for moving your furniture. You deducted these expenses in 2000. In January 2001, you paid for travel to the new city. You can deduct these additional expenses in 2001.

Reimbursed expenses. If you are reimbursed for your expenses, you may be able to deduct your allowable expenses either in the year you incurred them or in the year you paid them. If you use the cash method of accounting, you can choose to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year.

If you are reimbursed for your expenses in a year after you paid the expenses, you may want to delay taking the deduction until the year you receive the reimbursement. If you do not choose to delay your deduction until the year you are reimbursed, you must include the reimbursement in your income.

Choosing when to deduct. If you use the cash method of accounting, which is used by most individuals, you can choose to deduct moving expenses in the year your employer reimburses you if:

- 1) You paid the expenses in a year before the year of reimbursement, or
- 2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

How to make the choice. You can choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.



You cannot deduct any moving expenses for which you received a reimbursement that was not included in your income. (Reimbursements are discussed in Publication 521.)

Alimony

Introduction

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics:

- What payments are alimony,
- What payments are not alimony, such as child support,
- How to deduct alimony you paid,
- How to report alimony income you received, and
- Whether you must recapture the tax benefits of alimony. Recapture means adding back in your income all or part of a deduction you took in a prior year.

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984. For the rules for payments under pre-1985 instruments, see Publication 504, *Divorced or Separated Individuals*.

Use *Table 20-1* in this chapter as a guide to determine whether certain payments are considered alimony.

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless otherwise stated in the following discussions about alimony, the term "spouse" includes former spouse.

Divorce or separation instrument. The term "divorce or separation instrument" means:

- 1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
- 2) A written separation agreement, or
- 3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

Useful Items

You may want to see:

Publication

- 504 Divorced or Separated Individuals

General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include any of the following.

- 1) Child support.
- 2) Noncash property settlements.
- 3) Payments that are your spouse's part of community income. (See *Community Property* in Publication 504.)
- 4) Payments to keep up the payer's property.
- 5) Use of property.

Payments to a third party. Cash payments (including checks and money orders) to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

Mortgage payments. If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can claim the other half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can claim one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as **tenants in common**, you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as **tenants by the entirety** or **joint tenants**, none of your payments for taxes or insurance are alimony. But if you

itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

Other payments to a third party. If you made other third-party payments, see Publication 504 to see whether any part of the payments qualifies as alimony.

Instruments

Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984.

Exception for instruments executed before 1985. There are two situations where the rules for instruments executed after 1984 apply to instruments executed before 1985.

- 1) A divorce or separation instrument executed before 1985 and then modified after 1984 to specify that the after-1984 rules will apply.
- 2) A temporary divorce or separation instrument executed before 1985 and incorporated into, or adopted by, a final decree executed after 1984 that:
 - a) Changes the amount or period of payment, or
 - b) Adds or deletes any contingency or condition.

For the rules for alimony payments under pre-1985 instruments not meeting these exceptions, see *Instruments Executed Before 1985* in Publication 504.

Example 1. In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

Example 2. Assume the same facts as in *Example 1* except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and **all** the following requirements are met.

- 1) The payment is in cash.
- 2) The instrument does not designate the payment as not alimony.
- 3) The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a

Table 20–1. Alimony Requirements (Instruments executed after 1984)

<p>Payments ARE alimony if <u>all</u> of the following are true:</p> <p>Payments are required by a divorce or separation instrument.</p> <p>Payer and recipient spouse do not file a joint return.</p> <p>Payment is in cash (including checks or money orders).</p> <p>Payment is not designated in the instrument as not alimony.</p> <p>Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.</p> <p>Payments are not required after death of the recipient spouse.</p> <p>Payment is not designated as child support.</p>	<p>Payment are NOT alimony if <u>any</u> of the following are true:</p> <p>Payment is designated as child support.</p> <p>Payment is a noncash property settlement.</p> <p>Payments are spouse's part of community income.</p> <p>Payments are to keep up the payer's property.</p> <p>Payments are not required by a divorce or separation instrument.</p>
<p><i>These payments are deductible by the payer and includible in income by the recipient.</i></p>	<p><i>These payments are neither deductible by the payer nor includible in income by the recipient.</i></p>

- decree of divorce or separate maintenance.
- 4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
 - 5) The payment is not treated as child support.
- Each of these requirements is discussed next.

Payment must be in cash. Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony.

- Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- Execution of a debt instrument by the payer.
- The use of property.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules*, earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if **all** the following requirements are met.

- 1) The payments are in lieu of payments of alimony directly to your spouse.
- 2) The written request states that both spouses intend the payments to be treated as alimony.
- 3) You receive the written request from your spouse before you file your return for the year you made the payments.

Payments designated as not alimony. You and your spouse can designate that otherwise qualifying payments are not alimony. You do this

by including a provision in your divorce or separation instrument that states the payments are not deductible as alimony by you and are excludable from your spouse's income. For this purpose, any instrument (written statement) signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

Your spouse can exclude the payments from income only if he or she attaches a copy of the instrument designating them as not alimony to his or her return. The copy must be attached each year the designation applies.

Spouses cannot be members of the same household. Payments to your spouse while you are members of the same household are not alimony if you are legally separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave no later than 1 month after the date of the payment.

Exception. If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

Liability for payments after death of recipient spouse. If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for

example, the liability for continued payments would end under state law.

Example. You must pay your former spouse \$10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate \$20,000 in cash each year for 10 years. The death of your spouse would not terminate these payments under state law.

The \$10,000 annual payments are alimony. But because the \$20,000 annual payments will not end upon your former spouse's death, they are not alimony.

Substitute payments. If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. To the extent that your payments begin, accelerate, or increase because of the death of your spouse, otherwise qualifying payments you made may be treated as payments that were not alimony. Whether or not such payments will be treated as not alimony depends on all the facts and circumstances.

Example 1. Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay \$10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for \$10,000 of the \$30,000 annual payments. \$10,000 of each of the \$30,000 annual payments is not alimony.

Example 2. Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between \$450,000 (\$30,000 × 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate \$150,000 (\$450,000 – \$300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the \$30,000 annual payments. None of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer nor taxable to the payee.

Specifically designated as child support. A payment will be treated as specifically design-

nated as child support to the extent that the payment is reduced either:

- 1) On the happening of a contingency relating to your child, or
- 2) At a time that can be clearly associated with the contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

Contingency relating to your child. A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

- Becoming employed,
- Dying,
- Leaving the household,
- Leaving school,
- Marrying, or
- Reaching a specified age or income level.

Clearly associated with a contingency. Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

- 1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or local age of majority.
- 2) The payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different one of your children reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can treat the amount as alimony.

How To Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040. You cannot use Form 1040A or Form 1040EZ.

Enter the amount of alimony you paid on line 31a of Form 1040. In the space provided on line 31b, enter your spouse's social security number.

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid to each other recipient on an attached statement. Enter your total payments on line 31a.



If you do not provide your spouse's social security number, you may have to pay a \$50 penalty and your deduction may be disallowed.

How To Report Alimony Received

Report alimony you received on line 11 of Form 1040. You cannot use Form 1040A or Form 1040EZ.



You must give the person who paid the alimony your social security number. If you do not, you may have to pay a \$50 penalty.

Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were

being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A change in your divorce or separation instrument,
- A failure to make timely payments,
- A reduction in your ability to provide support, or
- A reduction in your spouse's support needs.

When to apply the recapture rule. You are subject to the recapture rule in the third year if the alimony you pay in the third year decreases by more than \$15,000 from the second year or the alimony you pay in the second and third years decreases significantly from the alimony you pay in the first year.

When you figure a decrease in alimony, do not include the following amounts.

- 1) Payments made under a temporary support order.
- 2) Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
- 3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments.

Figuring the recapture. For a blank worksheet for you to use to figure recaptured alimony, see *Table 3* in Publication 504.

Including the recapture in income. If you must include a recapture amount in income, show it on Form 1040, line 11 ("Alimony received"). Cross out "received" and print "recapture." On the dotted line next to the amount, enter your spouse's last name and social security number.

Deducting the recapture. If you can deduct a recapture amount, show it on Form 1040, line 31a ("Alimony paid"). Cross out "paid" and print "recapture." In the space provided, enter your spouse's social security number.

Part Five.

Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. Itemized deductions are deductions for certain expenses that are listed on Schedule A (Form 1040). The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts. See chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

21.

Standard Deduction

Important Changes

Increase in standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 2001 than it was in 2000. The amount depends on your filing status. *2001 Standard Deduction Tables* are shown at the end of this chapter.

Itemized deductions. The amount you can deduct for itemized deductions is limited if your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing separately). See chapter 22 for more information.

Introduction

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Who should itemize deductions.

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

The standard deduction is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, or taxes. The standard deduction is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Figuring the Amount

Before figuring the amount of your standard deduction, you must determine if you are eligible to take it.

Persons not eligible for the standard deduction. Your standard deduction is **zero** and you should itemize any deductions you have if:

- 1) You are married and filing a separate return, and your spouse itemizes deductions,
- 2) You are filing a tax return for a short tax year because of a change in your annual accounting period, or
- 3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

Note. If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the year, you can choose to be treated as a U.S. resident. (See Publication 519, *U.S. Tax Guide for Aliens*.) If you make this choice, you can take the standard deduction.



If an exemption for you can be claimed on another person's return (such as your parents' return), your standard deduction may be limited. See Standard Deduction for Dependents, later.

Standard Deduction Amount

Generally, the standard deduction amounts are adjusted each year for inflation. The standard deduction amounts for most taxpayers for 2001 are shown in *Table 21-1*.

Decedent's final return. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

Higher Standard Deduction for Age (65 or Older)

If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you can take a higher standard deduction for 2001 if your 65th birthday was on or before January 1, 2002.

Use *Table 21-2* to figure the standard deduction amount.

Higher Standard Deduction for Blindness

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction as shown in *Table 21-2*. You qualify for this benefit if you are totally or partly blind.

Partly blind. If you are partly blind, you must get a certified statement from an eye doctor or registered optometrist that:

- 1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- 2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, the statement should include this fact. You must keep the statement in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

Spouse 65 or Older or Blind

You can take the higher standard deduction if your spouse is age 65 or older or blind and:

- 1) You file a joint return, or
- 2) You file a separate return and can claim an exemption for your spouse because your spouse had no gross income and an exemption for your spouse could not be claimed by another taxpayer.



You cannot claim the higher standard deduction for an individual other than yourself and your spouse.

Examples

The following examples illustrate how to determine your standard deduction using *Tables 21-1* and *21-2*.

Example 1. Larry, 46, and Donna, 33, are filing a joint return for 2001. Neither is blind. They decide not to itemize their deductions. They use *Table 21-1*. Their standard deduction is \$7,600.

Example 2. Assume the same facts as in Example 1, except that Larry is blind at the end of 2001. Larry and Donna use *Table 21-2*. Their standard deduction is \$8,500.

Example 3. Bill and Terry are filing a joint return for 2001. Both are over age 65. Neither is blind. If they do not itemize deductions, they use *Table 21-2*. Their standard deduction is \$9,400.

Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of:

- 1) \$750, or
- 2) The individual's earned income for the year plus \$250 (but not more than the regular standard deduction amount, generally \$4,550).

However, if the individual is 65 or older or blind, the standard deduction may be higher.

If an exemption for you can be claimed on someone else's return, use *Table 21-3* to determine your standard deduction.

Earned income defined. Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a **scholarship or fellowship grant** that you must include in your gross income. See *Scholarship and Fellowship Grants* in chapter 13 for more information on what qualifies as a scholarship or fellowship grant.

Example 1. Michael is single. His parents claim an exemption for him on their 2001 tax

return. He has interest income of \$780 and wages of \$150. He has no itemized deductions. Michael uses *Table 21-3* to find his standard deduction. He enters \$150 (his earned income) on line 1, \$400 (\$150 plus \$250) on line 3, \$750 (the larger of \$400 and \$750) on line 5, and \$4,550 on line 6. The amount of his standard deduction, on line 7a, is \$750 (the smaller of \$750 and \$4,550).

Example 2. Joe, a 22-year-old full-time college student, is claimed on his parents' 2001 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has \$1,500 in interest income and wages of \$3,600. He has no itemized deductions. Joe finds his standard deduction by using *Table 21-3*. He enters his earned income, \$3,600, on line 1. He adds lines 1 and 2 and enters \$3,850 on line 3. On line 5 he enters \$3,850, the larger of lines 3 and 4. Since Joe is married filing a separate return, he enters \$3,800 on line 6. On line 7a he enters \$3,800 as his standard deduction because it is smaller than \$3,850, the amount on line 5.

Example 3. Amy, who is single, is claimed on her parents' 2001 tax return. She is 18 years old and blind. She has interest income of \$1,300 and wages of \$2,900. She has no itemized deductions. Amy uses *Table 21-3* to find her standard deduction. She enters her wages of \$2,900 on line 1. She adds lines 1 and 2 and enters \$3,150 on line 3. On line 5 she enters \$3,150, the larger of lines 3 and 4. Since she is single, Amy enters \$4,550 on line 6. She enters \$3,150 on line 7a. This is the smaller of the amounts on lines 5 and 6. Because she checked one box in the top part of the worksheet, she enters \$1,100 on line 7b. She then adds the amounts on lines 7a and 7b and enters her standard deduction of \$4,250 on line 7c.

Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. Also, you should itemize if you do not qualify for the standard deduction, as discussed earlier under *Persons not eligible for the standard deduction*.

You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.



You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than \$132,950 (\$66,475 if you are married filing separately). See chapter 22 and the instructions for

Schedule A (Form 1040), line 28, for more information on figuring the correct amount of your itemized deductions.

When to itemize. You may benefit from itemizing your deductions on Schedule A (Form 1040) if you:

- 1) Do not qualify for the standard deduction, or the amount you can claim is limited,
- 2) Had large uninsured medical and dental expenses during the year,
- 3) Paid interest and taxes on your home,
- 4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
- 5) Had large uninsured casualty or theft losses,
- 6) Made large contributions to qualified charities, or
- 7) Have total itemized deductions that are more than the standard deduction to which you otherwise are entitled.

These deductions are explained in chapters 23-30.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 28, on Form 1040, line 36.

Itemizing for state tax or other purposes. If you choose to itemize even though your itemized deductions are less than the amount of your standard deduction, write "IE" (itemized elected) next to line 36 (Form 1040).

Changing your mind. If you do not itemize your deductions and later find that you should have itemized — or if you itemize your deductions and later find you should not have — you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. See *Amended Returns and Claims for Refund* in chapter 1 for more information on amended returns.

Married persons who filed separate returns. You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lower total tax, even though one of you may pay more tax than you would have paid by using the other method. You both must use the same method of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction. (See *Persons not eligible for the standard deduction*, earlier.)

2001 Standard Deduction Tables

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 21-1. **Standard Deduction Chart for Most People***

IF your Filing Status is ...	Your Standard Deduction is:
Single	\$4,550
Married filing joint return or Qualifying widow(er) with dependent child	7,600
Married filing separate return	3,800
Head of household	6,650

*DO NOT use this chart if you were 65 or older or blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table 21-2 or 21-3 instead.

Table 21-2. **Standard Deduction Chart for People Age 65 or Older or Blind***

IF your Filing Status is ...	AND the Number in the Box Above is ...	THEN your Standard Deduction is:
Single	1	\$5,650
	2	6,750
Married filing joint return or Qualifying widow(er) with dependent child	1	8,500
	2	9,400
	3	10,300
	4	11,200
Married filing separate return	1	4,700
	2	5,600
	3	6,500
	4	7,400
Head of household	1	7,750
	2	8,850

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 21-3 instead.

Table 21-3. **Standard Deduction Worksheet for Dependents***

<p>If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.</p> <p>You 65 or older <input type="checkbox"/> Blind <input type="checkbox"/></p> <p>Your spouse, if claiming spouse's exemption 65 or older <input type="checkbox"/> Blind <input type="checkbox"/></p> <p>Total number of boxes you checked <input type="checkbox"/></p>	
1. Enter your earned income (defined below). If none, enter -0-.	1. _____
2. Additional amount	2. <u> \$250 </u>
3. Add lines 1 and 2.	3. _____
4. Minimum amount	4. <u> \$750 </u>
5. Enter the larger of line 3 or line 4.	5. _____
6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> • Single, enter \$4,550 • Married filing separate return, enter \$3,800 • Married filing jointly or Qualifying widow(er) with dependent child, enter \$7,600 • Head of household, enter \$6,650 	6. _____
7. Standard deduction. <p>a. Enter the smaller of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.</p> <p>b. If 65 or older or blind, multiply \$1,100 (\$900 if married or qualifying widow(er) with dependent child) by the number in the box above.</p> <p>c. Add lines 7a and 7b. This is your standard deduction for 2001.</p>	7a. _____ 7b. _____ 7c. _____
<p>Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.</p>	

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

22.

Limit on Itemized Deductions

Introduction

This chapter discusses the overall limit on itemized deductions. The topics include:

- Who is subject to the limit,
- Which itemized deductions are limited, and
- How to figure the limit.

Useful Items

You may want to see:

Form (and Instructions)

- **Schedule A (Form 1040)** Itemized Deductions

Are You Subject to the Limit?

You are subject to the limit on certain itemized deductions if your adjusted gross income (AGI) is more than \$132,950 (\$66,475 if you are married filing separately). Your AGI is the amount on line 34 of your Form 1040.

This limit does not apply to estates or trusts.

Which Itemized Deductions Are Limited?

The following Schedule A (Form 1040) deductions are subject to the overall limit on itemized deductions.

- Taxes— line 9.
- Interest— lines 10, 11, and 12.
- Gifts to charity— line 18.
- Job expenses and most other miscellaneous deductions— line 26.
- Other miscellaneous deductions— line 27, excluding gambling and casualty or theft losses.

Which Itemized Deductions Are Not Limited?

The following Schedule A (Form 1040) deductions are not subject to the overall limit on itemized deductions. However, they are still subject to other applicable limits.

- Medical and dental expenses— line 4.
- Investment interest expense— line 13.
- Casualty and theft losses from personal use property— line 19.
- Casualty and theft losses from income-producing property— line 27.
- Gambling losses— line 27.

How Do You Figure the Limit?

If your itemized deductions are subject to the limit, the total of all your itemized deductions is reduced by the smaller of:

- 1) 3% of the amount by which your AGI exceeds \$132,950 (\$66,475 if married filing separately), or
- 2) 80% of your itemized deductions that are affected by the limit. See *Which Itemized Deductions Are Limited*, earlier.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 27 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied any other limit on the allowance of any itemized deduction. These other limits include charitable contribution limits (chapter 26), the limit on certain meals and entertainment (chapter 28), and the 2%-of-adjusted-gross-income limit on certain miscellaneous deductions (chapter 30).

Itemized Deductions Worksheet. After you have completed Schedule A (Form 1040) through line 27, you can use the *Itemized Deductions Worksheet* in the Form 1040 instructions for Schedule A to figure your limit. Enter the result on line 28 of Schedule A. Keep the worksheet for your records.

TIP You should compare the amount of your standard deduction to the amount of your itemized deductions after applying the limit. Use the greater amount when completing line 36 of your Form 1040. See chapter 21 for information on how to figure your standard deduction.

Example

For tax year 2001, Bill and Terry Willow are filing a joint return on Form 1040. Their adjusted gross income is \$255,250. Their Schedule A itemized deductions are as follows:




Taxes—line 9	\$17,900
Interest—lines 10, 11, and 12	45,000
Investment interest expense—line 13	41,000
Gifts to charity—line 18	21,000
Job expenses—line 26	17,240
Total	<u>\$142,140</u>

The Willows' investment interest expense deduction (\$41,000 from line 13 of Schedule A) is not subject to the overall limit on itemized deductions.

The Willows use the *Itemized Deductions Worksheet* in the Form 1040 instructions for Schedule A to figure their overall limit. Their completed worksheet is shown in *Table 22-1*.

Of their \$142,140 total itemized deductions, the Willows can deduct only \$138,471 (\$142,140 – \$3,669). They enter \$138,471 on Schedule A, line 28.

Table 22-1. Itemized Deductions Worksheet (Keep for Your Records)

<p>1. Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27.</p>	<p>1. <u>142,140</u></p>
<p>2. Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling and casualty or theft losses included on line 27.</p>	<p>2. <u>41,000</u></p>
<div style="display: flex; align-items: center;"> <div style="text-align: center; margin-right: 10px;">  </div> <div> <p>Be sure your total gambling and casualty or theft losses are clearly identified on the dotted lines next to line 27.</p> </div> </div>	
<p>3. Is the amount on line 2 less than the amount on line 1?</p>	
<p><input type="checkbox"/> No.  Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.</p>	
<p><input checked="" type="checkbox"/> Yes. Subtract line 2 from line 1</p>	<p>3. <u>101,140</u></p>
<p>4. Multiply line 3 above by 80% (.80)</p>	<p>4. <u>80,912</u></p>
<p>5. Enter the amount from Form 1040, line 34</p>	<p>5. <u>255,250</u></p>
<p>6. Enter: \$132,950 if single, married filing jointly, head of household, or qualifying widow(er); \$66,475 if married filing separately.</p>	<p>6. <u>132,950</u></p>
<p>7. Is the amount on line 6 less than the amount on line 5?</p>	
<p><input type="checkbox"/> No.  Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.</p>	
<p><input checked="" type="checkbox"/> Yes. Subtract line 6 from line 5</p>	<p>7. <u>122,300</u></p>
<p>8. Multiply line 7 above by 3% (.03)</p>	<p>8. <u>3,669</u></p>
<p>9. Enter the smaller of line 4 or line 8</p>	<p>9. <u>3,669</u></p>
<p>10. Total itemized deductions. Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28</p>	<p>10. <u>138,471</u></p>

23.

Medical and Dental Expenses

Important Change

Standard mileage rate. The standard mileage rate allowed for out-of-pocket expenses for your car when you use your car for medical reasons is now 12 cents a mile. See *Transportation* under *What Expenses Are Deductible*.

Introduction

This chapter will help you determine:

- The definition of medical care,
- What expenses you can include this year,
- How much of the expenses you can deduct,
- Whose medical expenses you can include,
- What medical expenses are deductible,
- How you treat reimbursements, and
- How to report the deduction on your tax return.

Useful Items

You may want to see:

Publication

- 502** Medical and Dental Expenses

Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
-

What Is the Definition of Medical Care?

Medical care means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness.

Medical care expenses include the premiums you pay for insurance that covers the expenses of medical care, and the amounts you pay for transportation to get medical care. Medical care expenses also include limited amounts paid for any qualified long-term care insurance contract.

What Expenses Can You Include This Year?

You can include only the medical and dental expenses you paid this year, regardless of when the services were provided. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a "pay-by-phone" or "on-line" account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

When do you include a decedent's medical expenses? Medical expenses for a decedent that are paid from his or her estate are treated as paid at the time the medical services were provided if they are paid within the 1-year period beginning with the day after the date of death. See *Decedent* under *Whose Medical Expenses Can You Include*, later, for an exception.

Medical expenses paid before death by the decedent are included in figuring any deduction for medical and dental expenses on the decedent's final income tax return. This includes expenses for the decedent's spouse and dependents as well as for the decedent.

How Much of the Expenses Can You Deduct?

You can deduct only the amount of your medical and dental expenses that is **more than 7.5%** of your adjusted gross income (line 34, Form 1040).

In this chapter, the term "7.5% limit" is used to refer to 7.5% of your adjusted gross income. The phrase "subject to the 7.5% limit" is also used. This phrase means that you must subtract 7.5% (.075) of your adjusted gross income from your medical expenses to figure your medical expense deduction.

Example. Your adjusted gross income is \$20,000, 7.5% of which is \$1,500. You paid medical expenses of \$800. You cannot deduct any of your medical expenses because they are not more than 7.5% of your adjusted gross income.

Separate returns. If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

Community property states. If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally.

Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. If you live in a community property state, are married, and file a separate return, see Publication 555, *Community Property*.

Whose Medical Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

Spouse. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1. Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2. This year, John paid medical expenses for his wife Louise, who died last year. John married Belle this year and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

Dependent. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

- 1) That person lived with you for the entire year as a member of your household or is related to you,
- 2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which your tax year began, and
- 3) You provided over half of that person's total support for the calendar year.

You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return.

Example. In 2000 your son was your dependent. In 2001 he no longer qualified as your dependent. However, you paid \$800 in 2001 for medical expenses your son incurred in 2000 when he was your dependent. You can include the \$800 in figuring your medical expense deduction for 2001. You cannot include this amount on your 2000 tax return.

Adopted child. You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical services were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses provided you clearly substantiate that the payment is directly attributable to the medical care of the child. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.



You may be able to take a credit or exclusion for other expenses related to adoption. See Publication 968, Tax Benefits for Adoption, for more information.

Child of divorced or separated parents. If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child even if an exemption for the child is claimed by the other parent.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half of a person's support under such an agreement, you can include medical expenses you pay for that person, even if you cannot claim the person as a dependent.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you

can include the entire unreimbursed amount you paid for medical expenses.

Example. You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses. However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

Decedent

The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's

Table 23–1. Medical and Dental Expenses Checklist

You can include:		You cannot include:	
<ul style="list-style-type: none"> • Birth control pills prescribed by your doctor • Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502) • Cost of fertility enhancement procedures • Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled • Cost of lead-based paint removal (see Publication 502) • Cost of vasectomy • Expenses of an organ donor • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Laser eye surgery—to promote the correct function of the eye • Legal abortion • Legal operation to prevent having children • Long-term care contracts, qualified (see Publication 502) • Meals and lodging provided by a hospital during medical treatment • Medical and hospital insurance premiums • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) 	<ul style="list-style-type: none"> • Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric care at a specially equipped medical center (includes meals and lodging) • Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see <i>Wages for nursing services</i>, later) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special school or home for mentally or physically disabled persons (see Publication 502) • Stop-smoking programs • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services (see Publication 502) 	<ul style="list-style-type: none"> • Archer MSAs (see Publication 969) • Bottled water • Cost of nutritional supplements, vitamins, herbal supplements, “natural medicines”, etc., unless you can only obtain them legally with a physician's prescription • Diaper service • Expenses for your general health (even if following your doctor's advice) such as— <ul style="list-style-type: none"> —Health club dues —Household help (even if recommended by a doctor) —Social activities, such as dancing or swimming lessons —Trip for general health improvement 	<ul style="list-style-type: none"> • Funeral, burial, or cremation expenses • Illegal operation or treatment • Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes • Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc.

medical care as paid by the decedent at the time the medical services were provided. The expenses must be paid within the 1-year period beginning with the day after the date of death. If you are the survivor or personal representative making this choice, you must attach a statement to the decedent's Form 1040 (or the decedent's amended return, Form 1040X) saying that the expenses have not been and will not be claimed on the estate tax return.



Qualified medical expenses paid before death by the decedent are not deductible if paid with a tax-free distribution from any Medicare+Choice MSA or Archer MSA.

Amended returns and claims for refund are discussed in chapter 1.

What if you pay medical expenses of a deceased spouse or dependent? If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expenses.

What Medical Expenses Are Deductible?

Use *Table 23-1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040). See Publication 502 for information about other expenses you can include.

Insurance Premiums

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, X-rays, etc.,
- Prescription drugs,
- Replacement of lost or damaged contact lenses,
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care, or
- Qualified long-term care insurance contracts (subject to additional limitations). See *Qualified Long-term Care Insurance Contracts* in Publication 502.

You **cannot** deduct insurance premiums paid with pretax dollars. You cannot include the premiums because they are not included in box 1 of your Form W-2.

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical part must be separately

stated in the insurance contract or given to you in a separate statement.

Employer-sponsored health insurance plan. Do not include in your medical and dental expenses on Schedule A (Form 1040) any insurance premiums paid by an employer-sponsored health insurance plan unless the premiums are included in box 1 of your Form W-2. Also, do not include on Schedule A (Form 1040) any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form W-2.

Flexible spending arrangement. Contributions made by your employer to provide coverage for qualified long-term care services under a flexible spending or similar arrangement must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense on your tax return.

Medicare B. Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65 or after you became disabled, you can deduct the monthly premiums you paid. If you were over age 65 or disabled when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

Prepaid insurance premiums. Premiums you pay before you are age 65 for insurance for medical care for yourself, your spouse, or your dependents after you reach age 65 are medical care expenses in the year paid if they are:

- 1) Payable in equal yearly installments, or more often, and
- 2) Payable for at least 10 years, or until you reach age 65 (but not for less than 5 years).

Unused sick leave used to pay premiums. You must include in gross income cash payments you receive at the time of retirement for unused sick leave. You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), do not include the value of the unused sick leave in gross income. You cannot include this cost of continuing participation in that health plan as a medical expense.

Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, you may be able to deduct, as an adjustment to income, up to 60% of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. If you itemize your deductions, include the remaining premiums with all other medical care expenses on Schedule A (Form 1040), subject to the 7.5% limit. See chapter 7 of Publication 535, *Business Expenses*, for more information.

Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care. See *Nursing home*, later.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

- 1) The lodging is primarily for and essential to medical care.
- 2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
- 3) The lodging is not lavish or extravagant under the circumstances.
- 4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses for lodging cannot be more than \$50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to \$100 per night can be included as a medical expense for lodging. Meals are not included.

Nursing home. You can include in medical expenses the cost of medical care in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

Do not include the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

Transportation

You can include in medical expenses amounts paid for transportation primarily for, and essential to, medical care.

You can include:

- Bus, taxi, train, or plane fares, or ambulance service,
- Transportation expenses of a parent who must go with a child who needs medical care,

- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

You cannot include:

- Transportation expenses to and from work even if your condition requires an unusual means of transportation, or
- Transportation expenses if, for nonmedical reasons only, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to use your actual expenses, you can use a standard rate of **12 cents a mile** for use of your car for medical reasons.

You can also include the cost of parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate.

Example. Bill Jones drove 2,800 miles for medical reasons during the year. He spent \$200 for gas, \$5 for oil, and \$50 for tolls and parking. He wants to figure the amount he can include in medical expenses both ways to see which gives him the greater deduction.

He figures the actual expenses first. He adds the \$200 for gas, the \$5 for oil, and the \$50 for tolls and parking for a total of \$255.

He then figures the standard mileage amount. He multiplies the 2,800 miles by 12 cents a mile for a total of \$336. He then adds the \$50 tolls and parking for a total of \$386.

Bill includes the \$386 of car expenses with his other medical expenses for the year because the \$386 is more than the \$255 he figured using actual expenses.

Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See chapter 33.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

Impairment-Related Work Expenses (Business or Medical)

If you are disabled and have expenses which are necessary for you to be able to work (impairment-related work expenses), you can take a business deduction for these expenses,

rather than a medical deduction. You are disabled if you have:

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or
- A physical or mental impairment (for example, a sight or hearing impairment) that substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

You can deduct impairment-related expenses as business expenses if they are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

Example. You are blind. You must use a reader to do your work. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

How Do You Treat Reimbursements?

You can deduct as medical expenses only those amounts paid during the taxable year for which you received no insurance or other reimbursement.

Insurance Reimbursement

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

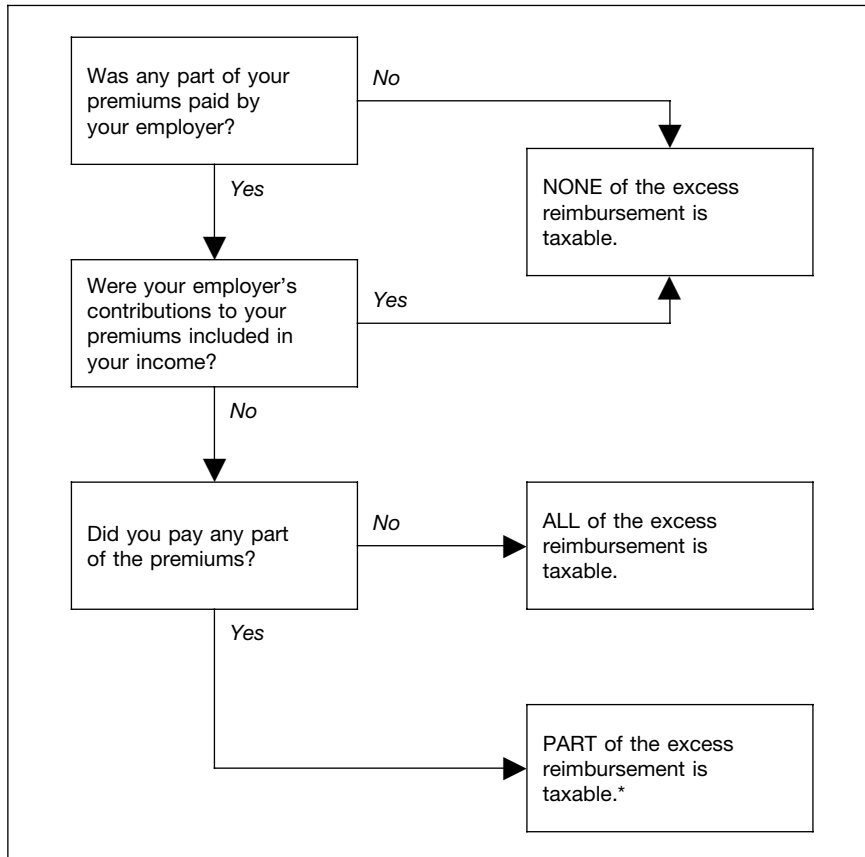
Generally, you do not reduce medical expenses by payments you receive for:

- Permanent loss or use of a member or function of the body (loss of limb, sight, hearing, etc.) or disfigurement that is based on the nature of the injury without regard to the amount of time lost from work,
- Loss of earnings, or
- Damages for personal injury or sickness.

You do not have a medical deduction if you are reimbursed for all of your medical expenses for the year.

Excess reimbursement. If you are reimbursed more than your medical expenses, you

Figure 23–A. Is Your Excess Medical Reimbursement Taxable?



*See *Premiums paid by you and your employer* in this chapter.

may have to include the excess in income. You may want to use *Figure 23–A* to help you decide if any of your reimbursement will be taxable income.

Premiums paid by you. If you pay the entire premium for your medical insurance or all of the costs of a plan similar to medical insurance, you generally do not include an excess reimbursement in your gross income.

Premiums paid by you and your employer. If both you and your employer contribute to your medical insurance plan and your employer's contributions are not included in your gross income, you must include in your gross income the part of an excess reimbursement that is from your employer's contribution.

You can figure the percentage of the excess reimbursement you must include in gross income using the following formula.

$$\frac{\text{Amount paid by employer}}{\text{Total annual cost of policy}} = \text{Percent of excess reimbursement that is taxable}$$

Example. You are covered by your employer's medical insurance policy. The annual premium is \$2,000. Your employer pays \$600 of that amount and the balance of \$1,400 is taken out of your wages. The part of any excess reimbursement you receive under the policy that is from your employer's contributions is figured as follows:

$$\frac{\$600}{\$2,000} = 30\%$$

You must include in your gross income 30% (.30) of any excess reimbursement you received for medical expenses under the policy.

Premiums paid by your employer. If your employer or your former employer pays the total cost of your medical insurance plan and your employer's contributions are not included in your income, you must report all of your excess reimbursement as other income.

More than one policy. If you are covered under more than one policy, the costs of which are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

Example. You are covered by your employer's health insurance policy. The annual premium is \$1,200. Your employer pays \$300,

and the balance of \$900 is deducted from your wages. You also paid the entire premium (\$250) for a personal health insurance policy.

During the year, you paid medical expenses of \$3,600. In the same year, you were reimbursed \$2,400 under your employer's policy and \$1,600 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution as follows:

Step 1.	
Reimbursement from employer's policy . . .	\$2,400
Reimbursement from your policy	1,600
Total reimbursement	\$4,000
Amount of medical expenses from your policy [(\$1,600 ÷ \$4,000) × \$3,600 total medical expenses]	\$1,440
Amount of medical expenses from your employer's policy [(\$2,400 ÷ \$4,000) × \$3,600 total medical expenses]	2,160
Total medical expenses	\$3,600
Excess reimbursement from your employer's policy (\$2,400 – \$2,160)	\$240

Step 2.	
Because both you and your employer contributed to the cost of this policy, you must divide the cost to determine the excess reimbursement from your employer's contribution.	
Employer's contribution in relation to the annual cost of the policy (\$300 ÷ \$1,200)	25%
Amount to report as other income on line 21, Form 1040 (25% × \$240)	\$60

Reimbursement in a later year. If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report the reimbursement as income up to the amount you previously deducted as medical expenses. However, do not report as income the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in chapter 13.

Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because your medical expenses were not more than 7.5% of your adjusted gross income, or because you did not itemize deductions, do not include in income the reimbursement for this expense that you receive in a later year. How-

ever, if the reimbursement is more than the expense, see *Excess reimbursement*, earlier.

Example. Last year, you had medical expenses of \$500. You cannot deduct the \$500 because it is less than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the \$500 medical expenses, you do not include that amount in your gross income.

Settlement of damage suit. If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses deducted in an earlier year is included in income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year*, earlier.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

How Do You Report the Deduction on Your Tax Return?

Once you have determined which medical care expenses you can include when figuring your deduction, you must report the deduction on your tax return.

What Tax Form Do You Use?

You figure your medical expense deduction on lines 1–4 of **Schedule A**, Form 1040. You cannot claim medical expenses on Form 1040A or Form 1040EZ. If you need more information on itemized deductions or you are not sure if you can itemize, see chapters 21 and 22.

Enter the amount you paid for medical and dental care on line 1, Schedule A (Form 1040). This should be your expenses that were not reimbursed by insurance or any other sources.

You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 34, Form 1040. For an example, see the partial Schedule A at the end of this chapter.

SCHEDULES A&B (Form 1040)		Schedule A—Itemized Deductions				OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service		(Schedule B is on back)				2001 Attachment Sequence No. 07	
Name(s) shown on Form 1040 Bill and Helen Jones						Your social security number 000; 00 ;0000	
Medical and Dental Expenses	1	Caution. Do not include expenses reimbursed or paid by others. Medical and dental expenses (see page A-2).	1	3,434			
	2	Enter amount from Form 1040, line 34 2 33,000	2				
	3	Multiply line 2 above by 7.5% (.075).	3	2,475			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4				959

24.

Taxes

Important Reminder

Limit on itemized deductions. If your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing separately), the overall amount of your itemized deductions may be limited. See chapter 22 for more information about this limit.

Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

This chapter covers:

- Income taxes (state, local, or foreign),
- Real estate taxes (state, local, or foreign),
- Personal property taxes (state or local), and
- Taxes and fees you cannot deduct.

At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.

Table. Use *Table 24-1* as a guide to determine which taxes you can deduct.

Business taxes. You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income. For information on these taxes, see Publication 535, *Business Expenses*.

State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

Useful Items

You may want to see:

Publication

- **514** Foreign Tax Credit for Individuals
- **530** Tax Information for First-Time Homeowners

Form (and Instructions)

- **Schedule A (Form 1040)** Itemized Deductions
- **Schedule E (Form 1040)** Supplemental Income and Loss
- **Form 1116** Foreign Tax Credit

Tests To Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

- 1) The tax must be imposed on you.
- 2) The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes actually paid during your tax year. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and are a cash basis taxpayer, you can deduct the tax only in the year it is actually paid.

If you use an accrual method of accounting, see Publication 538, *Accounting Periods and Methods*, for more information.

Income Taxes

This section discusses the deductibility of state and local income taxes (including employee contributions to state benefit funds) and foreign income taxes.

State and Local Income Taxes

You can deduct state and local income taxes.

Exception. You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

What To Deduct

Your deduction may be for withheld taxes, estimated tax payments, or other tax payments as follows.

Withheld taxes. Deduct state and local income taxes withheld from your salary in the year they are withheld. For 2001, these taxes will be shown in boxes 17 and 19 of your Form W-2. You may also have state or local income tax withheld on Form W-2G (box 14), Form 1099-MISC (box 16), or Form 1099-R (boxes 10 and 13).

Estimated tax payments. Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, you made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

Refund applied to taxes. Deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 2001 estimated state or local income taxes.

Do not reduce your deduction by either of the following items.

- Any state or local income tax refund (or credit) you expect to receive for 2001.
- Any refund of (or credit for) prior year state and local income taxes you actually received in 2001.

See *Refund (or credit) of state or local income taxes*, later.

Separate federal returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

Joint state and local returns. If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. However, you cannot deduct more than the amount you actually paid during the year. You can avoid this calculation if you and your spouse are jointly and individually liable for the full amount of the state and local income taxes. If so, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

Joint federal return. If you file a joint federal return, you can deduct the total of the state and local income taxes both of you paid.

Contributions to state benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on line 5 of Schedule A (Form 1040).

- California.
- New Jersey.

- New York Nonoccupational Disability Benefit Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen's Compensation Fund.



Employee contributions to private or voluntary disability plans are not deductible.

Refund (or credit) of state or local income taxes. If you receive a refund of (or credit for) state or local income taxes in a year after the year in which you paid them, you may have to include the refund in income on line 10 of Form 1040 in the year you receive it. This includes refunds resulting from taxes that were overwithheld, applied from a prior year return, not figured correctly, or figured again because of an amended return. If you did not itemize your deductions in the previous year, do not include the refund in income. If you deducted the taxes in the previous year, include all or part of the refund on line 10, Form 1040, in the year you receive the refund. For a discussion of how much to include, see *Recoveries* in chapter 13.

Foreign Income Taxes

Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information on these exclusions, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. For information on the foreign tax credit, get Publication 514.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority.

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) to specific property or people, even if the charge is paid to the taxing authority. For more information about taxes and charges that are not deductible, see *Real Estate-Related Items You Cannot Deduct*, later.

Tenant-shareholders in a cooperative housing corporation. Generally, you can deduct your share of the real estate taxes the corporation paid or incurred on the property. The corporation should provide you with a statement showing you your share of the taxes. For more

information, see *Special Rules for Cooperatives* in Publication 530.

Buyers and sellers of real estate. If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the **real property tax year** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to, but not including, the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at the closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, **you are considered to have paid your part of the tax at the time of the sale.** This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property. The buyer must include the same amount in his or her cost of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows.

1. Enter the total real estate taxes for the real property tax year _____
2. Enter the number of days in the real property tax year that you owned the property _____
3. Divide line 2 by 365 _____
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) _____

Note. Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

Delinquent taxes. Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

Examples. The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1. Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 7, was \$620. The tax on their new home, bought on May 3, was \$732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes on their old home as follows.

Taxes On Old Home

1. Enter the total real estate taxes for the real property tax year \$620
2. Enter the number of days in the real property tax year that you owned the property 126
3. Divide line 2 by 365345
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) \$214

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the \$214 in the selling price of the old home. (The buyers add the \$214 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows.

Taxes On New Home

1. Enter the total real estate taxes for the real property tax year \$732
2. Enter the number of days in the real property tax year that you owned the property 243
3. Divide line 2 by 365666
4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040) \$488

Since Dennis and Beth paid all of the taxes on the new home, they add \$244 (\$732 paid less \$488 deduction) to their cost of the new home. (The sellers add this \$244 to their selling price and deduct the \$244 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of \$214 and \$488, or \$702. They will enter this amount on line 6 of Schedule A (Form 1040).

Example 2. George and Helen Brown bought a new home on May 3, 2001. Their real property tax year for the new home is the calendar year. Real estate taxes for 2000 were assessed in their state on January 1, 2001. The taxes became due on May 31, 2001, and October 31, 2001.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 2000 were \$680. They paid \$340 on May 31, 2001, and \$340 on October 31, 2001. These taxes were for the 2000 real property tax year. The Browns cannot deduct them since they did not own the property until 2001. Instead, they must add \$680 to the cost of their new home.

In January 2002, the Browns receive their 2001 property tax statement for \$752, which they will pay in 2002. The Browns owned their new home during the 2001 real property tax year for 243 days (May 3 to December 31). They will figure their 2002 deduction for taxes as follows.

1. Enter the total real estate taxes for the real property tax year \$752
2. Enter the number of days in the real property tax year that you owned the property 243
3. Divide line 2 by 365666
4. Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040) \$501

The remaining \$251 (\$752 paid less \$501 deduction) of taxes paid in 2002, along with the \$680 paid in 2001, is added to the cost of their new home.

Table 24–1. Which Taxes Can You Deduct?

	You Can Deduct	You Cannot Deduct
Income Taxes	State and local income taxes. Foreign income taxes. Employee contributions to state funds listed under <i>Contributions to state benefit funds</i> .	Federal income taxes. Employee contributions to private or voluntary disability plans.
Real Estate Taxes	State and local real estate taxes. Foreign real estate taxes. Tenant's share of real estate taxes paid by cooperative housing corporation.	Taxes for local benefits (with exceptions). Trash and garbage pickup fees (with exceptions). Rent increase due to higher real estate taxes. Homeowners association charges.
Personal Property Taxes	State and local personal property taxes.	
Other Taxes	Taxes that are expenses of your trade or business or of producing income. One-half of self-employment tax paid. Taxes on property producing rent or royalty income. Occupational taxes.	Many taxes, such as state and local sales taxes and federal excise taxes. See <i>Taxes and Fees You Cannot Deduct</i> .
Fees and Charges	Fees and charges that are expenses of your trade or business or of producing income.	Fees and charges, such as fees for driver's licenses or charges for water bills. See <i>Taxes and Fees You Cannot Deduct</i> .

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 2001 tax deduction of \$931. This is the sum of the \$680 for 2000 and the \$251 for the 122 days the seller owned the home in 2001. The seller must also include the \$931 in the selling price when he or she figures the gain or loss on the sale. The seller should contact the Browns in January 2002 to find out how much real estate tax is due for 2001.

Form 1099–S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099–S, *Proceeds From Real Estate Transactions*, to report certain information to the IRS and to the seller of the property. Box 2 of the form is for the gross proceeds of the sale and should include the portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax paid and includes it in the sales price of the property.

For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099–S. The buyer deducts this amount as a real estate tax, and the seller reduces his or her real estate tax deduction (or includes it in income) by the same amount. See *Refund (or rebate)*, later.

Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you may not be able to deduct the total amount placed in escrow. You can deduct only the real estate tax that the third party actually paid to the taxing authority. If the third party does not notify you of the amount of real estate tax that was paid for you, contact the third party or the taxing authority to find the proper amount to show on your return.

Tenants by the entirety. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See Publication 504, *Divorced or Separated Individuals*, for information.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you receive a refund or rebate in 2001 of real estate taxes you paid in 2001, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 2001 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year. For more information, see *Recoveries* in chapter 13.

TIP If you did not itemize deductions in the year you paid the tax, do not report the refund as income.

Real Estate-Related Items You Cannot Deduct

Payments for the following items generally are not deductible as real estate taxes.

- Taxes for local benefits.

- Itemized charges for services (such as trash and garbage pickup fees).
- Transfer taxes (or stamp taxes).
- Rent increases due to higher real estate taxes.
- Homeowners' association charges.

Taxes for local benefits. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Itemized charges for services. An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. For example, you cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a \$5 fee charged for every 1,000 gallons of water you use),
- A periodic charge for a residential service (such as a \$20 per month or \$240 annual

fee charged to each homeowner for trash collection), or

- A flat fee charged for a single service provided by your government (such as a \$30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).



You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those just listed, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

Exception. Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- 1) The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- 2) The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- 3) Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Transfer taxes (or stamp taxes). Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners' association charges. These charges are not deductible because they are imposed by the homeowners' association, rather than the state or local government.

Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

- 1) Charged on personal property,

- 2) Based **only** on the value of the personal property, and
- 3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

Example. Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid \$32 based on the value (\$1,500) and weight (3,400 lbs.) of your car. You can deduct \$15 (1% × \$1,500) as a personal property tax, since it is based on the value. The remaining \$17 (\$32 × 34), based on the weight, is not deductible.

Taxes and Fees You Cannot Deduct

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees, such as federal income taxes, are not deductible because the tax law specifically prohibits a deduction for them.

Taxes and fees that are generally not deductible include the following items.

- **Estate, inheritance, legacy, or succession taxes.** These taxes are generally not deductible. However, you can deduct the estate tax attributable to income in respect of a decedent if you, as a beneficiary, must include that income in your gross income. In that case, deduct the estate tax as a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit. For more information, see *Estate Tax Deduction* in Publication 559, *Survivors, Executors, and Administrators*.
- **Federal income taxes.** This includes taxes withheld from your pay.
- **Fines.** You cannot deduct penalties for violation of any law, including forfeiture of related collateral deposits.
- **Gift taxes.**

- **License fees.** You cannot deduct license fees for personal purposes (such as marriage, driver's, and dog license fees).
- **Social security.** This includes social security, Medicare, or railroad retirement taxes withheld from your pay.
- **Social security and other employment taxes for household workers.** You generally cannot deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include them in medical or child care expenses. For more information, see chapters 23 and 33.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income producing activity. For other nondeductible items, see *Real Estate-Related Items You Cannot Deduct*, earlier.

Where To Deduct

You deduct taxes on the following schedules.

State and local income taxes. These taxes are deducted on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on line 43 of Form 1040. To claim the credit, you may have to complete and attach Form 1116. For more information, see chapter 38 or the instructions for Form 1040 or get Publication 514.

Real estate taxes and personal property taxes. These taxes are deducted on lines 6 and 7 of Schedule A (Form 1040), unless they are paid on property used in your business in which case they are deducted on Schedule C (Form 1040). Taxes on property that produces rent or royalty income are deducted on Schedule E (Form 1040).

Self-employment tax. Deduct one-half of your self-employment tax on line 27, Form 1040.

Other taxes. All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

25.

Interest Expense

Important Reminders

Personal interest. Personal interest is not deductible. Examples of personal interest include interest on a loan to purchase an automobile for personal use and credit card and installment interest incurred for personal expenses. But you may be able to deduct interest you pay on a qualified student loan. For details, see Publication 970, *Tax Benefits for Higher Education*.

Limit on itemized deductions. Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing a separate return). For more information, see chapter 22.

Introduction

This chapter discusses interest. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points, and
- Investment interest.

This chapter explains these deductions. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 25–1* to find out where to get more information on various types of interest, including investment interest.

Useful Items

You may want to see:

Publication

- **936** Home Mortgage Interest Deduction

Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

You can deduct home mortgage interest only if you meet all the following conditions.

- You must file Form 1040 and itemize deductions on Schedule A (Form 1040).

- You must be legally liable for the loan. You cannot deduct payments you make for someone else if you are not legally liable to make them. Both you and the lender must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between you and the lender.
- The mortgage must be a secured debt on a qualified home. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term “qualified home” means your main home or second home. For details, see Publication 936.)

Amount Deductible

In most cases, you will be able to deduct all of your home mortgage interest. Whether you can deduct all of it depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

Fully deductible interest. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. (If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category.)

The three categories are:

- 1) Mortgages you took out on or before October 13, 1987 (called **grandfathered debt**).
- 2) Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called **home acquisition debt**), but only if throughout 2001 these mortgages plus any grandfathered debt totaled \$1 million or less (\$500,000 or less if married filing separately).
- 3) Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called **home equity debt**), but only if throughout 2001 these mortgages totaled \$100,000 or less (\$50,000 or less if married filing separately) **and** totaled no more than the fair market value of your home reduced by (1) and (2).

The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

See *Part II* of Publication 936 for more detailed definitions of grandfathered, home acquisition, and home equity debt.

You can use *Figure 25–A* to check whether your home mortgage interest is fully deductible.

Limits on deduction. You cannot fully deduct interest on a mortgage that does not fit into any of the three categories listed above. If this applies to you, see *Part II* of Publication 936 to figure the amount of interest you can deduct.

Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

Late payment charge on mortgage payment.

You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

Sale of home. If you sell your home, you can deduct your home mortgage interest (subject to any limits that apply) paid up to, but not including, the date of sale.

Example. John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of \$1,220. The settlement sheet for the sale of the home showed \$50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is \$1,270 (\$1,220 + \$50).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points*, later.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396, Mortgage Interest Credit**. If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

For more information on the credit, see chapter 38.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

Mortgage assistance payments. If you qualify for mortgage assistance payments under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

No other effect on taxes. Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

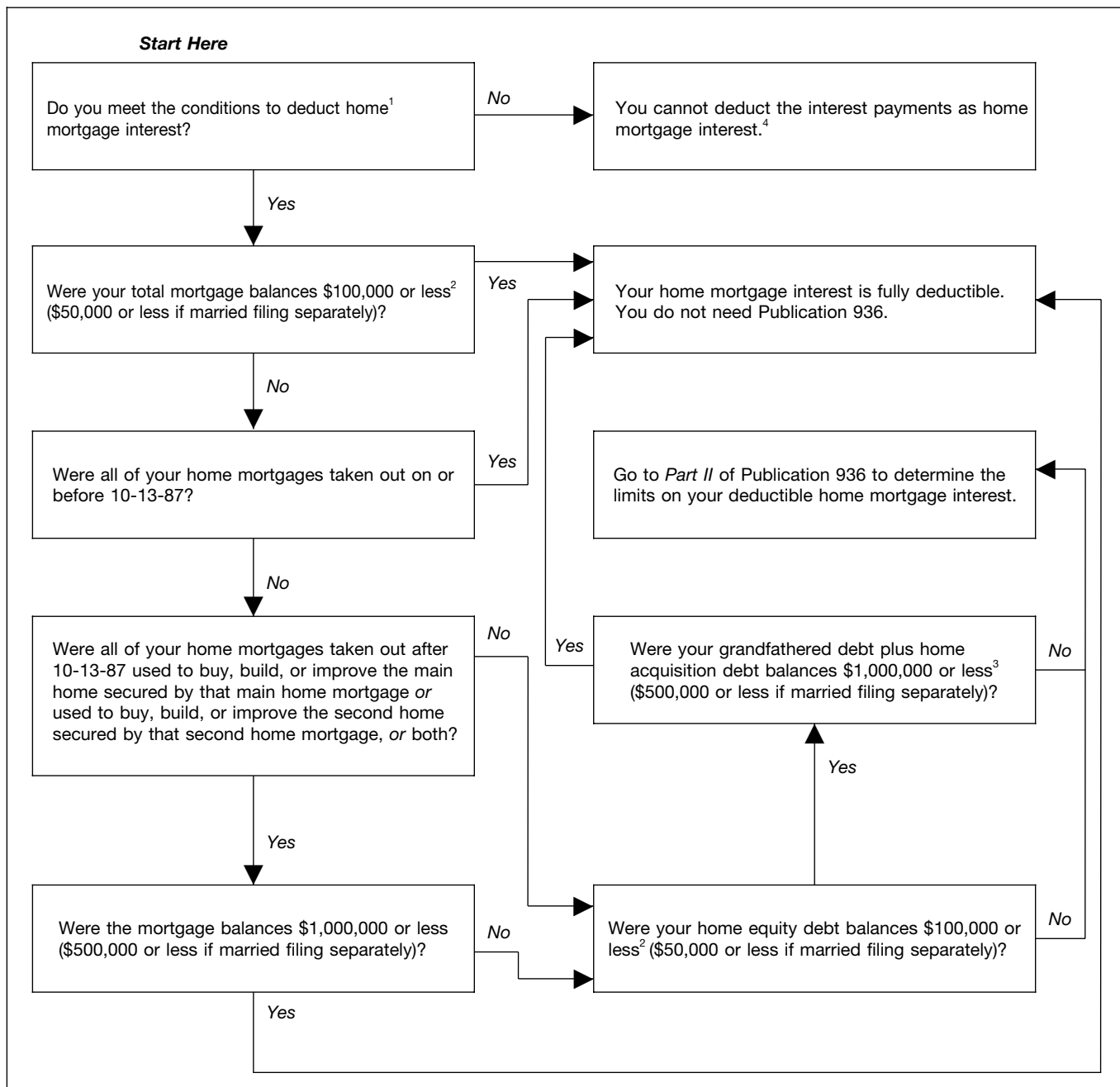
Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony. See the discussion of *Payments for jointly-owned home* in chapter 20.

Redeemable ground rent. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not

Figure 25–A. Is My Home Mortgage Interest Fully Deductible?

(Instructions: Include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



¹You must itemize deductions on Schedule A (Form 1040) and be legally liable for the loan. The loan must be a secured debt on a qualified home. See *Home Mortgage Interest*.

²If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in *Part II* of Publication 936.

³Amounts over the \$1,000,000 limit (\$500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

⁴See *Table 25-1* for where to deduct other types of interest payments.

ground rents. You cannot deduct them. For more information, see Publication 936.

Nonredeemable ground rent. Payments on a nonredeemable ground rent are not mortgage interest. You can deduct them as rent if they are a business expense or if they are for rental property.

Rental payments. If you live in a house before final settlement on the purchase, any payments you make for that period are rent and not interest. This is true even if the settlement papers call them interest. You cannot deduct these payments as home mortgage interest.

Mortgage proceeds invested in tax-exempt securities. You cannot deduct the home mortgage interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income. Grandfathered debt and home equity debt are defined earlier under *Amount Deductible*.

Refunds of interest. If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year. This is true whether the interest overcharge was refunded to you or was used to reduce the outstanding principal on your mortgage.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement*, showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement*, later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in chapter 13.

Points

The term “points” is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower’s mortgage. See *Points paid by the seller*, later.

General rule. You generally cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage.


Exception. You can fully deduct points in the year paid if you meet all the following tests. (You can use *Figure 25–B* as a quick guide to see whether your points are fully deductible in the year paid.)

- 1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
- 2) Paying points is an established business practice in the area where the loan was made.

- 3) The points paid were not more than the points generally charged in that area.
- 4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this method, see *Accounting Methods* in chapter 1.)
- 5) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- 6) The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
- 7) You use your loan to buy or build your main home.
- 8) The points were computed as a percentage of the principal amount of the mortgage.
- 9) The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller’s.

Note. If you meet all of these tests, you can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home, if tests (1) through (6) are met.

 **Second home.** The Exception does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Exception does not apply. If you do not qualify under the exception, or choose not to deduct the full amount of points in the year paid, see *Points* in chapter 5 of Publication 535, *Business Expenses*, for the rules on when and how much you can deduct. However, if the points relate to refinancing a home mortgage, see *Refinancing*, later.

Amounts charged for services. Amounts charged by the lender for specific services connected to the loan are not interest. Examples of these charges are:

- 1) Appraisal fees,
- 2) Notary fees,
- 3) Preparation costs for the mortgage note or deed of trust,
- 4) Mortgage insurance premiums, and
- 5) VA funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage. For information about the tax treatment of these amounts and other settlement fees and closing costs, get Publication 530, *Tax Information for First-Time Homeowners*.

Points paid by the seller. The term “points” includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by seller. The seller **cannot** deduct these fees as interest. But they are a selling expense that reduces the amount realized by the seller. See chapter 16 for information on the sale of your home.

Treatment by buyer. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under the *Exception*, earlier, are met, the buyer can deduct the points in the year paid. If any of those tests is not met, the buyer deducts the points over the life of the loan.

For information about basis, see chapter 14.

Funds provided are less than points. If you meet all the tests in the *Exception*, earlier, except that the funds you provided were less than the points charged to you (test 6), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1. When you took out a \$100,000 mortgage loan to buy your home in December, you were charged one point (\$1,000). You meet all the tests for deducting points in the year paid, except the only funds you provided were a \$750 down payment. Of the \$1,000 charged for points, you can deduct \$750 in the year paid. You spread the remaining \$250 over the life of the mortgage.

Example 2. The facts are the same as in *Example 1*, except that the person who sold you your home also paid one point (\$1,000) to help you get your mortgage. In the year paid, you can deduct \$1,750 (\$750 of the amount you were charged plus the \$1,000 paid by the seller). You spread the remaining \$250 over the life of the mortgage. You must reduce the basis of your home by the \$1,000 paid by the seller.

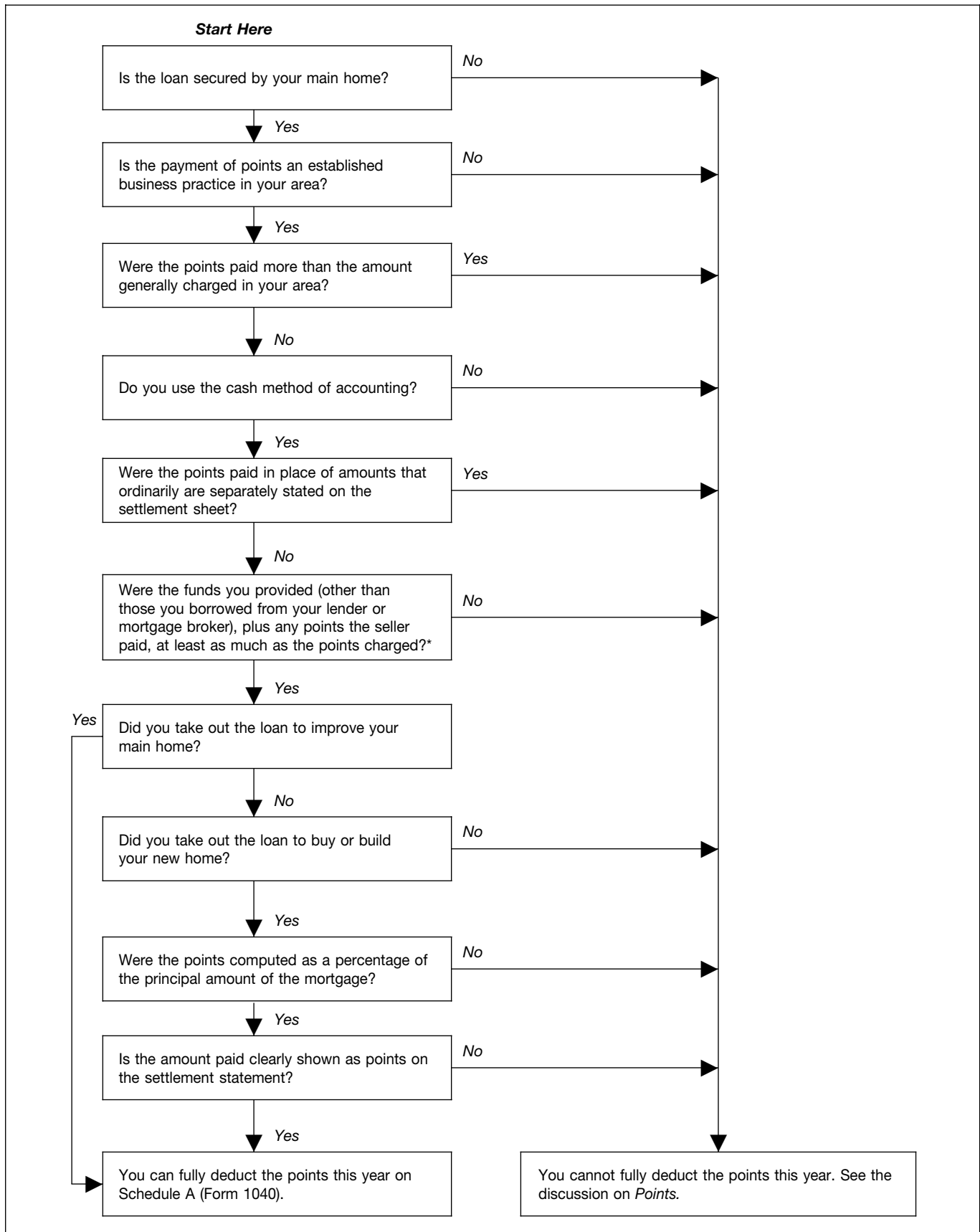
Excess points. If you meet all the tests in the *Exception*, earlier, except that the points paid were more than are generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan paid \$3,000 in points in 1993 that he had to spread out over the 15-year life of

Figure 25-B. **Are My Points Fully Deductible This Year?**



*The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

the mortgage. He had deducted \$1,600 of these points through 2000.

Dan prepaid his mortgage in full in 2001. He can deduct the remaining \$1,400 of points in 2001.

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.

However, if you use part of the refinanced mortgage proceeds to **improve your main home** and you meet the first six tests listed under *Exception*, earlier, you can fully deduct the part of the points related to the improvement in the year you paid them with your own funds. You can deduct the rest of the points over the life of the loan.

Example 1. In 1991, Bill Fields got a mortgage to buy a home. In 2001, Bill refinanced that mortgage with a 15-year \$100,000 mortgage loan. The mortgage is secured by his home. To get the new loan, he had to pay three points (\$3,000). Two points (\$2,000) were for prepaid interest, and one point (\$1,000) was charged for services, in place of amounts that ordinarily are stated separately on the settlement statement. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice in the area, and the points charged are not more than the amount generally charged there. Bill's first payment on the new loan was due July 1. He made six payments on the loan in 2001 and is a cash basis taxpayer.

Bill used the funds from the new mortgage to repay his existing mortgage. Although the new mortgage loan was for Bill's continued ownership of his main home, it was not for the purchase or improvement of that home. He cannot deduct all of the points in 2001. He can deduct two points (\$2,000) ratably over the life of the loan. He deducts \$67 $[(\$2,000 \div 180 \text{ months}) \times 6 \text{ payments}]$ of the points in 2001. The other point (\$1,000) was a fee for services and is not deductible.

Example 2. The facts are the same as in *Example 1*, except that Bill used \$25,000 of the loan proceeds to improve his home and \$75,000 to repay his existing mortgage. Bill deducts 25% (\$25,000 \div \$100,000) of the points (\$2,000) in 2001. His deduction is \$500 $(\$2,000 \times 25\%)$.

Bill also deducts the ratable part of the remaining \$1,500 $(\$2,000 - \$500)$ that must be spread over the life of the loan. This is \$50 $[(\$1,500 \div 180 \text{ months}) \times 6 \text{ payments}]$ in 2001. The total amount Bill deducts in 2001 is \$550 $(\$500 + \$50)$.

Limits on deduction. You cannot fully deduct points on a mortgage unless the mortgage fits into one of the categories listed earlier under *Fully deductible interest*. See Publication 936 for details.

Mortgage Interest Statement

If you paid \$600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a **Form 1098, Mortgage Interest Statement**, or a similar statement from the mortgage holder. You will

receive the statement if you pay interest to a person (including a financial institution or a co-operative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

You should receive the statement for each year by January 31 of the following year. A copy of this form will also be sent to the IRS.

The statement will show the total interest you paid during the year. If you purchased a main home during the year, it will also show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a governmental agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See *Points*, earlier, to determine whether you can deduct points not shown on Form 1098.

Prepaid interest on Form 1098. If you prepaid interest in 2001 that accrued in full by January 15, 2002, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2002 in 2001. (See *Prepaid interest*, earlier.) You will have to figure the interest that accrued for 2002 and subtract it from the amount in box 1. You will include the interest for January 2002 with the other interest you pay for 2002. See *How To Report*, later.

Refunded interest. If you received a refund of mortgage interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest*, earlier.

Investment Interest

This section discusses the interest expenses you may be able to deduct as an investor.

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. Nor can you deduct interest expenses on straddles.

Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

Investment Property

Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

Partners, shareholders, and beneficiaries.

To determine your investment interest, combine your share of investment interest from a partnership, S corporation, estate, or trust with your other investment interest.

Allocation of Interest Expense

If you borrow money for business or personal purposes as well as for investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt.

Limit on Deduction

Generally, your deduction for investment interest expense is limited to the amount of your **net investment income**.

You can carry over the amount of investment interest that you could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in that next year.

You can carry over disallowed investment interest to the next tax year even if it is more than your taxable income in the year the interest was paid or accrued.

Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

Investment income. This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends.

Choosing to include net capital gain. Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income.

You make this choice by completing line 4e of Form 4952 according to its instructions.

If you choose to include any amount of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.



Before making this choice, consider the overall effect on your tax liability. Compare your tax if you make this choice with your tax if you do not.

Investment income of child reported on parent's return.

Investment income includes the part of your child's interest and dividend income that you choose to report on your return. If the child does not have Alaska Permanent Fund dividends or capital gain distributions, this is the amount on line 6 of Form 8814, *Parents' Election To Report Child's Interest and Dividends*.

Table 25–1. **Where To Deduct Your Interest**

Type of Interest	Where to deduct	Where to find information
Student loan interest	Form 1040, line 24 or Form 1040A, line 17	Publication 970
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points <i>not</i> reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publication 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not Deductible	

Child's Alaska Permanent Fund dividends. If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on line 6 of Form 8814. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount of interest and dividend income on lines 1a and 2 of Form 8814. Subtract the result from the amount on line 6 of Form 8814.

Child's capital gain distributions. If part of the amount you report is your child's capital gain distributions, that part (which is reported on line 13 of Schedule D or line 13 of Form 1040) generally does not count as investment income. However, you can choose to include all or part of it in investment income. See chapter 3 of Publication 550 to figure the amount to include.

Your investment income also includes the amount on line 6 of Form 8814 (or, if applicable, the amount figured under *Child's Alaska Permanent Fund dividends*, earlier).

Investment expenses. Investment expenses include all income-producing expenses (other than interest expense) relating to investment property that are allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions. Use the smaller of:

- 1) The investment expenses included on line 22 of Schedule A (Form 1040), or
- 2) The amount on line 26 of Schedule A.

Losses from passive activities. Income or expenses that you used in computing income or loss from a passive activity are not included in determining your investment income or investment expenses (including investment interest expense). See Publication 925, *Passive Activity and At-Risk Rules*, for information about passive activities.

Form 4952

Use Form 4952, *Investment Interest Expense Deduction*, to figure your deduction for investment interest.

Exception to use of Form 4952. You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment interest expense is not more than your investment income from interest and ordinary dividends.
- You have no other deductible investment expenses.
- You have no disallowed investment interest expense from 2000.

If you meet all of these tests, you can deduct all of your investment interest.

More Information

For more information on investment interest, see *Investment Expenses* in chapter 3 of Publication 550.

Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. Nondeductible expenses include the following items.

- Personal interest (discussed later).
- Service charges (however, see *Other Expenses* in chapter 30).
- Annual fees for credit cards.
- Loan fees.
- Credit investigation fees.

- FHA mortgage insurance premiums and VA funding fees.
- Interest to purchase or carry tax-exempt securities.

Penalties. You cannot deduct fines and penalties for violations of law, regardless of their nature.

Personal Interest

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, business interest, or other deductible interest. It includes the following items.

- Interest on car loans (unless you use the car for business).
- Interest on federal, state, or local income tax.
- Finance charges on credit cards, retail installment contracts, and revolving charge accounts incurred for personal expenses.
- Late payment charges by a public utility.



You may be able to deduct interest you pay on a qualified **student loan**. For details, see Publication 970.

Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible, regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt proceeds to specific uses. For details on how to do this, see chapter 5 of Publication 535.

How To Report

You must file Form 1040 to deduct any home mortgage interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See Table 25–1 for a summary of where to deduct your interest expense.

Home mortgage interest and points. Deduct the home mortgage interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040). If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10. Attach a statement explaining the difference and print "See attached" next to line 10.

Deduct home mortgage interest that was *not* reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you

bought your home, show that person's name, address, and taxpayer identification number (TIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your TIN. A Form W-9 can be used for this purpose. Failure to meet any of these requirements may result in a \$50 penalty for each failure. The TIN can be either a social security number, an individual taxpayer identification number (issued by the Internal Revenue Service), or an employer identification number. See *Social Security Number* in chapter 1 for more information about TINs.

If you can take a deduction for points that were **not** reported to you on Form 1098, deduct those points on line 12 of Schedule A (Form 1040).

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the

interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on line 11 of Schedule A (Form 1040), and print "See attached" next to the line.

If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on line 10 of Schedule A (Form 1040). You should let each of the other borrowers know what his or her share is.

Mortgage proceeds used for business or investment. If your home mortgage interest deduction is limited but all or part of the mortgage proceeds were used for business, investment, or other deductible activities, see *Table 25-1*. It shows where to deduct the part of your excess interest that is for those activities.

Investment interest. Deduct investment interest, subject to certain limits discussed in Publication 550, on line 13 of Schedule A (Form 1040).

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds. See *Bond Premium Amortization* in Publication 550.

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example. You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

Contributions

Important Reminders

Disaster relief. You can deduct contributions earmarked for flood relief, hurricane relief, or other disaster relief to a qualified organization (defined later under *Organizations That Qualify To Receive Deductible Contributions*). However, you cannot deduct contributions earmarked for relief of a particular individual or family.

Written acknowledgment required. You can claim a deduction for a contribution of \$250 or more only if you have a written acknowledgment of your contribution from the qualified organization or if you have certain payroll deduction records. For more information, see *Records To Keep*, later in this chapter.

Payment partly for goods or services. A qualified organization must give you a written statement if you make a payment that is **more** than \$75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services. See *Contributions From Which You Benefit*, later in this chapter, for more information.

Introduction

This chapter explains how to claim a deduction for your charitable contributions. It discusses:

- Organizations that are qualified to receive deductible charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A **charitable contribution** is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

Form 1040 required. To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

Useful Items

You may want to see:

Publication

- 78** Cumulative List of Organizations

- 526** Charitable Contributions
- 561** Determining the Value of Donated Property

Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- 8283** Noncash Charitable Contributions

Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a **qualified organization**. To become a qualified organization, most organizations other than churches and governments, as described below, must apply to the IRS.



You can ask any organization whether it is a qualified organization, and most will be able to tell you. Or you can check IRS Publication 78, which lists most qualified organizations. You may find Publication 78 in your local library's reference section, or on the internet at www.irs.gov. You can also call the Tax Exempt/Government Entities Customer Service at 1-877-829-5500 to find out if an organization is qualified.

Types of Qualified Organizations

Generally, only the five following types of organizations can be qualified organizations.

- 1) **A community chest, corporation, trust, fund, or foundation** organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes.
 - a) Religious.
 - b) Charitable.
 - c) Educational.
 - d) Scientific.
 - e) Literary.
 - f) The prevention of cruelty to children or animals.

Certain organizations that foster national or international amateur sports competition also qualify.

- 2) **War veterans' organizations**, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.
- 3) **Domestic fraternal societies**, orders, and associations operating under the lodge system.

Note. Your contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

- 4) **Certain nonprofit cemetery** companies or corporations.

Note. Your contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

- 5) **The United States** or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

Note. To be deductible, your contribution to this type of organization must be made solely for public purposes.

Examples. Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Most nonprofit charitable organizations such as the Red Cross and the United Way.
- Most nonprofit educational organizations, including the Girl and Boy Scouts of America, colleges, museums, and day-care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct*.
- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities.
- Civil defense organizations.

Certain foreign charitable organizations.

Under income tax treaties with Canada, Israel, and Mexico, you may be able to deduct contributions to certain Canadian, Israeli, or Mexican charitable organizations. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. For additional information on the deduction of contributions to Canadian charities, see Publication 597, *Information on the United States-Canada Income Tax Treaty*. If you need more information on how to figure your contribution to Mexican and Israeli charities, see Publication 526.

Table 26–1. Examples of Charitable Contributions—A Quick Check

Deductible As Charitable Contributions	Not Deductible As Charitable Contributions
<p>Use the following lists for a quick check of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.</p> <p>Money or property you give to:</p> <ul style="list-style-type: none"> • Churches, synagogues, temples, mosques, and other religious organizations • Federal, state, and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt) • Nonprofit schools and hospitals • Public parks and recreation facilities • Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc. • War veterans groups <p>Costs you pay for a student living with you, sponsored by a qualified organization</p> <p>Out-of-pocket expenses when you serve a qualified organization as a volunteer</p>	<p>Money or property you give to:</p> <ul style="list-style-type: none"> • Civic leagues, social and sports clubs, labor unions, and chambers of commerce • Foreign organizations (except certain Canadian, Israeli, and Mexican charities) • Groups that are run for personal profit • Individuals • Groups whose purpose is to lobby for law changes • Homeowners' associations • Individuals • Political groups or candidates for public office <p>Cost of raffle, bingo, or lottery tickets</p> <p>Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups</p> <p>Tuition</p> <p>Value of your time or services</p> <p>Value of blood given to a blood bank</p>

Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is “for the use of” a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property*, later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limits on Deductions*, later.

Table 26–1 lists some examples of contributions you can deduct and some that you cannot deduct.

Contributions From Which You Benefit

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution that is **more than the value of the benefit** you receive.

If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item can be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

Example 1. You pay \$65 for a ticket to a dinner-dance at a church. All of the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of \$25. When you buy your ticket, you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you receive (\$25) from your total payment (\$65). You can deduct \$40 as a contribution to the church.

Example 2. At a fund-raising auction conducted by a charity, you pay \$600 for a week’s stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Athletic events. If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

Example 1. You pay \$300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university’s home football games. You can deduct \$240 (80% of \$300) as a charitable contribution.

Example 2. The facts are the same as in Example 1 except that your \$300 payment included the purchase of one season ticket for the stated ticket price of \$120. You must subtract the usual price of a ticket (\$120) from your \$300 payment. The result is \$180. Your deductible charitable contribution is \$144 (80% of \$180).

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.



Even if the ticket or other evidence of payment indicates that the payment is a “contribution,” this does not mean you can deduct the entire amount. If the ticket shows the price of admission and the amount of the contribution, you can deduct the contribution amount.

Example. You pay \$40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is “Contribution—\$40.” If the regular price for the movie is \$8, your contribution is \$32 (\$40 payment – \$8 regular price).

Membership fees or dues. You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Certain membership benefits can be disregarded. Both you and the organization can disregard certain membership benefits you get in return for an annual payment of **\$75 or less** to the qualified organization. You can pay more than \$75 to the organization if the organization does not require a larger payment for you to get the benefits. The following benefits are covered under this rule.

- 1) Any rights or privileges, other than those discussed under *Athletic events*, earlier, that you can use frequently while you are a member, such as:

Table 26–2. **Volunteers' Questions and Answers**

*If you do volunteer work for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, **Out-of-Pocket Expenses in Giving Services**.*

Question	Answer
I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid \$6 an hour to do the same work I do. Can I deduct \$36 a week for my time? The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	No, you cannot deduct the value of your time or services. Yes, you can deduct the costs of gas and oil that are directly related to getting to the qualified organization where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.
I volunteer as a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see chapter 33.)

- a) Free or discounted admission to the organization's facilities or events,
 - b) Free or discounted parking,
 - c) Preferred access to goods or services, and
 - d) Discounts on the purchase of goods and services.
- 2) Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than \$7.60. This amount may be adjusted annually for inflation.

Token items. You can deduct your entire payment to a qualified organization as a charitable contribution if both of the following are true.

- 1) You get a small item or other benefit of token value.
- 2) The qualified organization correctly determines that the value of the item or benefit you received is not substantial and informs you that you can deduct your payment in full.

Written statement. A qualified organization must give you a written statement if you make a payment to it that is **more than \$75** and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

Exception. An organization will not have to give you this statement if one of the following is true.

- 1) The organization is:

- a) The type of organization described in (5) under *Types of Qualified Organizations*, earlier, or
 - b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
- 2) You receive only items whose value is not substantial, as described under *Token items*, earlier.
 - 3) You receive only membership benefits that can be disregarded, as described earlier.

Expenses Paid for Student Living With You

You may be able to deduct some expenses of having a student live with you. You can deduct **qualifying expenses** for a foreign or American student who:

- 1) Lives in your home under a written agreement between you and a **qualified organization** as part of a program of the organization to provide educational opportunities for the student,
- 2) Is not your dependent or relative, and
- 3) Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to \$50 a month for each full calendar month the student lives with you.



Any month when conditions (1) through (3) above are met for 15 days or more counts as a full month.

For additional information, see *Expenses Paid for Student Living With You* in Publication 526.

Mutual exchange program. You cannot deduct the costs of a foreign student living in your

home under a mutual exchange program through which your child will live with a family in a foreign country.

Out-of-Pocket Expenses in Giving Services

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 26–2 contains questions and answers that apply to some individuals who volunteer their services.

Conventions. If you are a **chosen representative** attending a convention of a qualified organization, you can deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel*, later.

You cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct travel, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Uniforms. You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

Foster parents. You may be able to deduct as a charitable contribution some of the costs of being a foster parent (foster care provider) if you

have no profit motive in providing the foster care and are not, in fact, making a profit. A qualified organization must designate the individuals you take into your home for foster care.

You can deduct expenses that meet both of the following requirements.

- 1) They are unreimbursed out-of-pocket expenses to feed, clothe, and care for the foster child.
- 2) They must be mainly to benefit the qualified organization.

Unreimbursed expenses that you cannot deduct as charitable contributions may be considered support provided by you in determining whether you can claim the foster child as a dependent. For details see chapter 3.

Example. You cared for a foster child because you wanted to adopt her, not to benefit the agency that placed her in your home. Your unreimbursed expenses are not deductible as charitable contributions.

Car expenses. You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard mileage rate of **14 cents a mile** to figure your contribution.

You can deduct parking fees and tolls, whether you use your actual expenses or the standard mileage rate.

You must keep reliable written records of your car expenses. For more information, see *Car expenses under Records To Keep*, later.

Travel. Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only if there is **no significant element of personal pleasure**, recreation, or vacation in the travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties, or if for significant parts of the trip you do not have any duties, you cannot deduct your travel expenses.

Example 1. You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

Example 2. You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3. You work for several hours each morning on an archaeological dig sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4. You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, you must include in income the amount of the allowance that is more than your deductible travel expenses. You can deduct your necessary travel expenses that are more than the allowance.

Deductible travel expenses. These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

Because these travel expenses are not business related, they are not subject to the same limits as business-related expenses. For information on business travel expenses, see *Travel Expenses* in chapter 28.

Contributions You Cannot Deduct

There are some contributions that you cannot deduct, such as those made to individuals and those made to nonqualified organizations. (See *Contributions to Individuals* and *Contributions to Nonqualified Organizations*, next). There are others that you can deduct only part of, as discussed later under *Contributions From Which You Benefit*.

Contributions To Individuals

You cannot deduct contributions to specific individuals, including the following.

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of **deceased members**.

- Contributions to **individuals who are needy or worthy**. This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. **But** you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to a **member of the clergy** that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid for **another person** who provided services to a qualified organization.
Example. Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.
- Payments to a hospital that are for services for a **specific patient's care** or for services for a specific patient. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

Contributions To Nonqualified Organizations

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following.

- 1) **Certain state bar associations** if:
 - a) The state bar is not a political subdivision of a state,
 - b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
 - c) Your contribution is unrestricted and can be used for private purposes.
- 2) **Chambers of commerce** and other business leagues or organizations.
- 3) **Civic leagues and associations**.
- 4) **Communist organizations**.
- 5) **Country clubs** and other social clubs.
- 6) **Foreign organizations** other than:
 - a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds or if the foreign organization is only an administrative arm of the U.S. organization, or
 - b) Certain Canadian, Israeli, or Mexican charitable organizations. See *Certain foreign charitable organizations under Organizations That Qualify To Receive Deductible Contributions*, earlier.
- 7) **Homeowners' associations**.
- 8) **Labor unions**. But you may be able to deduct union dues as a miscellaneous itemized deduction, subject to the

2%-of-adjusted-gross-income limit, on Schedule A (Form 1040). See chapter 30.

9) **Political organizations and candidates.**

Contributions From Which You Benefit

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive. These contributions include the following.

- Contributions for **lobbying**. This includes amounts that you earmark for use in, or in connection with, influencing specific legislation.
- Contributions to a **retirement home** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of **raffles, bingo, lottery, etc.** You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance. For more information on how to report gambling winnings and losses, see *Gambling Losses Up To the Amount of Gambling Winnings* in chapter 30.
- Dues to **fraternal orders** and similar groups. However, see *Membership fees or dues*, earlier, under *Contributions You Can Deduct*.
- **Tuition**, or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying non-profit day-care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a "donation."

Value of Time or Services

You cannot deduct the value of your time or services, including:

- **Blood donations** to the Red Cross or to blood banks, and
- **The value of income lost** while you work as an unpaid volunteer for a qualified organization.

Personal Expenses

You cannot deduct personal, living, or family expenses, such as:

- **The cost of meals** you eat while you perform services for a qualified organization, unless it is necessary for you to be away from home overnight while performing the services, or
- **Adoption expenses**, including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim a

tax credit for these expenses, and/or exclude from your gross income adoption expenses paid or reimbursed by your employer. See *Adoption Credit* in chapter 38 and Publication 968, *Tax Benefits for Adoption*.

You also may be able to claim an exemption for the child. See *Adoption* in chapter 3.

Appraisal Fees

Fees that you pay to find the fair market value of donated property are not deductible as contributions. You can claim them, subject to the 2%-of-adjusted-gross-income limit, as miscellaneous deductions on Schedule A (Form 1040). See chapter 30.

Contributions of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments to the amount of your deduction. See *Giving Property That Has Increased in Value*, later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep* and *How To Report*, later.

Partial interest in property. Generally, you cannot deduct a charitable contribution (not made by a transfer in trust) of less than your entire interest in property. A contribution of the right to use property is a contribution of less than your entire interest in that property and is not deductible. For exceptions and more information, see *Partial Interest in Property Not in Trust* in Publication 561.

Future interests in tangible personal property. You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or a related organization.

Future interest. This is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

Determining Fair Market Value

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Publication 561 contains a more complete discussion.

Used clothing and household goods. Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

Example. Dawn Greene donated a coat to a thrift store operated by her church. She paid \$300 for the coat 3 years ago. Similar coats in the thrift store sell for \$25. The fair market value of the coat is therefore \$25. Dawn's donation is limited to \$25.

See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

Cars, boats, and aircraft. If you contribute a car, boat, or aircraft to a charitable organization, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called "blue books," containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally, and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Example. You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the "blue book" value of the car is \$1,600. However, your car needs extensive repairs and, after some checking, you find that you could sell it for \$750. You can deduct \$750, the **true** fair market value of the car, as a charitable contribution.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

Giving Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

Giving Property That Has Increased in Value

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your "basis" in property is generally what you paid for it. See chapter 14 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

- 1) Ordinary income property, or
- 2) Capital gain property.

Ordinary income property. Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

Example. You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is \$1,000, but you paid only \$800 (your basis). Because the \$200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to \$800 (fair market value less the appreciation).

Capital gain property. Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. It includes capital assets held more than 1 year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than 1 year.

Amount of deduction — general rule. When figuring your deduction for a gift of capital gain property, you usually can use the **fair market value** of the gift.

Exceptions. In certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

More information. For more information on donated appreciated property, see *Giving Property That Has Increased in Value* in Publication 526.

When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Time of making contribution. Usually, you make a contribution at the time of its unconditional delivery.

Checks. A check that you mail to a charity is considered delivered on the date you mail it.

Credit card. Contributions charged on your bank credit card are deductible in the year you make the charge.

Pay-by-phone account. If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

Stock certificate. A gift to a charity of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock is transferred on the books of the corporation.

Promissory note. If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments.

Option. If you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

Borrowed funds. If you make a contribution with borrowed funds, you can deduct the contribution in the year you make it, regardless of when you repay the loan.

Limits on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income, you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either **20%, 30%, or 50%** of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *Carryovers* under *How To Figure Your Deduction When Limits Apply* in Publication 526.

50% Limit

This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

The 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations*. But there is one **exception**. The 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *30% Limit*, later.)

50% limit organizations. You can ask any organization whether it is a 50% limit organization and most will be able to tell you. Or you may check IRS Publication 78 or call the Tax Exempt/

Government Entities Customer Service at the number listed earlier under *Organizations that Qualify To Receive Deductible Contributions*. The following is a partial list of the types of organizations that are 50% limit organizations.

- 1) Churches, and conventions or associations of churches.
- 2) Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site.
- 3) Hospitals and certain medical research organizations associated with these hospitals.
- 4) Publicly supported charities.
- 5) Private operating foundations.
- 6) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution.
- 7) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

30% Limit

This limit applies to the following contributions.

- Gifts of capital gain property to 50% limit organizations. (For other gifts of capital gain property, see *20% Limit*, later.) However, the 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.
- Gifts (other than gifts of capital gain property as explained under *20% Limit*, later) **for the use of** any organization.
- Gifts (other than capital gain property as explained under *20% Limit*, later) to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

20% Limit

This limit applies to all gifts of capital gain property to or for the use of qualified organizations (other than gifts of capital gain property to 50% limit organizations).

Carryovers

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted-gross-income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond

that time. For more information, see *Carryovers* in Publication 526.

Records To Keep

You must keep records to prove the amount of the cash and noncash contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are cash or noncash contributions.

Note. An organization generally must give you a written statement if it receives a payment from you that is more than \$75 and is partly a contribution and partly for goods or services. (See *Contributions From Which You Benefit* under *Contributions You Can Deduct*, earlier.) Keep the statement for your records. It may satisfy all or part of the recordkeeping requirements explained in the following discussions.

Cash Contributions

Cash contributions include those paid by cash, check, credit card, or payroll deduction. They also include your out-of-pocket expenses when donating your services.

For a contribution made in cash, the records you must keep depend on whether the contribution is:

- 1) Less than \$250, or
- 2) \$250 or more.

Amount of contribution. In figuring whether your contribution is \$250 or more, do not combine separate contributions. For example, if you gave your church \$25 each week, your weekly payments do not have to be combined. Each payment is a separate contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

If you made a payment that is partly for goods and services, as described earlier under *Contributions From Which You Benefit*, your contribution is the amount of the payment that is more than the value of the goods and services.

Contributions of Less Than \$250

For each cash contribution that is less than \$250, you must keep one of the following items.

- 1) A canceled check, **or** a legible and readable account statement that shows:
 - a) If payment was by check—the check number, amount, date posted, and to whom paid.
 - b) If payment was by electronic funds transfer—the amount, date posted, and to whom paid.
 - c) If payment was charged to a credit card—the amount, transaction date, and to whom paid.
- 2) A receipt (or a letter or other written communication) from the charitable organiza-

tion showing the name of the organization, the date of the contribution, and the amount of the contribution.

- 3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, and were regularly kept by you, or if, in the case of small donations, you have emblems, buttons, or other tokens that are regularly given to persons making small cash contributions.

Car expenses. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving and the date each time you used your car for a charitable purpose. If you use the standard mileage rate of 14 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses*, earlier, under *Out-of-Pocket Expenses in Giving Services*, for the expenses you can deduct.

Contributions of \$250 or More

You can claim a deduction for a contribution of \$250 or more only if you have an acknowledgment of your contribution from the qualified organization or certain payroll deduction records.

If you made more than one contribution of \$250 or more, you must have either a separate acknowledgment for each or one acknowledgment that shows your total contributions.

Acknowledgment. The acknowledgment must meet these tests.

- 1) It must be written.
- 2) It must include:
 - a) The amount of cash you contributed,
 - b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and
 - c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.
- 3) You must get it on or before the earlier of:

- a) The date you file your return for the year you make the contribution, or
- b) The due date, including extensions, for filing the return.

Payroll deductions. If you make a contribution by payroll deduction, you do not need an acknowledgment from the qualified organization. But if your employer deducted \$250 or more from a single paycheck, you must keep:

- 1) A pay stub, Form W-2, or other document furnished by your employer that proves the amount withheld, and
- 2) A pledge card or other document from the qualified organization that states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

Out-of-pocket expenses. If you render services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, you can satisfy the written acknowledgment requirement just discussed if:

- 1) You have adequate records to prove the amount of the expenses, and
- 2) By the required date, you get an acknowledgment from the qualified organization that contains:
 - a) A description of the services you provided,
 - b) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
 - c) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
 - d) A statement of any intangible religious benefits provided to you.

Noncash Contributions

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

- 1) Less than \$250,
- 2) At least \$250 but not more than \$500,
- 3) Over \$500 but not more than \$5,000, or
- 4) Over \$5,000.

Amount of contribution. In figuring whether your contribution is \$250 or more, do not combine separate contributions. If you received goods or services in return, as described earlier in *Contributions From Which You Benefit*, reduce your contribution by the value of those goods or services. If you figure your deduction by reducing the fair market value of the donated property by its appreciation, as described earlier in *Giving Property That Has Increased in Value*, your contribution is the reduced amount.

Deductions of Less Than \$250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

- 1) The name of the charitable organization,
- 2) The date and location of the charitable contribution, and
- 3) A reasonably detailed description of the property.



A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site).

Additional records. You must also keep reliable written records for each item of donated property. Your written records must include the following information.

- 1) The name and address of the organization to which you contributed.
- 2) The date and location of the contribution.
- 3) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
- 4) The fair market value of the property at the time of the contribution, and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.
- 5) The cost or other basis of the property if you must reduce its fair market value by appreciation. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure*

Your Deduction When Limits Apply in Publication 526 for information on how to make the capital gain property election.

- 6) The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year. Your records must include the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of any person in possession of the property, other than the organization to which you contributed.
- 7) The terms of any conditions attached to the gift of property.

Deductions of At Least \$250 But Not More Than \$500

If you claim a deduction of at least \$250 but not more than \$500 for a noncash charitable contribution, you must get and keep an acknowledgment of your contribution from the qualified organization. If you made more than one contribution of \$250 or more, you must have either a separate acknowledgment for each or one acknowledgment that shows your total contribution.

The acknowledgment must contain the information in items (1) through (3) listed under *Deductions of Less Than \$250*, earlier, and your written records must include the information listed in that discussion under *Additional records*.

The acknowledgment must also meet these tests.

- 1) It must be written.
- 2) It must include:
 - a) A description (but not necessarily the value) of any property you contributed,
 - b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and

- c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

- 3) You must get the acknowledgment on or before the earlier of:
 - a) The date you file your return for the year you make the contribution, or
 - b) The due date, including extensions, for filing the return.

Deductions Over \$500

You are required to give additional information if you claim a deduction over \$500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

Qualified Conservation Contribution

If the gift was a "qualified conservation contribution," your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

How To Report

Enter your cash contributions (including out-of-pocket expenses) on line 15, Schedule A (Form 1040).

Enter your noncash contributions on line 16 of Schedule A (Form 1040).

If your total deduction for all noncash contributions for the year is over \$500, you must also file **Form 8283**. See *How To Report* in Publication 526 for more information.

27.

Nonbusiness Casualty and Theft Losses

Important Change

Postponed tax deadlines in disaster areas. The IRS may postpone for up to 120 days certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA. For more information, see *Postponed tax deadlines*, later, under *Disaster Area Loss*.

Introduction

This chapter explains the tax treatment of personal (not business related) casualty losses, theft losses, and losses on deposits.

The chapter also explains the following topics.

- How to figure the amount of your loss.
- How to treat insurance and other reimbursements you receive.
- The deduction limits.
- When and how to report a casualty or theft.

Forms to file. When you have a casualty or theft, you have to file Form 4684. You will also have to file one or more of the following forms.

- Schedule A (Form 1040), *Itemized Deductions*
- Schedule D (Form 1040), *Capital Gains and Losses*

Condemnations. For information on condemnations of property, see *Involuntary Conversions* in chapter 1 of Publication 544.

Workbook for casualties and thefts. Publication 584 is available to help you make a list of your stolen or damaged personal-use property and figure your loss. It includes schedules to help you figure the loss on your home, its contents, and your motor vehicles.

Other sources of information. For information on a casualty or theft loss of business or income-producing property, see Publication 547.

For information on a condemnation of your home, see *Involuntary Conversions* in chapter 1 of Publication 544.

Useful Items

You may want to see:

Publication

- **544** Sales and Other Dispositions of Assets
- **547** Casualties, Disasters, and Thefts
- **584** Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)

Form (and Instructions)

- **Schedule A (Form 1040)** Itemized Deductions
- **Schedule D (Form 1040)** Capital Gains and Losses
- **4684** Casualties and Thefts

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A **sudden** event is one that is swift, not gradual or progressive.
- An **unexpected** event is one that is ordinarily unanticipated and unintended.
- An **unusual** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

Deductible losses. Deductible casualty losses can result from a number of different causes, including the following.

- Car accidents (but see *Nondeductible losses*, next, for exceptions).
- Earthquakes.
- Fires (but see *Nondeductible losses*, next, for exceptions).
- Floods.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses* in Publication 547.
- Hurricanes.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.
- Storms.
- Tornadoes.
- Vandalism.
- Volcanic eruptions.

Nondeductible losses. A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.
- A fire if you willfully set it or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration.

- The steady weakening of a building due to normal wind and weather conditions.
- The deterioration and damage to a water heater that bursts. **But** the rust and water damage to rugs and drapes caused by the bursting of a water heater **does qualify** as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests. **But**, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

Theft

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the laws of the state where it occurred and it must have been done with criminal intent.

Theft includes the taking of money or property by the following means.

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.
- Threats.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Mislaid or lost property. The simple disappearance of money or property is not a theft.

However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this type of loss, you can choose one of the following ways to deduct the loss.

- As a casualty loss.
- As an ordinary loss.
- As a nonbusiness bad debt.

Casualty loss or ordinary loss. You can choose to deduct a loss on deposits as a casualty loss or as an ordinary loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. If you treat the loss as a casualty or ordinary loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. Once you make this choice, you cannot change it without approval of the Internal Revenue Service.

Nonbusiness bad debt. If you do not choose to deduct the loss as a casualty loss or as an ordinary loss, you must wait until the actual loss is determined before you can deduct the loss as a nonbusiness bad debt.

How to report. The kind of deduction you choose for your loss on deposits determines how you report your loss. If you choose:

- Casualty loss — report it on Form 4684 first and then on Schedule A (Form 1040).
- Ordinary loss — report it on Schedule A (Form 1040).
- Nonbusiness bad debt — report it on Schedule D (Form 1040).

More information. For more information, see *Special Treatment for Losses on Deposits in Insolvent or Bankrupt Financial Institutions* in the instructions for Form 4684.

Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You must be able to support the amount you claim for the loss as discussed next.

Casualty loss proof. For a casualty loss, your records should show all the following.

- 1) The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- 2) That the loss was a direct result of the casualty.
- 3) That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

Theft loss proof. For a theft loss, your records should show all the following.

- 1) When you discovered that your property was missing.
- 2) That your property was stolen.
- 3) That you were the owner of the property.

Amount of Loss

Figure the amount of your loss using the following steps.

- 1) Determine your adjusted basis in the property before the casualty or theft.
- 2) Determine the decrease in fair market value of the property as a result of the casualty or theft.
- 3) From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you received or expect to receive.

For personal-use property and property used in performing services as an employee, apply the deduction limits, discussed later, to determine the amount of your deductible loss.

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or the reimbursement you receive or expect to receive.

Adjusted Basis

Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information, see chapter 14.

Decrease in Fair Market Value

Fair market value (FMV) is the price for which you could sell your property to a willing buyer when neither of you have to sell or buy and both of you know all the relevant facts.

The decrease in FMV is the difference between the property's fair market value immediately before and immediately after the casualty or theft.

FMV of stolen property. The FMV of property immediately after a theft is considered to be zero, since you no longer have the property.

Recovered stolen property. Recovered stolen property is your property that was stolen and

later returned to you. If you recover property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained earlier) or the decrease in FMV from the time it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

If your refigured loss is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax. For more information on the amount to report, see *Recoveries* in chapter 13.

Figuring Decrease in FMV—Items To Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But other measures can also be used to establish certain decreases.

Appraisal. An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following.

- The appraiser's familiarity with your property before and after the casualty or theft.
- The appraiser's knowledge of sales of comparable property in the area.
- The appraiser's knowledge of conditions in the area of the casualty.
- The appraiser's method of appraisal.

Appraisal fee. The appraisal fee is not a part of the casualty or theft loss. It is an expense in determining your tax liability. You can deduct it as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

Cost of cleaning up or making repairs. The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But you can use the cost of cleaning up or making repairs as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are actually made.
- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs take care of the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following.

- Removing destroyed or damaged trees and shrubs minus any salvage you receive.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.

Car value. Books issued by various automobile organizations that list your car may be useful in figuring the value of your car. You can modify the book's retail value by such factors as mileage and the condition of your car to figure its value. The prices are not "official," but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Figuring Decrease in FMV— Items Not To Consider

The following items are generally not considered when establishing the decrease in the FMV of your property.

Replacement cost. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

Cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, you cannot deduct the amount you spend on insurance or to board up your house against a storm.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Related expenses. Any incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its fair market value.

Decline in market value of property. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Publication 547.

Photographs. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged.

Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

The cost of photographs obtained for this purpose is not a part of the loss. You can claim this cost as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 30.

Insurance and Other Reimbursements

If you receive an insurance payment or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. See *Reimbursement Received After Deducting Loss*, later.

Failure to file a claim for reimbursement. If your property is covered by insurance, you should file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this rule does not apply to the portion of the loss not covered by insurance (for example, a deductible).

Example. You have a car insurance policy with a \$500 deductible. Because your insurance did not cover the first \$500 of an auto collision, the \$500 would be deductible (subject to the deduction limits discussed later). This is true even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for the deductible.

Gain from reimbursement. If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is more than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain. See Publication 547 for more information on how to treat a gain from a reimbursement for a casualty or theft.

Types of Reimbursements

The most common type of reimbursement is an insurance payment for your stolen or damaged property. Other types of reimbursements are discussed next. Also see the *Instructions for Form 4684*.

Employer's emergency disaster fund. If you receive money from your employer's emergency disaster fund and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, you must take that money into consideration in computing the casualty loss deduction. Take into consideration only the amount you used to replace your destroyed or damaged property.

Example. Your home was extensively damaged by a tornado. Your loss after reimburse-

ment from your insurance company was \$10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received \$4,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss (\$10,000) by the \$4,000 you received from your employer's fund. Your casualty loss before applying the deduction limit discussed later is \$6,000.

Cash gifts. If you receive excludable cash gifts as a disaster victim and there are no limits on how you can use the money, you do not reduce your casualty loss by these excludable cash gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

Example. Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You used part of the cash gifts to pay for repairs to your home. There were no limits or restrictions on how you could use the cash gifts. Because it was an excludable gift, the money you received and used to pay for repairs to your home does not reduce your casualty loss on the damaged home.

Insurance payments for living expenses. You do not reduce your casualty loss by insurance payments you receive to cover living expenses in either of the following situations.

- You lose the use of your main home because of a casualty.
- Government authorities do not allow you access to your main home because of a casualty or threat of one.

Inclusion in income. If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on line 21 of Form 1040.

A temporary increase in your living expenses is the difference between the actual living expenses you and your family incurred during the period you could not use your home and your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following.

- Rent for suitable housing.
- Transportation.
- Food.
- Utilities.
- Miscellaneous services.

Normal living expenses consist of these same expenses that you would have incurred but did not because of the casualty.

Example. As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay \$525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was \$1,200. You normally pay \$200 a month for food. Your food expenses for the month you

lived in the motel were \$400. You received \$1,100 from your insurance company to cover your living expenses. You determine the payment you must include in income as follows.

1) Insurance payment for living expenses	\$1,100
2) Actual expenses during the month you are unable to use your home because of the fire	\$1,600
3) Normal living expenses	725
4) Temporary increase in living expenses: Subtract line 3 from line 2	875
5) Amount of payment includible in income: Subtract line 4 from line 1	\$225

Tax year of inclusion. You include the taxable part of the insurance payment in income for the year you regain the use of your main home or, if later, for the year you receive the taxable part of the insurance payment.

Example. Your main home was destroyed by a tornado in August 1999. You regained use of your home in November 2000. The insurance payments you received in 1999 and 2000 were \$1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 2000 Form 1040. If, in 2001, you receive further payments to cover the living expenses you had in 1999 and 2000, you must include those payments in income on your 2001 Form 1040.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

Reimbursement Received After Deducting Loss

If you figured your casualty or theft loss using your expected reimbursement, you may have to adjust your tax return for the tax year in which you receive your actual reimbursement. This section explains the adjustment you may have to make.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. Your personal car had an FMV of \$2,000 when it was destroyed in a collision with another car last year. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. You subtracted the expected reimbursement when you figured your loss. You did not have a deductible loss last year.

This January, the court awarded you a judgment of \$2,000. However, in July it became apparent that you will be unable to collect any amount from the other driver. You can deduct the loss this year subject to the limits discussed later.

Actual reimbursement more than expected. If you later receive more reimbursement than you expected after you claimed a deduction for the loss, you may have to include the extra

reimbursement in your income for the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For more information, see *Recoveries* in chapter 13.



If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a gain on the casualty or theft. If you have already taken a deduction for a loss and you receive the reimbursement in a later year, you may have to include the gain in your income for the later year. Include the gain as ordinary income up to the amount of your deduction that reduced your tax for the earlier year. See Publication 547 for more information on how to treat a gain from the reimbursement of a casualty or theft.

Actual reimbursement same as expected. If you receive exactly the reimbursement you expected, you do not have any amount to include in your income or any loss to deduct.

Example. Last December, you had a collision while driving your personal car. Repairs to the car cost \$950. You had \$100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. Because you expected a reimbursement from the insurance company, you did not have a casualty loss deduction last year.

Due to the \$100 rule (discussed later under *Deduction Limits*), you cannot deduct the \$100 deductible you paid. When you receive the \$850 from the insurance company this year, do not report it as income.

Single Casualty on Multiple Properties

Personal property. If a single casualty or theft involves more than one item of personal property, you must figure the loss on each item separately. Then combine the losses to determine your total loss from that casualty or theft. Personal property is any property that is not real property.

Example. A fire in your home destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) You paid \$750 for the chair and you established that it had an FMV of \$500 just before the fire. The rug cost \$3,000 and had an FMV of \$2,500 just before the fire. You bought the table at an auction for \$100 before discovering it was an antique. It had been appraised at \$900 before the fire. You figure your loss on each of these items as follows:

	<u>Chair</u>	<u>Rug</u>	<u>Table</u>
1) Basis (cost)	\$750	\$3,000	\$100
2) FMV before fire	\$500	\$2,500	\$900
3) FMV after fire	-0-	-0-	-0-
4) Decrease in FMV	\$500	\$2,500	\$900
5) Loss (smaller of (1) or (4))	\$500	\$2,500	\$100
6) Total loss			\$3,100

Real property. In figuring a casualty loss on personal-use real property, treat the entire property (including any improvements, such as buildings, trees, and shrubs) as one item. Figure the loss using the smaller of the adjusted basis or the decrease in FMV of the entire property.

Example. You bought your home a few years ago. You paid \$160,000 (\$20,000 for the land and \$140,000 for the house). You also spent \$2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at \$200,000 before the fire, but only \$30,000 after the fire. (The loss to your household furnishings is not shown in this example. It would be figured separately, as explained earlier under *Personal property*.) Shortly after the fire, the insurance company paid you \$155,000 for the loss. You figure your casualty loss as follows:

1) Adjusted basis of the entire property (land, building, and landscaping)	\$162,000
2) FMV of entire property before fire	\$200,000
3) FMV of entire property after fire	30,000
4) Decrease in FMV of entire property	\$170,000
5) Loss (smaller of (1) or (4))	\$162,000
6) Subtract insurance	155,000
7) Amount of loss	\$7,000

Deduction Limits

After you have figured your casualty or theft loss, you must figure how much of the loss you can deduct. If the loss was to property for your personal use or your family's, there are **two limits** on the amount you can deduct for your casualty or theft loss.

- 1) You must reduce each casualty or theft loss by \$100 (\$100 rule).
- 2) You must further reduce the total of all your losses by 10% of your adjusted gross income (10% rule).

You make these reductions on Form 4684.

These rules are explained next and *Table 27-1* summarizes how to apply the \$100 rule and the 10% rule in various situations. For more detailed explanations and examples, see *Publication 547*.

Property used partly for business and partly for personal purposes. When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the personal-use part and for the business or income-producing part. You must figure each loss separately because the \$100 rule and the 10% rule apply only to the loss on the personal-use part of the property.

\$100 Rule

After you have figured your casualty or theft loss, you must reduce that loss by \$100. This reduction applies to each total casualty or theft loss. It does not matter how many pieces of

Table 27–1. How To Apply the Deduction Limits

		\$100 Rule	10% Rule
General Application		You must reduce each casualty or theft loss by \$100 when figuring your deduction. Apply this rule after you have figured the amount of your loss.	You must reduce your total casualty or theft loss by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100 (the \$100 rule).
Single Event		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
More Than One Event		Apply to the loss from each event.	Apply to the total of all your losses from all events.
More Than One Person— With Loss From the Same Event (other than a married couple filing jointly)		Apply separately to each person.	Apply separately to each person.
Married Couple— With Loss From the Same Event	Filing Jointly	Apply as if you were one person.	Apply as if you were one person.
	Filing Separately	Apply separately to each spouse.	Apply separately to each spouse.
More Than One Owner (other than a married couple filing jointly)		Apply separately to each owner of jointly owned property.	Apply separately to each owner of jointly owned property.

property are involved in an event. Only a single \$100 reduction applies.

Example. A hailstorm damages your home and your car. Determine the amount of loss, as discussed earlier, for each of these items. Since the losses are due to a single event, you combine the losses and reduce the combined amount by \$100.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

10% Rule

You must reduce the total of all your casualty or theft losses by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100. If you have both gains and losses from casualties or thefts, see *Gains and losses*, later in this discussion.

Example 1. In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was \$2,000. Your adjusted gross income is \$29,500. You first apply the \$100 rule and then the 10% rule. Figure your theft loss deduction as follows.

1) Loss after insurance	\$2,000
2) Subtract \$100	100
3) Loss after \$100 rule	\$1,900
4) Subtract 10% × \$29,500 AGI	2,950
5) Theft loss deduction	-0-

You do not have a theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$2,950).

Example 2. In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was \$1,200. In November, a fire damaged your basement and totally destroyed

the furniture, washer, dryer, and other items stored there. Your loss on the basement items after reimbursement was \$1,700. Your adjusted gross income is \$25,000. You figure your casualty loss deduction as follows.

	Car	Basement
1) Loss	\$1,200	\$1,700
2) Subtract \$100 per incident	100	100
3) Loss after \$100 rule	<u>\$1,100</u>	<u>\$1,600</u>
4) Total loss		\$2,700
5) Subtract 10% × \$25,000 AGI		2,500
6) Casualty loss deduction		\$200

Gains and losses. If you had both gains and losses from casualties or thefts to personal-use property, you must compare your total gains to your total losses. Do this after you have reduced each loss by \$100.

Losses more than gains. If your losses are more than your recognized gains, subtract your gains from your losses and reduce the result by 10% of your adjusted gross income. The rest is your deductible loss.

Gains more than losses. If your recognized gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your losses.

When To Report Gain or Loss

If you receive an insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a gain from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone the gain as explained in Publication 547.

If you have a loss, see *Table 27–2*.

Loss on deposits. If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits*, earlier.

Casualty loss. Generally, you can deduct a casualty loss only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year.

Theft loss. You can generally deduct a theft loss only in the year you discover your property was stolen. You must be able to show that there was a theft, but you do not have to know when the theft occurred. However, you should show when you discovered that your property was missing.

Disaster Area Loss

If you have a casualty loss in a Presidentially declared disaster area, you can choose to deduct the loss on your tax return for either of the following years.

- 1) The year the casualty occurred.
- 2) The year immediately preceding the year the casualty occurred.

Postponed tax deadlines. The IRS may postpone for up to 120 days certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area by publishing a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement.

Table 27–2. **When To Deduct a Loss**

IF you have a loss...	THEN deduct it in the year...
From a casualty,	The loss occurred.
In a Presidentially declared disaster area,	The disaster occurred or the year immediately before the disaster.
From a theft,	The theft was discovered.
On a deposit treated as a:	
• Casualty,	• A reasonable estimate can be made.
• Bad debt,	• Deposits are totally worthless.
• Ordinary loss,	• A reasonable estimate can be made.

- Any individual whose main home is located in a covered disaster area (defined later).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any relief worker affiliated with a recognized government or philanthropic organization who is assisting in a covered disaster area.
- Any individual, business entity, or sole proprietor whose records are needed to meet a postponed deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does **not** have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.

- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any other person determined by the IRS to be affected by a Presidentially declared disaster.

Covered disaster area. This is an area of a Presidentially declared disaster area in which the IRS has decided to postpone tax deadlines for up to 120 days.

Abatement of interest. In addition to postponing the tax deadlines, the IRS may grant an extension to file income tax returns and pay income tax. In this case, the IRS will abate the interest for the length of the extension period and for the length of any postponement.

More information. For more information, see *Disaster Area Losses* in Publication 547.

How To Report Gains and Losses

Use Form 4684 to report a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out.

IF you have a:	Report it on:
Gain	Schedule D (Form 1040)
Loss	Schedule A (Form 1040)

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any deductible loss and any insurance or other reimbursement. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 14 for more information.

Net operating loss (NOL). If your casualty or theft loss deduction is more than your income, you may have an NOL. You can use an NOL to lower your tax in an earlier year, allowing you to get a refund for tax you have already paid. Or, you can use it to lower your tax in a later year. You do not have to be in business to have an NOL from a casualty or theft loss. For more information, see Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

28.

Car Expenses and Other Employee Business Expenses

Important Change

Standard mileage rate. The standard mileage rate for the cost of operating your car in 2001 is 34½ cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained under *Transportation Expenses*, later.

Important Reminders

Standard meal allowance. The standard meal allowance (also referred to as the limit on meals and incidental expenses (M&IE rate)) for most small localities in the United States is \$30. However, the standard meal allowance is higher for most major cities and many other localities in the continental United States. See Publication 1542, *Per Diem Rates*. These rates (allowances/limits) are also listed in Appendix A of Chapter 41, Part 301 of the Code of Federal Regulations. If you have a computer, you can find them on the Internet at www.policyworks.gov/perdiem. Click on "Domestic per diem rates." Use of the standard meal allowance is explained under *What Travel Expenses Are Deductible*, later.

Meal expenses when subject to "hours of service" limits. Generally, you can deduct only 50% of your business-related meal expenses while traveling away from your tax home for business purposes. You can deduct a higher percentage if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. (These limits apply to certain workers who are under certain federal regulations.) The percentage is 60% for 2001. See *Exceptions to the 50% Limit* under *50% Limit*, later.

Limits that apply to employee deductions. If you are an employee, deduct your work-related expenses discussed in this chapter as a miscellaneous itemized deduction on Schedule A (Form 1040). Generally, the amount of miscellaneous itemized deductions you can deduct is limited to the amount that is more than 2% of your adjusted gross income. It may be further limited if your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing separately). For more information, see chapter

22 and the instructions for Schedule A (Form 1040).

Introduction

You may be able to deduct the ordinary and necessary business-related expenses you have for:

- Travel,
- Entertainment,
- Gifts, or
- Transportation.

An **ordinary expense** is one that is common and accepted in your field of trade, business, or profession. A **necessary expense** is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

This chapter explains:

- What expenses are deductible,
- What records you need to prove your expenses,
- How to treat any expense reimbursements you may receive, and
- How to report your expenses on your return.

Who does not need to use this publication.

If you are an employee, you will not need to read this chapter if **all** of the following are true.

- 1) You fully accounted to your employer for your work-related expenses.
- 2) You received full reimbursement for your expenses.
- 3) Your employer required you to return any excess reimbursement and you did so.
- 4) Box 12 of your Form W-2, *Wage and Tax Statement*, shows no amount with a code **L**.

If you meet these four conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements*, later, if you would like more information on reimbursements and accounting to your employer.



If you meet these conditions and your employer included reimbursements on your Form W-2 in error, ask your employer for a corrected Form W-2.

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses
- 1542** Per Diem Rates

Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions

- Schedule C (Form 1040)** Profit or Loss From Business
- Schedule C-EZ (Form 1040)** Net Profit From Business
- Schedule F (Form 1040)** Profit or Loss From Farming
- Form 2106** Employee Business Expenses
- Form 2106-EZ** Unreimbursed Employee Business Expenses

Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section defines "travel expenses," "tax home," "temporary assignment," and the "standard meal allowance." It also discusses the rules for travel inside and outside the United States and deductible convention expenses.

Travel expenses defined. For tax purposes, travel expenses are the ordinary and necessary expenses (defined earlier) of traveling away from home for your business, profession, or job.

You will find examples of deductible travel expenses in *Table 28-1*.

Traveling away from home. You are traveling away from home if:

- 1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
- 2) You need to sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1. You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home.

Example 2. You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, you are not traveling away from home. You cannot deduct travel expenses.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accom-

Table 28–1. Travel Expenses You Can Deduct

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

IF you have expenses for:	THEN you can deduct the costs of:
Transportation	Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see <i>Luxury Water Travel</i> and <i>Cruise ships</i> (under <i>Conventions</i>) in Publication 463 for additional rules and limits.
Taxi, commuter bus, and airport limousine	Fares for these and other types of transportation that take you between: <ul style="list-style-type: none"> • The airport or station and your hotel, and • The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
Baggage and shipping	Sending baggage and sample or display material between your regular and temporary work locations.
Car	Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
Lodging and meals	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See <i>Meals</i> for additional rules and limits.
Cleaning	Dry cleaning and laundry.
Telephone	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

pany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

Tax Home

To determine whether you are traveling away from home, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the **entire city or general area** in which your business or work is located.

If you have more than one regular place of business, your tax home is your main place of business. See *Main place of business or work*, later.

If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work*, later.

If you do not have a regular place of business or post of duty and there is no place where you regularly live, you are considered a **transient (an itinerant)** and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered to be traveling away from home.

Main place of business or work. If you have more than one place of work, consider the following when determining which one is your main place of business or work.

- 1) The total time you ordinarily spend in each place.
- 2) The level of your business activity in each place.

- 3) Whether your income from each place is significant or insignificant.

Example. You live in Cincinnati where you have a seasonal job for 8 months each year and earn \$25,000. You work the other 4 months in Miami, also at a seasonal job, and earn \$9,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live.

Factors used to determine tax home. If you do not have a regular or main place of business or work, use the following three factors to determine where your tax home is.

- 1) You perform part of your business in the area of your main home and use that home for lodging while doing business in the area.
- 2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
- 3) You have not abandoned the area in which both your historical place of lodging and your claimed main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you satisfy all three factors, your tax home is the home where you regularly live. If you satisfy only two factors, you may have a tax home depending on all the facts and circumstances. If you satisfy only one factor, you are a **transient**; your tax home is wherever you work and you cannot deduct travel expenses.

Example. You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training throughout the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You do not satisfy factor (1) because you did not work in Boston. You satisfy factor (2) because you had duplicate living expenses. You also satisfy factor (3) because you did not abandon your apartment in Boston as your main home, you kept your community contacts, and you frequently returned to live in your apartment. You have a tax home in Boston.

Travel to family home. If you (and your family) do not live at your tax home, you cannot deduct the cost of traveling between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Example 1* that follows.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 2*, below.

Example 1. You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any expenses you have for meals and lodging in Phoenix or the cost of traveling from Phoenix to Tucson. This is because Phoenix is your tax home.

Example 2. Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

Temporary Assignment or Job

You may regularly work at your tax home and another location. It may not be practical to return home from this other location at the end of each work day.

Temporary assignment vs. indefinite assignment. If your assignment or job away from your main place of work is **temporary**, your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. You can deduct your travel expenses, if they otherwise qualify for deduction. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is **indefinite**, the location of the assignment or job becomes your new tax home and you cannot deduct your travel expenses while there. An assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See chapter 19 for more information.

Exception for federal crime investigations or prosecutions. If you are a federal employee participating in a federal crime investigation or

prosecution, you are not subject to the one-year rule. This means you may be able to deduct travel expenses even if you are away from your tax home for more than one year.

For you to qualify, the Attorney General must certify that you are traveling:

- 1) For the federal government,
- 2) In a temporary duty status, and
- 3) To investigate or prosecute, or provide support services for the investigation or prosecution of, a federal crime.

You can deduct your otherwise allowable travel expenses throughout the period of certification.

Determining temporary or indefinite. You must determine whether your assignment is temporary or indefinite when you start work. If you expect an assignment or job to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. An assignment or job that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

Going home on days off. If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling between your temporary place of work and your tax home. You can claim these expenses up to the amount it would have cost you to stay at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any of your expenses for meals and lodging during the probationary period.

What Travel Expenses Are Deductible?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.

You can deduct ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

Table 28–1 summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.



When you travel away from home on business, you should keep records of all the expenses you have and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described in *Table 28–2*.

Separating costs. If you have one expense that includes the costs of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses.

Employee. You can deduct the travel expenses of someone who goes with you if that person:

- 1) Is your employee,
- 2) Has a bona fide business purpose for the travel, and
- 3) Would otherwise be allowed to deduct the travel expenses.

Business associate. If a business associate travels with you and meets the conditions in (2) and (3) above, you can deduct the travel expenses you have for that person. A business associate is someone with whom you could reasonably expect to actively conduct business. A business associate can be a current or prospective (likely to become) customer, client, supplier, employee, agent, partner, or professional advisor.

Bona fide business purpose. A bona fide business purpose exists if you can prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to make the expenses deductible.

Example. Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee. Linda occasionally types notes, performs similar services, and accompanies Jerry to luncheons and dinners. The performance of these services does not establish that her presence on the trip is necessary to the conduct of Jerry's business. Her expenses are not deductible.

Jerry pays \$115 a day for a double room. A single room costs \$90 a day. He can deduct the total cost of driving his car to and from Chicago, but only \$90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

Meals

You can deduct the cost of meals in either of the following two situations.

- 1) It is necessary for you to stop for substantial sleep or rest to properly perform your duties while traveling away from home on business.
- 2) The meal is business-related entertainment.

Business-related entertainment is discussed under *Entertainment Expenses*, later. The following discussion deals only with meals that are not business-related entertainment.

Lavish or extravagant. You cannot deduct expenses for meals that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

50% limit on meals. You can figure your meal expenses using either of the following two methods.

- 1) Actual cost.
- 2) The standard meal allowance.

Both of these methods are explained below. But, regardless of the method you use, you generally can deduct only 50% of the unreimbursed cost of your meals.

If you are reimbursed for the cost of your meals, how you apply the 50% limit depends on whether your employer's reimbursement plan was accountable or nonaccountable. If you are not reimbursed, the 50% limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses*. Accountable and nonaccountable plans are discussed later under *Reimbursements*.

Actual cost. You can use the actual cost of your meals to figure the amount of your expense before reimbursement and application of the 50% deduction limit. If you use this method, you must keep records of your actual cost.

Standard meal allowance. Generally, you can use the "standard meal allowance" method as an alternative to the actual cost method. It allows you to use a set amount for your daily meals and incidental expenses (M&IE), instead of keeping records of your actual costs. The set amount varies depending on where and when you travel. In this chapter, "standard meal allowance" refers to the federal rate for M&IE, discussed later under *Amount of standard meal allowance*. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See *Recordkeeping*, later.

Incidental expenses. These include, but are not limited to, your costs for the following items.

- 1) Laundry, cleaning and pressing of clothing.
- 2) Fees and tips for persons who provide services, such as porters and baggage carriers.

Incidental expenses do not include taxicab fares, lodging taxes, or the costs of telegrams or telephone calls.



Federal employees should refer to the federal travel regulations at www.policyworks.gov/ftr for changes affecting their claims for reimbursement of these expenses.

50% limit may apply. If you use this method for meal expenses and you are not reimbursed or you are reimbursed under a nonaccountable plan, you can generally deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount. The 50% limit is explained later under *Entertainment Expenses*. Accountable and nonaccountable plans are discussed later under *Reimbursements*.



There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.

Who can use the standard meal allowance? You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses.

Who cannot use the standard meal allowance. You cannot use the standard meal allowance if you are related to your employer as defined next.

Related to employer. You are related to your employer if:

- 1) Your employer is your brother or sister, half brother or half sister, spouse, ancestor, or lineal descendant,
- 2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
- 3) Certain relationships (such as grantor, fiduciary, or beneficiary) exist between you, a trust, and your employer.

You may be considered to indirectly own stock, for purposes of (2), if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a member of your family or your partner owns the stock.

Use of the standard meal allowance for other travel. You can use the standard meal allowance to figure your meal expenses when you travel in connection with investment and other income-producing property. You can also use it to figure your meal expenses when you travel for qualifying educational purposes. You **cannot** use the standard meal allowance to figure the cost of your meals when you travel for medical or charitable purposes.

Amount of standard meal allowance. The standard meal allowance is the federal M&IE rate. For travel in 2001, the rate is **\$30 a day** for most small localities in the United States. Most major cities and many other localities in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. Locations qualifying for rates of \$34, \$38, \$42, or \$46 a day are listed in Publication 1542.

If you travel to more than one location in one day, use the rate in effect for the area where you

stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers*, later.

Standard meal allowance for areas outside the continental United States. The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas*.



Your employer may have these rates available, or you can purchase the publication from the:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250-7954



You can also order it by calling the Government Printing Office at 1-202-512-1800 (not a toll-free number).



Per diem rates are also available on the Internet. If you have a computer and a modem, you can access foreign per diem rates at:

www.state.gov

You can access domestic per diem rates at:
www.policyworks.gov/perdiem

Special rate for transportation workers. You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

- 1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
- 2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a **\$38 a day** standard meal allowance (\$42 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, you must use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for days you depart and return. For both the day you depart for and the day you return from a business trip, you must prorate the standard meal allowance (figure a reduced amount for each day). You can do so by one of two methods.

- 1) **Method 1:** You can claim $\frac{3}{4}$ of the standard meal allowance, or
- 2) **Method 2:** You can prorate using any method that you consistently apply and that is in accordance with reasonable business practice.

Example. Jen is employed in New Orleans as a convention planner. In March, her employer

sent her on a 3-day trip to Washington, DC, to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, DC, at 5:30 p.m. After spending two nights there, she flew back to New Orleans on Friday and arrived back home at 8:00 p.m. Jen's employer gave her a flat amount to cover her expenses and included it with her wages.

Under Method 1, Jen can claim 2½ days of the standard meal allowance for Washington, DC: ¾ of the daily rate for Wednesday and Friday (the days she departed and returned), and the full daily rate for Thursday.

Under Method 2, Jen could also use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim 3 days of the standard meal allowance even though a federal employee would have to use method 1 and be limited to only 2½ days.

Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States. See *Part of Trip Outside the United States*, later.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a personal side trip, or had other personal activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example. You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend \$630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been \$580. You can deduct \$580 for your trip, including the round-trip transportation to and from New Orleans. The deduction for your meals is subject to the 50% limit on meals mentioned earlier.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your

destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules for travel in the United States. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States*.

Example. You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. Because there are no scheduled stops between Puerto Rico and New York, all of the return trip is outside the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

See chapter 1 of Publication 463 for information on luxury water travel.

Travel Entirely for Business or Considered Entirely for Business

You can deduct all your travel expenses of getting to and from your business destination if your trip is entirely for business or considered entirely for business.

Travel entirely for business. If you travel outside the United States and you spend the entire time on business activities, you can deduct all of your travel expenses.

Travel considered entirely for business. Even if you did not spend your entire time on business activities, your trip is considered entirely for business if you meet at least one of the following four exceptions.

Exception 1 – No substantial control. Your trip is considered entirely for business if you did not have substantial control over arranging the trip. The fact that you control the timing of your trip does not, by itself, mean that you have substantial control over arranging your trip.

You do not have substantial control over your trip if you:

- 1) Are an employee who was reimbursed or paid a travel expense allowance,
- 2) Are not related to your employer, and
- 3) Are not a managing executive.

“Related to your employer” was defined earlier in this chapter under *Who cannot use the standard meal allowance?*

A “managing executive” is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

Exception 2 – Outside United States no more than a week. Your trip is considered entirely for business if you were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but do count the day you return to the United States.

Exception 3 – Less than 25% of time on personal activities. Your trip is considered entirely for business if:

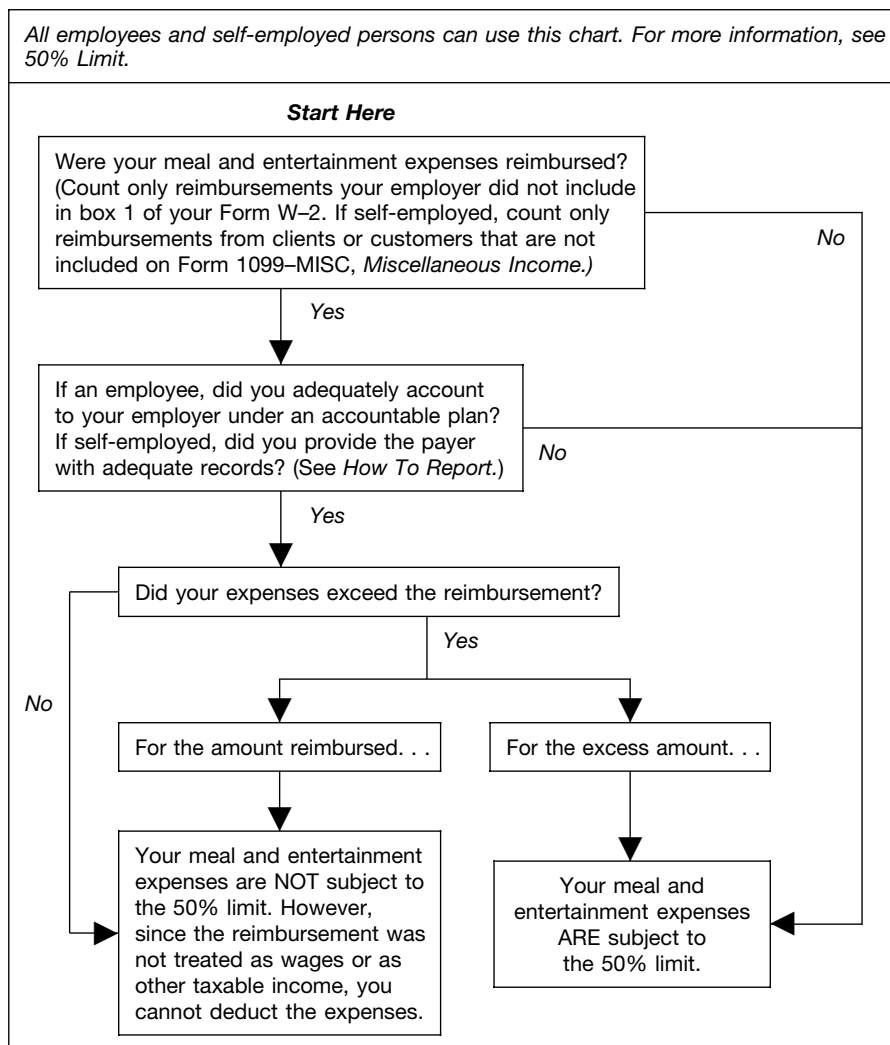
- 1) You were outside the United States for more than a week, and
- 2) You spent less than 25% of the total time you were outside the United States on nonbusiness activities.

For this purpose, count both the day your trip began and the day it ended.

Exception 4 – Vacation not a major consideration. Your trip is considered entirely for business if you can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

Figure 28–A. Does the 50% Limit Apply to Your Expenses?

There are exceptions to these rules. See *Exceptions to the 50% Limit*.



cial duties and responsibilities; it will be enough if the agenda is so related to your position that it shows your attendance was for business purposes.

Conventions held outside the North American area. See chapter 1 of Publication 463 for information on conventions held outside the North American area.

Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

You can deduct entertainment expenses only if they are both ordinary and necessary (defined earlier) and meet one of the following two tests.

- 1) Directly-related test.
- 2) Associated test.

Both of these tests are explained in Publication 463.



The amount you can deduct for entertainment expenses may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under 50% Limit.

Club dues and membership fees. You cannot deduct dues (including initiation fees) for membership in any club organized for:

- 1) Business,
- 2) Pleasure,
- 3) Recreation, or
- 4) Other social purpose.

This rule applies to any membership organization if one of its principal purposes is either:

- 1) To conduct entertainment activities for members or their guests, or
- 2) To provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not you can deduct the dues. You cannot deduct dues paid to:

- 1) Country clubs,
- 2) Golf and athletic clubs,
- 3) Airline clubs,
- 4) Hotel clubs, and
- 5) Clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot de-

Travel Primarily for Business

If you travel outside the United States primarily for business but spend some of your time on nonbusiness activities, you generally cannot deduct all of your travel expenses. You can only deduct the business portion of your cost of getting to and from your destination. You must make an allocation between your business and nonbusiness activities to determine your deductible amount. These travel allocation rules are discussed in chapter 1 of Publication 463.



You do not have to allocate your travel expense deduction if you meet one of the four exceptions listed earlier under Travel considered entirely for business. In those cases, you can deduct the total cost of getting to and from your destination.

Travel Primarily for Personal Reasons

If you travel outside the United States primarily for vacation or for **investment** purposes, the entire cost of the trip is a nondeductible **personal expense**. If you spend some time attending brief professional seminars or a continuing

education program, you can deduct your registration fees and other expenses you have that are directly related to your business.

Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family.

If the convention is for **investment**, political, social, or other nonbusiness purposes, you cannot deduct the expenses.



Your appointment or election as a delegate does not, in itself, determine whether you can deduct travel expenses. You can deduct your travel expenses only if your attendance is connected to your own trade or business.

Convention agenda. The convention agenda or program generally shows the purpose of the convention. You can show your attendance at the convention benefits your trade or business by comparing the agenda with the official duties and responsibilities of your position. The agenda does not have to deal specifically with your offi-

duct expenses for entertainment that are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally cannot deduct more than the face value of the ticket, even if you paid a higher price.

Gift or entertainment. Any item that might be considered either a gift or entertainment generally will be considered entertainment. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift.

If you give a customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you have a choice. You can treat the cost of the tickets as either a gift expense or an entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date by filing an amended return. Generally, an amended return must be filed within 3 years from the date the original return was filed or within 2 years from the time the tax was paid, whichever is later.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the cost of the tickets as a gift expense.

Separating costs. If you have one expense that includes the costs of entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of entertainment and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes entertainment in its lounge on the same bill with your room charge.

A meal as a form of entertainment. Entertainment includes the cost of a meal you provide to a customer or client, whether the meal is a part of other entertainment or by itself. A meal expense includes the cost of food, beverages, taxes, and tips for the meal. To deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.



You cannot claim the cost of your meal both as an entertainment expense and as a travel expense.

Taking turns paying for meals or entertainment. If a group of business acquaintances take turns picking up each others' meal or entertainment checks without regard to whether any business purposes are served, no member of the group can deduct any part of the expense.

Trade association meetings. You can deduct expenses for entertainment that are directly related to, and necessary for, attending business meetings or conventions of certain exempt organizations **if** the expenses of your attendance are related to your active trade or business. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations.

Additional information. For more information on entertainment expenses, including discussions of the directly-related and associated tests, see chapter 2 of Publication 463.

50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. (If you are subject to the Department of Transportation's "hours of service" limits, you can deduct a higher percentage. See *Individuals subject to "hours of service" limits*, later.)

The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

Figure 28–A summarizes the general rules explained in this section.

The 50% limit applies to business meals or entertainment expenses you have while:

- 1) Traveling away from home (whether eating alone or with others) on business,
- 2) Entertaining customers at your place of business, a restaurant, or other location, or
- 3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Included expenses. Expenses subject to the 50% limit include:

- Taxes and tips relating to a business meal or entertainment activity,
- Cover charges for admission to a nightclub,
- Rent paid for a room in which you hold a dinner or cocktail party, and
- Amounts paid for parking at a sports arena.

However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

Application of 50% limit. The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by one of the exceptions discussed later in this section.

The 50% limit also applies to certain meal and entertainment expenses that are not business-related. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the other rules discussed in this chapter.

Example 1. You spend \$100 for a business-related meal. If \$40 of that amount is not allowable because it is lavish and extravagant, the remaining \$60 is subject to the 50% limit. Your deduction cannot be more than \$30 (.50 × \$60).

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid \$150 for the two tickets, which had a face

value of \$60 each (\$120 total). Your deduction cannot be more than \$60 (.50 × \$120).

Exceptions to the 50% Limit

Generally, business-related meal and entertainment expenses are subject to the 50% limit. *Figure 28–A* can help you determine if the 50% limit applies to you.

Your meal or entertainment expense is **not** subject to the 50% limit if the expense meets either of the following exceptions.

Employee's reimbursed expenses. If you are an employee, you are not subject to the 50% limit on the amount of expenses for which your employer reimburses you under an accountable plan. Accountable plans are discussed later under *Reimbursements*.

Individuals subject to "hours of service" limits. You can deduct a higher percentage of your meal expenses if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage is 60% for 2001, and it gradually increases to 80% by the year 2008.

Individuals subject to the Department of Transportation's "hours of service" limits include the following persons.

- 1) Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
- 2) Interstate truck operators and bus drivers who are under Department of Transportation regulations.
- 3) Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
- 4) Certain merchant mariners who are under Coast Guard regulations.

Gift Expenses

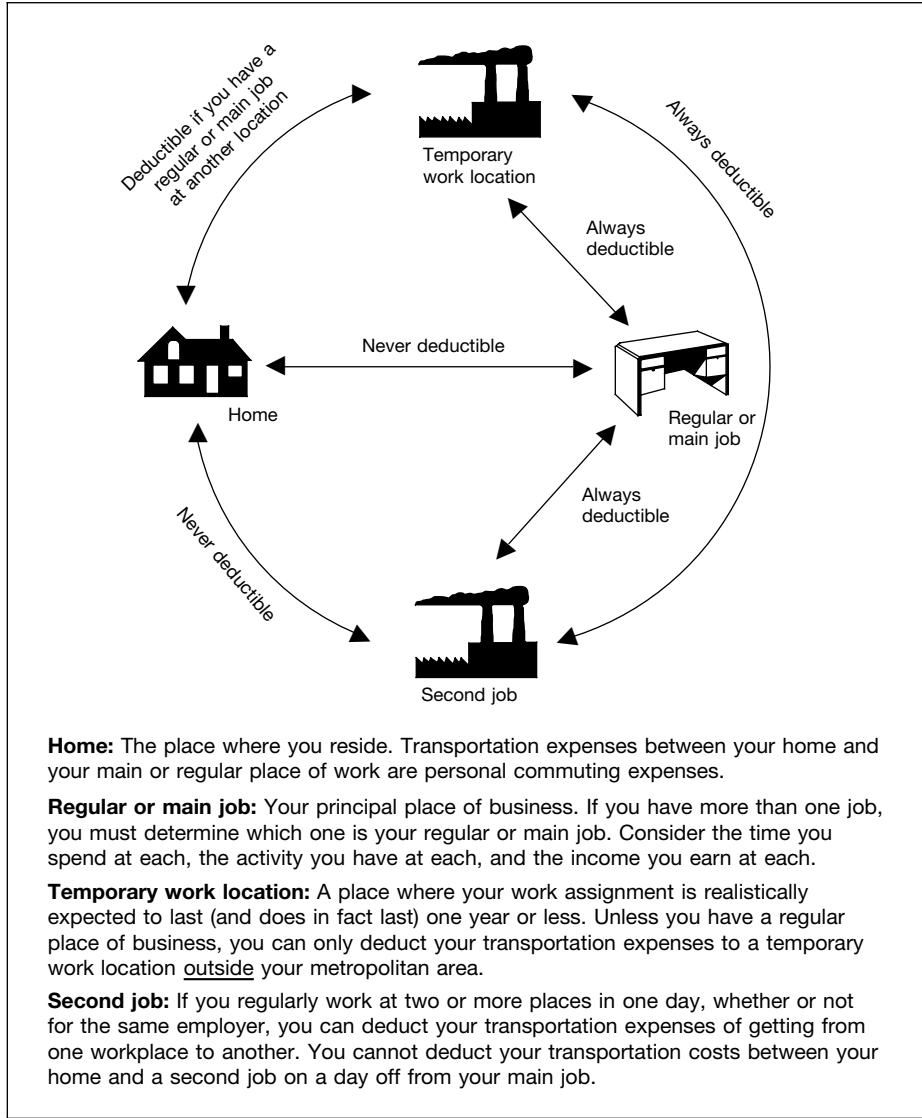
If you give gifts in the course of your trade or business, you can deduct all or part of the cost. This section explains the limits and rules for deducting the costs of gifts.

\$25 limit. You can deduct no more than \$25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If you give a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule does not apply if you have a bona fide, independent business connection with that family member and the gift is not intended for the customer's eventual use.

Figure 28–B. When Are Transportation Expenses Deductible?

Most employees and self-employed persons can use this chart. (Do not use this chart if your home is your principal place of business. See *Office in the home.*)



tickets as either a gift expense or an entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date by filing an amended return. Generally, an amended return must be filed within 3 years from the date the original return was filed or within 2 years from the time the tax was paid, whichever is later.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the cost of the tickets as a gift expense.

Transportation Expenses

This section discusses expenses you can deduct for business transportation when you are not traveling away from home as defined earlier. These expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Transportation expenses include the ordinary and necessary costs of all of the following.

- Getting from one workplace to another in the course of your business or profession when you are traveling within your tax home. (Tax home is defined earlier under *Travel Expenses.*)
- Visiting clients or customers.
- Going to a business meeting away from your regular workplace.
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Transportation expenses do **not** include expenses you have while traveling away from home overnight. Those expenses are travel expenses, which are discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your car expense deduction. See *Car Expenses*, later.

Illustration of transportation expenses. *Figure 28–B* illustrates the rules for when you can deduct transportation expenses when you have a regular or main job away from your home. You may want to refer to it when deciding whether you can deduct your transportation expenses.

Temporary work location. If you have one or more regular places of business away from your home and you commute to a temporary work location in the same trade or business, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location.

If your employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise.

If your employment at a work location is realistically expected to last for more than 1 year or if there is no realistic expectation that the employment will last for 1 year or less, the em-

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the \$25 limit.

A cost is incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not an incidental cost if the value of the basket is substantial compared to the value of the fruit.

Exceptions. The following items are not considered gifts for purposes of the \$25 limit.

- 1) An item that costs \$4 or less and:
 - a) Has your name clearly and permanently imprinted on the gift, and
 - b) Is one of a number of identical items you widely distribute.

Examples include pens, desk sets, and plastic bags and cases.
- 2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or entertainment generally will be considered entertainment. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift.

If you give a customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you have a choice. You can treat the cost of the

ployment is not temporary, regardless of whether it actually lasts for more than 1 year.

If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to last more than 1 year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.

If the temporary work location is beyond the general area of your regular place of work and you stay overnight, you are traveling away from home. You may have deductible travel expenses as discussed earlier in this chapter.

No regular place of work. If you have no regular place of work but ordinarily work in the metropolitan area where you live, you can deduct daily transportation costs between home and a temporary work site **outside** that metropolitan area.

Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area.

You cannot deduct daily transportation costs between your home and temporary work sites **within** your metropolitan area. These are nondeductible commuting costs.

Two places of work. If you work at two places in one day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you cannot deduct more than the amount it would have cost you to go directly from the first location to the second.

Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

Armed Forces reservists. A meeting of an Armed Forces reserve unit is a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting from one workplace to the other as just discussed under *Two places of work*.

You usually cannot deduct the expense if the reserve meeting is held on a day on which you do not work at your regular job. In this case, your transportation generally is considered a nondeductible commuting cost. However, you can deduct your transportation expenses if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These expenses are discussed earlier under *Travel Expenses*.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, or taxi, or of driving a car between **your home** and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far

your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip from personal to business. You cannot deduct your commuting expenses.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Advertising display on car. Putting display material that advertises your business on your car does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you still cannot deduct your expenses for those uses.

Car pools. You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include payments from passengers in your income. You can then deduct your car expenses (using the rules in this chapter).

Hauling tools or instruments. Hauling tools or instruments in your car while commuting to and from work does not make your car expenses deductible. However, you can deduct any additional costs you have for hauling tools or instruments (such as for renting a trailer you tow with your car).

Union members' trips from a union hall. If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses. Although you need the union to get your work assignments, you are employed where you work, not where the union hall is located.

Office in the home. If you have an office in your home that qualifies as a **principal place of business**, you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See chapter 30 for information on determining if your home office qualifies as a principal place of business.)

If your home office does not qualify as a principal place of business, follow the rules for commuting and other transportation expenses explained earlier.

Examples of deductible transportation expenses. The following examples show when you can deduct transportation expenses based on the location of your work and your home.

Example 1. You regularly work in an office in the city where you live. Your employer sends you to a one-week training session at a different office in the same city. You travel directly from your home to the training location and return

each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Example 2. Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.


Example 3. You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. Transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your deductible expenses: actual expenses or the standard mileage rate.

If you use actual expenses to figure your deduction for a car you lease, there are rules that affect the amount of your lease payments that you can deduct. See *Leasing a car* under *Actual Car Expenses*, later.

In this chapter, "car" includes a van, pickup, or panel truck.

 **TIP** You may be entitled to a tax credit for an electric vehicle (see chapter 38) or a deduction from gross income for a part of the cost of a clean-fuel vehicle that you place in service during the year. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see chapter 12 of Publication 535.

Rural mail carriers. If you are a rural mail carrier, you may be able to treat the amount of qualified reimbursement you received as the amount of your allowable expense. Because the qualified reimbursement is treated as paid under an accountable plan, your employer should not include the amount of reimbursement in your income. And, since the reimbursement equals the expense, you have no deduction to report on your tax return.

A "qualified reimbursement" is the amount of reimbursement you receive that meets both of the following conditions.

- 1) It is given as an equipment maintenance allowance (EMA) to employees of the U.S. Postal Service.
- 2) It is at the rate contained in the 1991 collective bargaining agreement. Any later agreement cannot increase the qualified reimbursement amount by more than the rate of inflation.

See your employer for information on your reimbursement.



If you are a rural mail carrier and received a qualified reimbursement, you cannot use the standard mileage rate.

Standard Mileage Rate

You may be able to use the standard mileage rate to figure the deductible costs of operating your car for business purposes. For 2001, the standard mileage rate is **34½ cents** a mile for all business miles.



If you use the standard mileage rate for a year, you **cannot** deduct your actual car expenses for that year.

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* under *How To Report*, later.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car you own, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must use it for the entire lease period. For leases that began on or before December 31, 1997, the standard mileage rate must be used for the entire portion of the lease period (including renewals) that is after that date.

If you choose to use the standard mileage rate, you are considered to have chosen not to use the depreciation methods under the Modified Accelerated Cost Recovery System (MACRS). This is because the standard mileage rate includes an allowance for depreciation that is not expressed in terms of years. If you change to the actual expenses method in a later year, but before your car is fully depreciated, you have to estimate the remaining useful life of the car and use straight line depreciation. For more information about depreciation included in the standard mileage rate, see the exception in *Methods of depreciation* under *Depreciation Deduction* in chapter 4 of Publication 463.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

- 1) Use the car for hire (such as a taxi),
- 2) Use two or more cars at the same time (as in fleet operations),
- 3) Claimed a depreciation deduction for the car using ACRS or MACRS depreciation in an earlier year,
- 4) Claimed a section 179 deduction on the car,
- 5) Claimed actual car expenses after 1997 for a car you leased, or
- 6) Are a rural mail carrier who received a qualified reimbursement. (See *Rural mail carriers*, earlier.)

Two or more cars. If you own two or more cars that are used for business at the same time, you cannot use the standard mileage rate for the business use of any car. However, you may be

able to deduct your actual expenses for operating each of the cars in your business. See *Actual Car Expenses* in chapter 4 of Publication 463 for information on how to figure your deduction.

You are **not** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

Example 1. Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can use the standard mileage rate for the business mileage of the car and the van.

Example 2. Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the van and she uses the car to travel to the various customers. Maureen cannot use the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same time. She must use actual expenses for both vehicles.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual Car Expenses

If you do not use the standard mileage rate, you may be able to deduct your actual car expenses.



If you qualify to use both methods, you may want to figure your deduction both ways to see which gives you a larger deduction.

Actual car expenses include the costs of:

Depreciation	Lease payments	Registration fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. You can divide your expense based on the miles driven for each purpose.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see chapter 5 of Publication 535.



If you use a home equity loan to purchase your car, you may be able to deduct the interest. See chapter 25 for more information.

Taxes paid on your car. If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See chapter 24 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and are recovered through depreciation, discussed later.

Fines and collateral. You cannot deduct fines and collateral you pay for traffic violations.

Depreciation and section 179 deductions. Generally, the cost of a car, plus sales tax, luxury tax, and improvements, is a capital expense. Because the benefits last longer than one year, you generally cannot deduct a capital expense. However, you can recover this cost by claiming a section 179 deduction (the deduction allowed by section 179 of the Internal Revenue Code) and/or a depreciation deduction. By using depreciation, you recover the cost over more than one year by deducting part of it each year. The section 179 deduction and the depreciation deduction are discussed in more detail in chapter 4 of Publication 463.

Generally, there are limits on both of these deductions. Special rules apply if you use your car 50% or less in your work or business.

Leasing a car. If you lease a car that you use in your business, you can use the standard mileage rate or actual expenses to figure your deductible car expense.

Deductible payments. If you choose to use actual expenses, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for personal use of the car, such as commuting.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car, even if the payments are called lease payments.

If you lease a car for 30 days or more, you may have to reduce your lease payment deduction by an "inclusion amount." For information on reporting lease inclusion amounts, see *Leasing a Car* in chapter 4 of Publication 463.

Sale, Trade-in, or Other Disposition

If you sell, trade in, or otherwise dispose of your car, you may have a taxable gain or a deductible loss. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car. Chapter 15 has information on sales of property. For details on how to report the disposition, see Publication 544.

Recordkeeping

If you deduct travel, entertainment, gift, or transportation expenses, you must be able to prove (substantiate) certain elements of the expense.

This section discusses the records you need to keep to prove these expenses.



If you keep timely and accurate records, you will have support to show the IRS if your tax return is ever examined. You will also have proof of expenses that your employer may require if you are reimbursed under an accountable plan. These plans are discussed later under *Reimbursements*.

How To Prove Expenses

Table 28–2 is a summary of records you need to prove each expense discussed in this chapter. You must be able to prove the elements listed across the top portion of the chart. You prove them by having the information and receipts (where needed) for the expenses listed in the first column.



You cannot deduct amounts that you approximate or estimate.

You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone. However, if you prepare a record in a computer memory device with the aid of a logging program, it is considered an adequate record.

What Are Adequate Records?

You should keep the proof you need in an account book, diary, statement of expense, or similar record. You should also keep documentary evidence that, together with your records, will support each element of an expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses.

Exception. Documentary evidence is not needed if any of the following conditions apply.

- 1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging. (Accountable plans and per diem allowances are discussed later under *Reimbursements*.)
- 2) Your expense, other than lodging, is less than \$75.
- 3) You have a transportation expense for which a receipt is not readily available.

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has all of the following information.

- 1) The name and location of the hotel.
- 2) The dates you stayed there.

- 3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has all of the following information.

- 1) The name and location of the restaurant.
- 2) The number of people served.
- 3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

Timely-kept records. You should record the elements of an expense or of a business use at or near the time of the expense or use and support it with sufficient documentary evidence. A timely-kept record has more value than a statement prepared later when generally there is a lack of accurate recall.

You do not need to write down the elements of every expense on the day of the expense. If you maintain a log on a weekly basis which accounts for use during the week, the log is considered a timely-kept record.

If you give your employer, client, or customer an expense account statement, it can also be considered a timely-kept record. This is true if you copy it from your account book, diary, statement of expense, or similar record.

Proving business purpose. You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, then you do not need to give a written explanation.

Confidential information. You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

What If I Have Incomplete Records?

If you do not have complete records to prove an element of an expense, then you must prove the element with:

- 1) Your own written or oral statement, containing specific information about the element, and
- 2) Other supporting evidence that is sufficient to establish the element.

Destroyed records. If you cannot produce a receipt because of reasons beyond your control, you can prove a deduction by reconstructing your records or expenses. Reasons beyond your control include fire, flood, and other casualty.

Separating and Combining Expenses

This section explains when expenses must be kept separate and when expenses can be combined.

Separating expenses. Each separate payment is generally considered a separate expense. For example, if you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

Combining items. You can make one daily entry in your record for reasonable categories of expenses. Examples are taxi fares, telephone calls, or other incidental travel costs. Meals should be in a separate category. You can include tips for meal-related services with the costs of the meals.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Allocating total cost. If you can prove the total cost of travel or entertainment but you cannot prove how much it cost for each person who participated in the event, you may have to allocate the total cost among you and your guests on a pro rata basis. An allocation would be needed, for example, if you did not have a business relationship with all of your guests.

If your return is examined. If your return is examined, you may have to provide additional information to the IRS. This information could be needed to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

How Long To Keep Records and Receipts

You must keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep your records that support

Table 28–2. **How To Prove Certain Business Expenses**

IF you have expenses for:	THEN you must keep records that show details of the following elements.			
	Amount	Time	Place or Description	Business Purpose and Business Relationship
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, daily meals for traveler, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained. <u>Relationship:</u> N/A
Entertainment	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see <i>Business Purpose</i> .)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see <i>Business Purpose</i> .)	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity. <u>Relationship:</u> Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
Gifts	Cost of the gift.	Date of the gift.	Description of the gift.	
Transportation	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination.	<u>Purpose:</u> Business purpose for the expense. <u>Relationship:</u> N/A

your deduction (or an item of income) for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date. For a more complete explanation, get Publication 583, *Starting a Business and Keeping Records*.

Reimbursed for expenses. Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep copies of this information. However, you may have to prove your expenses if any of the following conditions apply.

- 1) You claim deductions for expenses that are more than reimbursements.
- 2) Your expenses are reimbursed under a nonaccountable plan.
- 3) Your employer does not use adequate accounting procedures to verify expense accounts.
- 4) You are related to your employer, as defined earlier under *Who cannot use the standard meal allowance*.

See the next section, *How To Report*, for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

Additional information. Chapter 5 of Publication 463 has more information on recordkeeping, including examples.

How To Report

This section explains where and how to report the expenses discussed in this chapter. It discusses reimbursements and how to treat them under accountable and nonaccountable plans. It also explains rules for fee-basis officials, certain performing artists, and certain disabled employees. This section ends with an illustration of how to report travel, entertainment, gift, and car expenses on Form 2106–EZ.

Self-employed. You must report your income and expenses on Schedule C or C–EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106 or 2106–EZ. See your form instructions for information on how to complete

your tax return. You can also find information in Publication 535 if you are a sole proprietor, or in Publication 225, *Farmer’s Tax Guide*, if you are a farmer.

Both self-employed and an employee. If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, C–EZ, or F (Form 1040), as discussed earlier. Report your business expenses for your work as an employee on Form 2106 or 2106–EZ, as discussed next.

Employee. If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use the shorter Form 2106–EZ instead of Form 2106 if you meet both of the following conditions.

- 1) You are an employee deducting expenses attributable to your job.
- 2) You were not reimbursed by your employer for your expenses (amounts included in box 1 of your Form W–2 are not considered reimbursements).

- 3) If you are claiming car expenses, you use the standard mileage rate.

For more information on how to report your expenses on Forms 2106 and 2106-EZ, see *Completing Forms 2106 and 2106-EZ*, later.

Gifts. If you did not receive any reimbursements (or the reimbursements were all included in box 1 of your Form W-2), the only business expense you are claiming is for gifts, and the rules for certain individuals (such as performing artists), discussed later under *Special Rules*, do not apply to you, do not complete Form 2106 or 2106-EZ. Instead, claim the amount of your deductible gifts directly on line 20 of Schedule A (Form 1040).

Statutory employees. If you received a Form W-2 and the "Statutory employee" box in box 13 was checked, you report your income and expenses related to that income on Schedule C or C-EZ (Form 1040). Do not complete Form 2106 or 2106-EZ.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.



If you are entitled to a reimbursement from your employer but you do not claim it, you cannot claim a deduction for the expenses to which that unclaimed reimbursement applies.

Reimbursement for personal expenses. If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income in box 1 of your Form W-2. You cannot deduct personal expenses.

Reimbursements

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

No reimbursement. You are not reimbursed or given an allowance for your expenses if you are paid a salary or commission with the understanding that you will pay your own expenses. In this situation, you have no reimbursement or allowance arrangement, and you do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106-EZ*, later, for information on completing your tax return.

Reimbursement, allowance, or advance. A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee

business expenses. Arrangements include per diem and car allowances.

A per diem allowance is a fixed amount of daily reimbursement your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. (The term "incidental expenses" is defined earlier under *Meals*.) A car allowance is an amount your employer gives you for the business use of your car.

Your employer should tell you what method of reimbursement is used and what records you must provide.

Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules.

- 1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
- 2) You must adequately account to your employer for these expenses within a reasonable period of time.
- 3) You must return any excess reimbursement or allowance within a reasonable period of time.

See *Adequate Accounting and Returning Excess Reimbursements*, later.

An **excess reimbursement or allowance** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer.

The definition of **reasonable period of time** depends on the facts and circumstances of your situation. However, regardless of the facts and circumstances of your situation, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

- 1) You receive an advance within 30 days of the time you have an expense.
- 2) You adequately account for your expenses within 60 days after they were paid or incurred.
- 3) You return any excess reimbursement within 120 days after the expense was paid or incurred.
- 4) You are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding advances **and** you comply within 120 days of the statement.

Employee meets accountable plan rules. If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W-2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.



If your employer included reimbursements in box 1 of your Form W-2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W-2.

Accountable plan rules not met. Even though you are reimbursed under an accountable plan, some of your expenses may not meet all three rules. Those expenses that fail to meet all three rules for accountable plans are treated as having been reimbursed under a nonaccountable plan (discussed later).

Reimbursement of nondeductible expenses. You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses do not meet rule (1) for accountable plans, and they are treated as paid under a nonaccountable plan.

Example. Your employer's plan reimburses you for travel expenses while away from home on business and also for meals when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals when you work late at the office is treated as paid under a nonaccountable plan.



The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.

Adequate Accounting

One of the three rules for an accountable plan is that you must adequately account to your employer for your expenses. You adequately account by giving your employer a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it, along with documentary evidence (such as receipts) of your travel, mileage, and other employee business expenses. (See Table 28-2, earlier, for details you need to enter in your record and documents you need to prove certain expenses.)

You must account for **all** amounts you received from your employer during the year as advances, reimbursements, or allowances. This includes amounts you charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that is more than the amount for which you accounted.

Per Diem and Car Allowances

If your employer reimburses you for your expenses using a per diem or car allowance, you can generally use the allowance as proof for the amount of your expenses. A per diem or car allowance satisfies the adequate accounting requirements for the amount of your expenses only if all four of the following conditions apply.

- 1) Your employer reasonably limits payments of your expenses to those that are ordinary and necessary in the conduct of the trade or business.
- 2) The allowance is similar in form to and not more than the federal rate (discussed later).
- 3) You prove the time (dates), place, and business purpose of your expenses to your employer (as explained in *Table 28-2*) within a reasonable period of time.
- 4) You are not related to your employer (as defined earlier under *Who cannot use the standard meal allowance*). If you are related to your employer, you must be able to prove your expenses to the IRS even if you have already adequately accounted to your employer and returned any excess reimbursement.

If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs (including recognition of cost differences in different areas for per diem amounts), you will not be considered to have accounted to your employer. In this case, you must be able to prove your expenses to the IRS.

The federal rate. The federal rate can be figured using any one of the following methods.

- 1) For per diem amounts:
 - a) The regular federal per diem rate.
 - b) The standard meal allowance.
 - c) The high-low rate.
- 2) For car expenses:
 - a) The standard mileage rate.
 - b) A fixed and variable rate (FAVR).

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. Your employer should have these rates available. (Employers can get Publication 1542, which gives the rates in the continental United States for the current year.)

The standard meal allowance. The standard meal allowance (discussed earlier) is the federal rate for meals and incidental expenses (M&IE). The rate for most small localities in the United States is \$30. Most major cities and many other localities qualify for higher rates. The rates for all localities within the continental United States are listed in Publication 1542.

You receive an allowance only for meals and incidental expenses when your employer does one of the following.

- 1) Provides you with lodging (furnishes it in kind).
- 2) Reimburses you, based on your receipts, for the actual cost of your lodging.
- 3) Pays the hotel, motel, etc., directly for your lodging.
- 4) Does not have a reasonable belief that you had (or will have) lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.
- 5) Computes the allowance on a basis similar to that used in computing your compensation, such as number of hours worked or miles traveled.

High-low rate. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city.

Under the high-low method, the per diem amount for travel during January through September of 2001 is \$201 (including \$42 for M&IE) for certain high-cost locations. All other areas have a per diem amount of \$124 (including \$34 for M&IE). (Employers can get Publication 1542 (Revised March 2001), which gives the areas eligible for the \$201 per diem amount under the high-low method for all or part of this period.)



Effective October 1, 2001, the per diem rates under this method increased. The increased rate for certain high-cost locations is \$204 (including \$42 for M&IE). The increased rate for all other locations is \$124 (including \$34 for M&IE). However, an employer can continue to use the lower rates described in the preceding paragraph for the remainder of 2001 if those rates and locations are used consistently during October, November, and December for all employees. Employers who did not use the high-low method during the first 9 months of 2001 cannot begin to use it before 2002. See Revenue Procedure 2001-47 for more information.

Prorating the standard meal allowance on partial days of travel. The standard meal allowance is for a full 24-hour day of travel. If you travel for part of a day, such as on the days you depart and return, you must prorate the full-day M&IE rate. This rule also applies if your employer uses the regular federal per diem rate or the high-low rate.

You can use either of the following methods to figure the federal M&IE for that day.

- 1) **Method 1:**
 - a) For the day you depart, add $\frac{3}{4}$ of the standard meal allowance amount for that day.
 - b) For the day you return, add $\frac{3}{4}$ of the standard meal allowance amount for the preceding day.
- 2) **Method 2:** Prorate the standard meal allowance using any method that you con-

sistently apply and that is in accordance with reasonable business practice.

The standard mileage rate. This is a set rate per mile that you can use to compute your deductible car expenses. For 2001, the standard mileage rate is **34½ cents a mile** for all business miles. This rate is adjusted periodically.

Fixed and variable rate (FAVR). This is an allowance your employer may use to reimburse your car expenses. Under this method, your employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your fixed costs (such as depreciation (or lease payments), insurance, etc.). If your employer chooses to use this method, your employer will request the necessary records from you.

Reporting your expenses with a per diem or car allowance. If your reimbursement is in the form of an allowance received under an accountable plan, the following two facts affect your reporting.

- 1) The federal rate.
- 2) Whether the allowance or your actual expenses were more than the federal rate.

The following discussions explain where to report your expenses depending upon how the amount of your allowance compares to the federal rate.

Allowance LESS than or EQUAL to the federal rate. If your allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W-2. You do not need to report the related expenses or the allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses are more than your allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance or the standard mileage rate, you do not have to prove that amount.

Example. Nicole drives 10,000 miles a year for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 20 cents a mile.

Since Nicole's \$3,450 expenses computed under the standard mileage rate (10,000 miles \times 34½ cents) are more than her \$2,000 reimbursement (10,000 miles \times 20 cents), she itemizes her deductions to claim the excess expenses. Nicole completes Form 2106 (showing **all** of her expenses and reimbursements) and enters \$1,450 (\$3,450 - \$2,000) as an itemized deduction.

Allowance MORE than the federal rate. If your allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate in box 12 of your Form W-2. This amount is not taxable. However, the excess allowance will be included in

Table 28–3. Reporting Travel, Entertainment, Gift, and Car Expenses and Reimbursements

IF the type of reimbursement (or other expense allowance) arrangement is under:	THEN the employer reports on Form W–2:	AND the employee reports on Form 2106: *
An accountable plan with:		
<i>Actual expense reimbursement:</i> Adequate accounting made <u>and</u> excess returned	No amount.	No amount.
<i>Actual expense reimbursement:</i> Adequate accounting and return of excess both required <u>but</u> excess not returned	The excess amount as wages in box 1.	No amount.
<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting made <u>and</u> excess returned.	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form is not filed.
<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting and return of excess both required <u>but</u> excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	No amount.
<i>Per diem or mileage allowance exceeds the federal rate:</i> Adequate accounting up to the federal rate only <u>and</u> excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.	All expenses (and reimbursement reported on Form W–2, box 13) only if expenses in excess of the federal rate are claimed. Otherwise, form is not required.
A nonaccountable plan with:		
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.	All expenses.
No reimbursement plan:	The entire amount as wages in box 1.	All expenses.
* You may be able to use Form 2106–EZ. See <i>Completing Forms 2106 and 2106–EZ</i> .		

box 1 of your Form W–2. You must report this part of your allowance as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and, generally, deduct those excess expenses. You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 12 of your Form W–2) and all your expenses. You should be able to prove these amounts to the IRS.

Example. Joe lives and works in Austin. His employer sent him to San Diego for 4 days and paid the hotel directly for Joe’s hotel bill. The employer reimbursed Joe \$50 a day for his meals and incidental expenses. The federal rate for San Diego is \$46 a day.

Joe can prove that his actual meal expenses totaled \$290. His employer’s accountable plan

will not pay more than \$50 a day for travel to San Diego, so Joe does not give his employer the records that prove that he actually spent \$290. However, he does account for the time, place, and business purpose of the trip. This is Joe’s only business trip this year.

Joe was reimbursed \$200 ($\50×4 days), which is \$16 more than the federal rate of \$184 ($\46×4 days). The employer includes the \$16 as income on Joe’s Form W–2 in box 1. The employer also enters \$184 in box 12 of Joe’s Form W–2, along with a code L.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year (\$290) on Form 2106. He also enters the reimbursements that were not included in his income (\$184). His total deductible expense, before the 50% limit, is \$106. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, \$53, as an itemized deduction.

Returning Excess Reimbursements

Under an accountable plan, you are required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. **Excess reimbursement** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

“Adequate accounting” and “reasonable period of time” were discussed earlier.

Travel advance. You receive a travel advance if your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably expected to be no more than your expense. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time.

If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

Unproved amounts. If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described in *Table 28–2*), you must return this unproved amount of the travel advance within a reasonable period of time. If you do not do this, the unproved amount is considered paid under a nonaccountable plan (discussed later).

Per diem allowance MORE than federal rate. If your employer’s accountable plan pays you an allowance that is higher than the federal rate, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W–2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example. Your employer sends you on a 5-day business trip to Phoenix and gives you a \$225 ($\45×5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses for Phoenix is \$42. Your trip lasts only 3 days. Under your employer’s accountable plan, you must return the \$90 ($\45×2 days) advance for the 2 days you did not travel. You do not have to return the \$9 difference between the allowance you received and the federal rate for Phoenix [$(\$45 - \$42) \times 3$ days]. However, the \$9 will be reported on your Form W–2 as wages.

Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed earlier under *Accountable Plans*.

In addition, even if your employer has an accountable plan, the following payments will be

treated as being paid under a nonaccountable plan.

- 1) Excess reimbursements you fail to return to your employer.
- 2) Reimbursement of nondeductible expenses related to your employer's business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans*.

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, ask your employer.

Reporting your expenses under a nonaccountable plan. Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W-2.

You must complete Form 2106 or 2106-EZ and itemize your deductions to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses*. Also, your total expenses will be subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

Example. Kim's employer gives her \$500 a month (\$6,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a nonaccountable plan. Her employer will include the \$6,000 on Kim's Form W-2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or 2106-EZ and itemize her deductions.

Completing Forms 2106 and 2106-EZ

This section briefly describes how employees complete Forms 2106 and 2106-EZ. *Table 28-3* explains what the employer reports on Form W-2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

Form 2106-EZ. You may be able to use the shorter Form 2106-EZ to claim your employee business expenses. You can use this form if you meet all 3 of the following conditions.

- 1) You are an employee deducting expenses attributable to your job.
- 2) You were not reimbursed by your employer for your expenses (amounts included in box 1 of your Form W-2 are not considered reimbursements).
- 3) If you claim car expenses, you use the standard mileage rate.

Car expenses. If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. These are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form

2106. Car expenses using the standard mileage rate can also be figured on Form 2106-EZ by completing Part II and line 1 of Part I.

Transportation expenses. Show your transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part I, of Form 2106-EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

Employee business expenses other than meals and entertainment. Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or lines 3 and 4 of Form 2106-EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.



If line 4 expenses are the only ones you are claiming, you received no reimbursements (or the reimbursements were all included in box 1 of your Form W-2), and the Special Rules discussed later do not apply to you, do not complete Form 2106 or 2106-EZ. Claim these amounts directly on line 20 of Schedule A (Form 1040). List the type and amount of each expense on the dotted lines and include the total on line 20.

Meal and entertainment expenses. Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include meals while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9, Column B, of Form 2106.

If you file Form 2106-EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

Hours of service limits. If you are subject to the Department of Transportation's "hours of service" limits, use 60% instead of 50%.

Reimbursements. Enter on line 7 of Form 2106 the amounts your employer (or third party) reimbursed you that were **not** included in box 1 of your Form W-2. (You cannot use Form 2106-EZ.) This includes any reimbursement reported under code **L** in box 13 of Form W-2.

Allocating your reimbursement. If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. This is necessary if your employer pays your reimbursement in the following manner:

- 1) Pays you a single amount that covers meals and/or entertainment, as well as other business expenses, and
- 2) Does not clearly identify how much is for deductible meals and/or entertainment.

You must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

Example. Rob's employer paid him an expense allowance of \$5,000 this year under an accountable plan. The \$5,000 payment consisted of \$2,000 for airfare and \$3,000 for entertainment and car expenses. The employer did not clearly show how much of the \$3,000 was for the cost of deductible entertainment. Rob actually spent \$6,500 during the year (\$2,000 for airfare, \$2,000 for entertainment, and \$2,500 for car expenses).

Since the airfare allowance was clearly identified, Rob knows that \$2,000 of the payment goes in Column A, line 7 of Form 2106. To allocate the remaining \$3,000, Rob uses the worksheet from the instructions for Form 2106. His completed worksheet follows.

1. Enter the total amount of reimbursements your employer gave you that were not reported to you in box 1 of Form W-2 . . .	\$3,000
2. Enter the total amount of your expenses for the periods covered by this reimbursement	4,500
3. Of the amount on line 2, enter your total expense for meals and entertainment . . .	2,000
4. Divide line 3 by line 2. Enter the result as a decimal (rounded to at least three places)	.444
5. Multiply line 1 by line 4. Enter the result here and in Column B, line 7	1,332
6. Subtract line 5 from line 1. Enter the result here and in Column A, line 7	1,668

On line 7 of Form 2106, Rob enters \$3,668 (\$2,000 airfare and \$1,668 of the \$3,000) in Column A and \$1,332 (of the \$3,000) in Column B.

After you complete the form. After you have completed your Form 2106 or 2106-EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers, this is line 20 of Schedule A (Form 1040). However, if you are a government official paid on a fee basis, a performing artist, or a disabled employee with impairment-related work expenses, see *Special Rules*, later.

Limits on employee business expenses. Your employee business expenses may be subject to any of the three limits described next. These limits are figured in the following order on the specified form.

1. Limit on meals and entertainment. Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106-EZ. See *50% Limit* under *Entertainment Expenses*, earlier.

2. Limit on miscellaneous itemized deductions. Employees deduct employee business expenses (as figured on Form 2106 or 2106-EZ) on line 20 of Schedule A (Form 1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2%-of-adjusted-gross-income limit. This limit is figured on line 25 of Schedule A (Form 1040).

3. Limit on total itemized deductions. If your adjusted gross income (line 34 of Form 1040) is more than \$134,950 (\$66,475 if you are married filing separately), the total of certain itemized deductions, including employee business expenses, may be limited. See chapter 22 for more information on this limit.

Special Rules

This section discusses special rules that apply only to government officials who are paid on a fee basis, performing artists, and disabled employees with impairment-related work expenses.

Officials paid on a fee basis. Certain fee-basis officials can claim their employee business expenses whether or not they itemize their other deductions on Schedule A (Form 1040).

Fee-basis officials are persons who are employed by a state or local government and who are paid in whole or in part on a fee basis. They can deduct their business expenses in performing services in that job as an adjustment to gross income rather than as a miscellaneous itemized deduction.

If you are a fee-basis official, include your employee business expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 32 of Form 1040. Write "FBO" and the amount of your employee business expenses in the space to the left of line 32 of Form 1040.

Expenses of certain performing artists. If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet *all* of the following requirements.

- 1) During the tax year, you perform services in the performing arts for at least two employers.
- 2) You receive at least \$200 each from any two of these employers.
- 3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.
- 4) Your adjusted gross income is not more than \$16,000 before deducting these business expenses.

Special rules for married persons. If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

Where to report. If you meet all of the above requirements, you should first complete Form 2106 or 2106-EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 32 of Form 1040. Write "QPA" and the amount of your performing-arts-related expenses in the space to the left of line 32 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106-EZ and deduct your employee business expenses as an itemized deduction on line 20 of Schedule A (Form 1040).

Impairment-related work expenses of disabled employees. If you are an employee with a physical or mental disability, your impairment-related work expenses are not subject to the 2%-of-adjusted-gross-income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106-EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 27 of Schedule A (Form 1040), and identify the type and amount of this expense on the dotted line next to line 27. Enter your employee business expenses that are *unrelated* to your disability from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 20 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see chapter 23.

Illustrated Example

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill

leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show Fashion's new line of merchandise to Town Department Store, an old customer. While in Troy, he talks with Tom Brown, purchasing agent for Town Department Store, to discuss the new line. He later takes John Smith of Attire Co. out to dinner to discuss Attire Co.'s buying Fashion's new line of clothing.

Bill purchased his car on January 3, 1998. He uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of \$75 or more.

During the year, Bill drove a total of 25,000 miles of which 20,000 miles were for business. He answers all the questions in Part II of Form 2106. He figures his car expense to be \$6,900 (20,000 business miles \times 34½ cents standard mileage rate).

His total employee business expenses are shown in the following table.

Type of Expense	Amount
Parking fees and tolls	\$ 325
Car expenses	6,900
Meals	2,632
Lodging, laundry, dry cleaning	8,975
Entertainment	1,870
Gifts, education, etc.	430
Total	\$ 21,132

Bill received an allowance of \$3,600 (\$300 per month) to help offset his expenses. Bill did not have to account to his employer for the reimbursement, and the \$3,600 was included as income in box 1 of his Form W-2.

Because Bill's reimbursement was included in his income and he is using the standard mileage rate for his car expenses, he files **Form 2106-EZ** with his tax return. His filled-in form is shown on the next page.

Unreimbursed Employee Business Expenses

2001

Attachment
Sequence No. **54A**

Department of the Treasury
Internal Revenue Service

▶ **Attach to Form 1040.**

Your name <i>Bill Wilson</i>	Occupation in which you incurred expenses <i>Sales</i>	Social security number <i>555 00 5555</i>
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You May Use This Form Only if All of the Following Apply.

- You are an employee deducting expenses attributable to your job.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2001.

Caution: You can use the standard mileage rate for 2001 **only if:** (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service **or** (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1	Vehicle expense using the standard mileage rate. Complete Part II and multiply line 8a by 34½¢ (.345).	1	6,900
2	Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	325
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	8,975
4	Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	430
5	Meals and entertainment expenses: \$ <u>4,502</u> x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 60% (.60) instead of 50%. For details, see instructions).	5	2,251
6	Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount).	6	18,881

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

- 7 When did you place your vehicle in service for business use? (month, day, year) ▶ 1 / 3 / 98
- 8 Of the total number of miles you drove your vehicle during 2001, enter the number of miles you used your vehicle for:
 a Business 20,000 b Commuting 2,600 c Other 2,400
- 9 Do you (or your spouse) have another vehicle available for personal use? **Yes** **No**
- 10 Was your vehicle available for personal use during off-duty hours? **Yes** **No**
- 11a Do you have evidence to support your deduction? **Yes** **No**
 b If "Yes," is the evidence written? **Yes** **No**

General Instructions

Section references are to the Internal Revenue Code.

A Change To Note

The standard mileage rate has been increased to 34½ cents for each mile of business use in 2001.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 to claim your unreimbursed employee business expenses if you meet all the requirements listed above Part I.

Recordkeeping

You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment, gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of \$75 or more.

Additional Information

For more details about employee business expenses, see:

Pub. 463, Travel, Entertainment, Gift, and Car Expenses

Pub. 529, Miscellaneous Deductions

Pub. 587, Business Use of Your Home (Including Use by Day-Care Providers)

Pub. 946, How To Depreciate Property

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 20604Q

Form **2106-EZ** (2001)

29.

Tax Benefits for Work-Related Education

Important Change for 2001

Standard mileage rate. Generally, if you drive your car to and from school, you can deduct 34½ cents per mile. See *Using your car* under *What Educational Expenses Are Deductible*.

Important Change for 2002

Employer-provided educational assistance program extended. The tax-free status of up to \$5,250 of employer-provided educational assistance benefits each year was scheduled to end for courses beginning after December 31, 2001. This benefit has been extended and, beginning January 1, 2002, the benefit also applies to graduate-level courses.

Introduction

If you are working and have work-related educational expenses, you may be able to deduct all or part of the cost of your education as a business expense deduction. This chapter discusses:

- Qualifying education,
- What educational expenses are deductible, and
- Where to deduct expenses.

You cannot deduct educational expenses that are not work related, such as the costs of sending your children to college. However, you may be eligible for other tax benefits. Information on the education tax credits is in chapter 36, on making withdrawals from IRAs for educational expenses in chapter 18, and on cancellation of student loans in chapter 13. Information on student loan interest is in Publication 970, *Tax Benefits for Higher Education*.

Useful Items

You may want to see:

Publication

- **463** Travel, Entertainment, Gift, and Car Expenses

- **508** Tax Benefits for Work-Related Education
- **970** Tax Benefits for Higher Education

Form (and Instructions)

- **2106** Employee Business Expenses
- **2106-EZ** Unreimbursed Employee Business Expenses
- **Schedule A (Form 1040)** Itemized Deductions

Qualifying Education

You can deduct the costs of qualifying education. This is education that meets **at least one** of the following two tests.

- 1) The education is **required by your employer or the law** to keep your present salary, status, or job. The required education must serve a bona fide business purpose of your employer.
- 2) The education **maintains or improves skills** needed in your present work.

However, even if the education meets one or both of the above tests, it is not qualifying education if it:

- 1) Is needed to meet the **minimum educational requirements** of your present trade or business, or
- 2) Is part of a program of study that will **qualify you for a new trade or business**.

You can deduct the expenses for qualifying education even if the education could lead to a degree.

You can use *Figure 29–A* as a quick check to see if your education qualifies.

Education Required by Employer or by Law

Once you have met the minimum educational requirements for your job, your employer or the law may require you to get more education. This additional education is qualifying education if all three of the following requirements are met.

- 1) It is required for you to keep your present salary, status, or job,
- 2) The requirement serves a business purpose of your employer, and
- 3) The education is not part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education can be qualifying education only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills*.

Example. You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching

job. If the courses will not qualify you for a new trade or business, they are qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

Education To Maintain or Improve Skills

If your education is not required by your employer or the law, it can be qualifying education only if it maintains or improves skills needed in your present work. This could include refresher courses, courses on current developments, and academic or vocational courses.

Example. You repair televisions, radios, and stereo systems for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

Maintaining skills vs. qualifying for new job. Education to maintain or improve skills needed in your present work is not qualifying education if it will also qualify you for a new trade or business.

Temporary absence. If you stop working for a year or less in order to get education to maintain or improve skills needed in your present work and then return to the same work, your absence is considered temporary. Education that you get during a temporary absence is qualifying education if it maintains or improves skills needed in your present work.

Example. You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work even if you do not go back to work with the same employer.

Indefinite absence. If you stop work for more than a year, your absence from your job is considered indefinite. Education during an indefinite absence, even if it maintains or improves skills needed in the work from which you are absent, is considered to qualify you for a new trade or business. Therefore, it is not qualifying education.

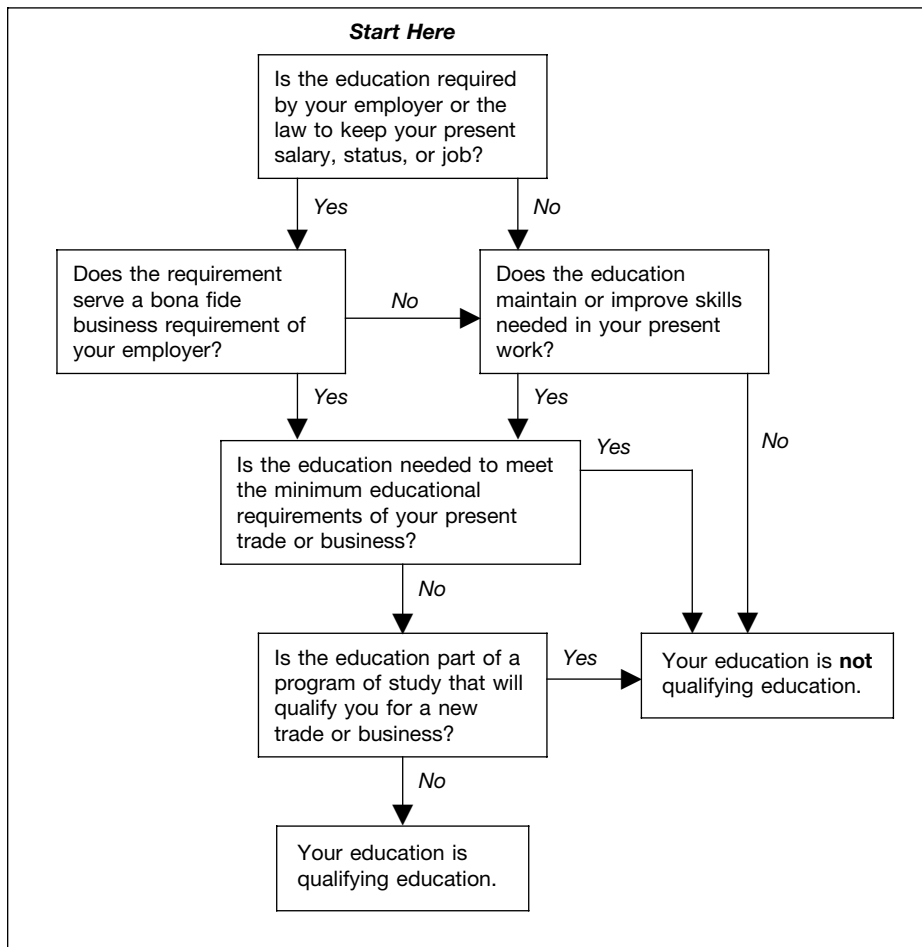
Education To Meet Minimum Requirements

Education you need to meet the minimum educational requirements for your present trade or business is not qualifying education. The minimum educational requirements are determined by:

- 1) Laws and regulations,
- 2) Standards of your profession, trade, or business, and
- 3) Your employer.

Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to meet any new minimum educational requirements. This means that if the minimum requirements change after you were hired, any education you need to meet

Figure 29-A. Does Your Education Qualify?



within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school can hire persons with only 3 years of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether or not it includes the ten professional education courses, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all the required education except the fifth year, you have met the minimum educational requirements. The fifth year of training is qualifying education unless it is part of a program of study that will qualify you for a new trade or business.

Example 2. Assume the same facts as in Example 1 except that you have a bachelor's degree and only six professional education courses. The additional four education courses can be qualifying education. Although you do not have all the required courses, you have already met the minimum educational requirements.

Example 3. Assume the same facts as in Example 1 except that you are hired with only 3 years of college. The courses you take that lead to a bachelor's degree (including those in education) are not qualifying education. They are needed to meet the minimum educational requirements for employment as a teacher.

Example 4. You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you can become a faculty member only if you get a graduate degree. Also, you can keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are not qualifying education.

Certification in a new state. Once you have met the minimum educational requirements for teachers for your state, you are considered to have met the minimum educational requirements in all states. This is true even if you must get additional education to be certified in another state. Any additional education you need is qualifying education. You have already met the minimum requirements for teaching. Teaching in another state is not a new trade or business.

Example. You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying education because the teaching position in State B involves the same general kind of work for which you were qualified in State A.

the new requirements can be qualifying education.



You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.

Example 1. You are a full-time engineering student. Although you have not received your degree or certification, you work part time as an engineer for a firm that will employ you as a full-time engineer after you finish college. Although your college engineering courses improve your skills in your present job, they are also needed to meet the minimum job requirements for a full-time engineer. The education is not qualifying education.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses can be qualifying education because you have already satisfied the minimum requirements that were in effect when you were hired.

Requirements for Teachers

States or school districts usually set the minimum educational requirements for teachers. The requirement is the college degree or the minimum number of college hours usually required of a person hired for that position.

If there are no requirements, you will have met the minimum educational requirements when you become a faculty member. You generally will be considered a faculty member when **one or more** of the following occurs.

- 1) You have tenure.
- 2) Your years of service count toward obtaining tenure.
- 3) You have a vote in faculty decisions.
- 4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example 1. The law in your state requires beginning secondary school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training

Education That Qualifies You for a New Trade or Business

Education that is part of a program of study that will qualify you for a new trade or business is not qualifying education. This is true even if you do not plan to enter that trade or business.

If you are an employee, a change of duties that involves the same general kind of work is not a new trade or business.

Example 1. You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is not qualifying because the law degree will qualify you for a new trade or business.

Example 2. You are a general practitioner of medicine. You take a 2-week course to review developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are not qualifying education. They are part of a program of study that can qualify you for a new profession.

Teaching and Related Duties

All teaching and related duties are considered the same general kind of work. A change in duties in any of the following ways is not considered a change to a new business.

- 1) Elementary school teacher to secondary school teacher.
- 2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
- 3) Classroom teacher to guidance counselor.
- 4) Classroom teacher to school administrator.

What Educational Expenses Are Deductible?

If your education meets the requirements described earlier under *Qualifying Education*, you can generally deduct your educational expenses. If you are not self-employed, you can deduct educational expenses only if you itemize your deductions.

You cannot deduct expenses related to tax-exempt and excluded income.

Deductible expenses. The following educational expenses can be deducted.

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. Educational expenses do not include personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Unclaimed reimbursement. If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement.

Example. Your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a **temporary basis**, you can also deduct the costs of returning from school to home.

Temporary basis. If your attendance at school is realistically expected to last (and does in fact last) for 1 year or less, you go to school on a temporary basis (unless there are facts and circumstances that would indicate otherwise).

If your attendance at school is realistically expected to last for more than 1 year or if there is no realistic expectation that the attendance will last for 1 year or less, the attendance is not temporary, regardless of whether it actually lasts for more than 1 year.

If attendance at school initially is realistically expected to last for 1 year or less, but at some later date the attendance is realistically expected to last more than 1 year, that attendance will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.



Attendance at school on a temporary basis was formerly defined as attendance on an irregular or short-term basis (generally a matter of days or weeks).



You can file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return, for any year in which you used the former definition of attendance on a temporary basis. However, you generally must file the amended return within 3 years from the time you filed the original return or within 2 years from the time you paid the tax, whichever is later.

Deductible expenses. If you are regularly employed and go directly from home to school

on a temporary basis, you can deduct the round-trip costs of transportation between your home and school. This is true regardless of the location of the school, the distance traveled, or whether you attend school on nonwork days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

Example 1. You regularly work in Camden, New Jersey, and go directly from work to home. You also attend school every night for 3 months to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

Example 2. Assume the same facts as in *Example 1* except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

Example 3. Assume the same facts as in *Example 1* except that you attend the school for 9 months on Saturdays, nonwork days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

Example 4. Assume the same facts as in *Example 1* except that you attend classes twice a week for 15 months. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

Using your car. If you use your car (whether you own or lease it) for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 2001 is 34½ cents per mile. Whichever method you use, you can also deduct parking fees and tolls. See *Car Expenses* in chapter 28 for information on deducting your actual expenses of using a car.

Travel Expenses

You can deduct expenses for travel, meals (see *50% Limit*, later), and lodging if:

- 1) You travel overnight to obtain qualified education, and
- 2) The main purpose of the trip is to attend a work-related course or seminar.

Travel expenses for qualifying education are treated the same as travel expenses for other employee business purposes. For more information, see chapter 28.



You cannot deduct expenses for personal activities, such as sightseeing, visiting, or entertaining.

Mainly personal travel. If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. You can deduct only your expenses for lodging and 50% of your expenses for meals during the time you attend the qualified educational activities.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of time spent on personal activities with time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

Example 1. John works in Newark, New Jersey. He traveled to Chicago to take a deductible 1-week course at the request of his employer. His main reason for going to Chicago was to take the course.

While there, he took a sightseeing trip, entertained some friends, and took a side trip to Pleasantville for a day.

Since the trip was mainly for business, he can deduct his round-trip airfare to Chicago. He cannot deduct his transportation expenses of going to Pleasantville. He can deduct only the meals (subject to the 50% limit) and lodging connected with his educational activities.

Example 2. Dave works in Nashville and recently traveled to California to take a 2-week seminar. The seminar is qualifying education.

While there, he spent an extra 8 weeks on personal activities. The facts, including the extra 8-week stay, show that his main purpose was to take a vacation.

He cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals (subject to the 50% limit) and lodging for the 2 weeks he attended the seminar.

Cruises and conventions. Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if the seminars or courses are work related, your deduction for travel may be limited. This applies to:

- 1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
- 2) Conventions outside the North American area.

For a discussion of the limits on travel expense deductions that apply to cruises and conventions, see *Luxury Water Travel and Conventions* in Publication 463.

50% Limit

You can deduct only 50% of the cost of your qualifying meals while traveling away from home to obtain education. You cannot have been reimbursed for the meals.

Employees must use Form 2106 or Form 2106-EZ to apply the 50% limit.

Travel as Education

You cannot deduct the cost of travel as a form of education.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as educational expenses. This is true even if you spent most of your time learning French by visiting French schools and families, attending movies or plays, and engaging in similar activities.

Student Loan Interest Expense

You may be able to deduct interest you pay on a qualified student loan. If you qualify, you can take this deduction whether or not the education is work related and even if you do not itemize deductions on Schedule A (Form 1040). For more information on the deduction of student loan interest, see Publication 970.

Expenses Relating to Tax-Exempt and Excluded Income

Some educational assistance you receive may be tax-exempt or excluded from your income. Since you do not pay tax on this income, you may not be able to deduct the related expenses. Examples of tax-exempt or excluded income include scholarships, veterans' educational assistance, and the Education Savings Bond Program. If you received assistance from any of these sources, see *Expenses Relating to Tax-Exempt and Excluded Income* in Publication 508.

Employer-Provided Educational Assistance

If you receive educational assistance benefits from your employer under an educational assistance program, you can exclude up to \$5,250 of those benefits each year. This means your employer should not include the benefits with your wages, tips, and other compensation shown in box 1 of your Form W-2. This also means that you do not have to include the benefits on your income tax return.



You must reduce your deductible educational expenses by the amount of any tax-free educational assistance benefits you received for those expenses.

Educational assistance program. To qualify as an educational assistance program, the plan must be written and must meet certain other requirements. Your employer can tell you whether there is a qualified program where you work.

Educational assistance. Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, books, supplies, and equipment. The payments must be for

undergraduate-level courses that begin before January 1, 2002. The payments do not have to be for work-related courses.



Beginning January 1, 2002, this benefit has been expanded to include both undergraduate and graduate-level courses.

Educational assistance benefits do **not** include payments for the following items.

- 1) Meals, lodging, transportation, or tools or supplies (other than textbooks) that you can keep after completing the course of instruction.
- 2) Education involving sports, games, or hobbies unless the education has a reasonable relationship to the business of your employer or is required as part of a degree program.
- 3) Graduate-level courses that are normally taken under a program leading to a law, business, medical, or other advanced academic or professional degree.

Benefit over \$5,250. If your employer pays more than \$5,250 for educational benefits for you during the year, you must generally pay tax on the amount over \$5,250. Your employer should include in your wages (box 1 of your Form W-2) the amount you must include in income.

Working condition fringe benefit. However, if the payments also qualify as a working condition fringe benefit, your employer does not have to include them in your wages. A working condition fringe benefit is a benefit which, had you paid for it, you could deduct as an employee business expense.

Where To Deduct Expenses

Self-employed persons and employees report their educational expenses differently.

The following information explains what forms you must use to deduct the cost of your qualifying education.

Self-Employed Persons

If you are self-employed, you must report the cost of your qualifying education on the appropriate form used to report your business income and expenses (Schedule C, C-EZ, or F). If your educational expenses include expenses for a car or truck, travel, or meals, report them the same way you report other business expenses for those items. See the instructions for the form you file for information on how to complete it.

Employees

If you are an employee, you can deduct the cost of qualifying education only if you were not reimbursed by your employer or if the costs exceeded your reimbursement. (Amounts your employer paid under a nonaccountable plan and included in box 1 of your Form W-2 are not

considered reimbursements.) How you treat any reimbursement you receive depends on the type of reimbursement arrangement and the amount of the reimbursement. For information on how to report your reimbursement, see chapter 28.

Include the cost of your qualifying education with your deduction for any other employee business expenses on line 20 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.) This deduction is subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

Form 2106 or 2106-EZ. To figure your deduction for employee business expenses, including qualifying education, you generally must complete Form 2106 or Form 2106-EZ.

Form not required. Do not complete either Form 2106 or Form 2106-EZ if:

- You were not reimbursed for any of your expenses, and
- You are not claiming travel, transportation, or meal expenses.

If you meet both of these requirements, enter the expenses directly on line 20 of Schedule A

(Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.)

Using Form 2106-EZ. This form is shorter and easier to use than Form 2106. Generally you can use this form if:

- You were not reimbursed for any of your expenses, and
- You are using the standard mileage rate if you are claiming vehicle expenses.

If you do not meet both of these requirements, use Form 2106.

Performing artists and fee-basis officials. If you are a qualified performing artist, or a state (or local) government official who is paid in whole or in part on a fee basis, you can deduct the cost of your qualifying education as an adjustment to gross income rather than as an itemized deduction.

For more information on qualified performing artists and fee-basis officials, see chapter 28.

Impairment-related work expenses. If you are disabled and have impairment-related work expenses that are necessary for you to be able to get qualifying education, you can deduct these expenses on line 27 of Schedule A (Form 1040). They are not subject to the 2%-of-adjusted-gross-income limit.

For more information on impairment-related work expenses, see chapter 28.

Recordkeeping



You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the return and claiming the deduction.

For specific information about keeping records of business expenses, see *Recordkeeping* in chapter 28.

30.

Miscellaneous Deductions

Important Reminder

Limit on itemized deductions. For 2001, if your adjusted gross income is more than \$132,950 (\$66,475 if you are married filing separately), you may have to reduce the amount of certain itemized deductions, including most miscellaneous deductions.

Introduction

This chapter explains which expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter covers the following topics.

- Deductions subject to the 2% limit.
- Deductions not subject to the 2% limit.
- Expenses you cannot deduct.



You must keep records to verify your deductions. You should keep receipts, canceled checks, financial account statements, and other documentary evidence. For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals*.

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 525** Taxable and Nontaxable Income
- 529** Miscellaneous Deductions
- 535** Business Expenses
- 587** Business Use of Your Home (Including Use by Day-Care Providers)
- 946** How To Depreciate Property

Form (and Instructions)

- 2106** Employee Business Expenses
- 2106-EZ** Unreimbursed Employee Business Expenses

Deductions Subject to the 2% Limit

You can deduct certain expenses as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim the amount of expenses that is more than 2% of your adjusted gross income. You figure your deduction on Schedule A by subtracting 2% of your adjusted gross income from the total amount of these expenses. Your adjusted gross income is the amount on line 34, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit. For example, you apply the 50% (or 60%) limit on business-related meals and entertainment (discussed in chapter 28) before you apply the 2% limit.

Deductions subject to the 2% limit are discussed in the three categories in which you report them on Schedule A.

- 1) **Unreimbursed employee expenses** (line 20).
- 2) **Tax preparation fees** (line 21).
- 3) **Other expenses** (line 22).

Impairment-related work expenses. If you have a physical or mental disability, certain expenses you incur that allow you to work may not be subject to the 2% limit. See *Impairment-Related Work Expenses* under *Deductions Not Subject to the 2% Limit*, later.

Performing artists. If you are a qualified performing artist, you may be able to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. See *Special Rules* in chapter 28 if you need more information about this exception.

State and local government officials paid on a fee basis. If you performed services as an employee of a state or local government and you were paid in whole or in part on a fee basis, you can claim your trade or business expenses in performing those services as an adjustment to gross income, rather than as a miscellaneous deduction. See *Officials Paid on a Fee Basis* under *Deductions Not Subject to the 2% Limit*, later.

Unreimbursed Employee Expenses (Line 20)

You can deduct only unreimbursed employee expenses that are:

- 1) Paid or incurred during your tax year,
- 2) For carrying on your trade or business of being an employee, and
- 3) Ordinary and necessary.

An expense is **ordinary** if it is common and accepted in your type of trade or business. An expense is **necessary** if it is appropriate and helpful to your trade or business.

Examples of unreimbursed employee expenses are listed next. The list is followed by

discussions of additional unreimbursed employee expenses that are more common.

- Business bad debt of an employee.
- Education that is work related. (See chapter 29.)
- Legal fees related to your job.
- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Travel, transportation, entertainment, gift, and car expenses related to your work. (See chapter 28.)

Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

Depreciation on Computers or Cellular Telephones

You can claim a depreciation deduction for a computer or cellular telephone that you use in your work as an employee if its use is:

- 1) For the convenience of your employer, and
- 2) Required as a condition of your employment.

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer or cellular telephone, see Publication 529.

Dues to Chambers of Commerce and Professional Societies

You may be able to deduct dues paid to professional organizations (such as bar associations and medical associations) and to chambers of commerce and similar organizations, if membership helps you carry out the duties of your job. Similar organizations include:

- Boards of trade,
- Business leagues,
- Civic or public service organizations,
- Real estate boards, and
- Trade associations.

You **cannot** deduct dues paid to an organization if one of its main purposes is to:

- 1) Conduct entertainment activities for members or their guests, or
- 2) Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible. See *Club Dues* under *Non-deductible Expenses*, later.

Lobbying and political activities. You may not be able to deduct that part of your dues that is for certain lobbying and political activities. See *Dues used for lobbying* under *Lobbying Expenses*, later.

Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating expenses and depreciation of your home.

You can claim this deduction for the business use of a part of your home only if you use that part of your home **regularly** and **exclusively**:

- 1) As your principal place of business for any trade or business,
- 2) As a place to meet or deal with your patients, clients, or customers in the normal course of your trade or business, or
- 3) In the case of a separate structure not attached to your home, in connection with your trade or business.

The regular and exclusive business use must be **for the convenience of your employer** and not just appropriate and helpful in your job. Get Publication 587 for more detailed information and a worksheet.

Job Search Expenses

You can deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You cannot deduct these expenses if:

- 1) You are looking for a job in a new occupation,
- 2) There was a substantial break between the ending of your last job and your looking for a new one, or
- 3) You are looking for a job for the first time.

Employment and outplacement agency fees.

You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

Employer pays you back. If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income up to the amount of your tax benefit in the earlier year. (See *Recoveries* in chapter 13.)

Employer pays the employment agency. If your employer pays the fees directly to the employment agency and you are not responsi-

ble for them, you do not include them in your gross income.

Résumé. You can deduct amounts you spend for typing, printing, and mailing copies of a résumé to prospective employers if you are looking for a new job in your present occupation.

Travel and transportation expenses. If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. You can deduct the travel expenses if the trip is primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal or is primarily to look for a new job.

Even if you cannot deduct the travel expenses to and from an area, you can deduct the expenses of looking for a new job in your present occupation while in the area.

You may choose to use the standard mileage rate to figure your car expenses. The standard mileage rate for 2001 is 34½ cents per mile. See chapter 28 for more information.

Licenses and Regulatory Fees

You can deduct the amount you pay each year to state or local governments for licenses and regulatory fees for your trade, business, or profession.

Occupational Taxes

You can deduct an occupational tax charged at a flat rate by a locality for the privilege of working or conducting a business in the locality. If you are an employee, you can claim occupational taxes only as a miscellaneous deduction subject to the 2% limit; you cannot claim them as a deduction for taxes elsewhere on your return.

Repayment of Income Aid Payment

An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs because of lack of work. If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment.

Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. You must have undertaken the research as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, you cannot deduct the cost of travel as a form of education.

Tools Used in Your Work

Generally, you can deduct amounts you spend for tools used in your work if the tools wear out and are thrown away within 1 year from the date of purchase. You can depreciate the cost of tools that have a useful life substantially beyond the tax year. For more information about depreciation, get Publication 946.

Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund, even if the union requires you to make the contributions.

You may not be able to deduct amounts you pay to the union that are related to certain lobbying and political activities. See *Lobbying Expenses* under *Nondeductible Expenses*, later.

Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes if the following two requirements are met.

- 1) You must wear them as a condition of your employment.
- 2) The clothes are not suitable for everyday wear.



It is not enough that you wear distinctive clothing. The clothing must be specifically required by your employer. Nor is it enough that you do not, in fact, wear your work clothes away from work. The clothing must not be suitable for taking the place of your regular clothing.

Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

Protective clothing. You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

Military uniforms. You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

Tax Preparation Fees (Line 21)

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 2001 return, you can deduct fees paid in 2001 for preparing your 2000 return. These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return.

Deduct expenses of preparing tax schedules relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Deduct the expenses of preparing the remainder of the return on line 21, Schedule A (Form 1040).

Other Expenses (Line 22)

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit. These are expenses you pay:

- 1) To produce or collect income that must be included in your gross income,
- 2) To manage, conserve, or maintain property held for producing such income, or
- 3) To determine, contest, pay, or claim a refund of any tax.

You can deduct expenses you pay for the purposes in (1) and (2) above only if they are reasonably and closely related to these purposes. Some of these other expenses are explained in the following discussions.

If the expenses you pay produce income that is only partially taxable, see *Tax-Exempt Income Expenses*, later, under *Nondeductible Expenses*.

Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

Certain Casualty and Theft Losses

You can deduct a casualty or theft loss as a miscellaneous itemized deduction subject to the 2% limit if you used the damaged or stolen property in performing services as an employee. First report the loss in Section B of Form 4684, *Casualties and Thefts*. You may also have to include the loss on Form 4797, *Sales of Business Property*, if you are otherwise required to file that form. Your deduction is the amount of the loss included on lines 32 and 38b of Form 4684 and line 18b of Form 4797. For other casualty and theft losses, see chapter 27.

Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

Depreciation on Home Computer

You can deduct depreciation on your home computer if you use it to produce income (for example, to manage your investments that produce taxable income). You generally must depreciate the computer using the straight line method over the Alternative Depreciation System (ADS) recovery period. But if you work as an employee and also use the computer in that work, see Publication 946.

Excess Deductions of an Estate

If an estate's total deductions in its last tax year are more than its gross income for that year, the beneficiaries succeeding to the estate's property can deduct the excess. Do not include deductions for personal exemptions and charitable contributions when figuring the estate's total deductions. The beneficiaries can claim the deduction only for the tax year in which, or with which, the estate terminates, whether the year of termination is a normal year or a short tax year. For more information, see *Termination of Estate* in Publication 559, *Survivors, Executors, and Administrators*.

Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities. You can use the fee only to figure gain or loss from the sale. See the instructions for columns (d) and (e) of Schedule D (Form 1040) for information on how to report the fee.

Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business because it is not carried on to make a profit. See *Activity not for profit* in chapter 13 under *Other Income*.

Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partners or shareholders can deduct their share of passed-through deductions for investment expenses as miscellaneous itemized deductions subject to the 2% limit.

Example. You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as miscellaneous itemized deductions subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income.

Publicly offered mutual funds. Publicly offered mutual funds do not pass deductions for investment expenses through to shareholders. A mutual fund is "publicly offered" if it is:

- 1) Continuously offered pursuant to a public offering,
- 2) Regularly traded on an established securities market, or
- 3) Held by or for at least 500 persons at all times during the tax year.

A publicly offered mutual fund will send you a Form 1099-DIV, or a substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return as income. You cannot deduct investment expenses.

Information returns. You should receive information returns from pass-through entities.

Partnerships and S corporations. These entities issue Schedule K-1, which lists the items and amounts you must report and identifies the tax return schedules and lines to use.

Nonpublicly offered mutual funds. These funds will send you a Form 1099-DIV, *Dividends and Distributions*, or a substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses

you paid for managing your investments that produce taxable income.

Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

- 1) Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business,
- 2) For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way, or
- 3) To collect taxable alimony.

You can deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. You deduct expenses of resolving nonbusiness tax issues on Schedule A (Form 1040).

Loss on Deposits

For information on whether, and if so, how, you may deduct a loss on your deposit in a qualified financial institution, see *Deposit in Insolvent or Bankrupt Financial Institution* in chapter 15.

Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of \$3,000 or less, the deduction is subject to the 2% limit. If it was more than \$3,000, see *Repayments Under Claim of Right* under *Deductions Not Subject to the 2% Limit*, later.

Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in chapter 12.

Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

- 1) Holding shares acquired through a plan,
- 2) Collecting and reinvesting cash dividends, and
- 3) Keeping individual records and providing detailed statements of accounts.

Trustee's Administrative Fees for IRA

Trustee's administrative fees that are billed separately and paid by you in connection with your individual retirement arrangement (IRA) are deductible (if they are ordinary and necessary) as a miscellaneous itemized deduction subject to the 2% limit. For more information about IRAs, see chapter 18.

Deductions Not Subject to the 2% Limit

You can deduct the items listed below as miscellaneous itemized deductions. They are not subject to the 2% limit. Report these items on line 27, Schedule A (Form 1040).

List of Deductions

Each of the following items are discussed in detail after the list.

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Repayments of more than \$3,000 under a claim of right.
- Unrecovered investment in an annuity.
- Expenses of officials paid on a fee basis.

Amortizable Premium on Taxable Bonds

In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.

Part of the premium on some bonds may be a miscellaneous deduction not subject to the 2% limit. For more information, see *Amortizable Premium on Taxable Bonds* in Publication 529 and *Bond Premium Amortization* in chapter 3 of Publication 550, *Investment Income and Expenses*.

Certain Casualty and Theft Losses

You can deduct a casualty or theft loss as a miscellaneous itemized deduction not subject to the 2% limit if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First report the loss in Section B of Form 4684. You may also have to include the loss on Form 4797 if you are otherwise required to file that form. Your deduction is the amount of the loss included on lines 32 and 38b of Form 4684 and line 18b of Form 4797. For more information on casualty and theft losses, see chapter 27.

Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return. See Publication 559 for more information.

Gambling Losses Up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings for the year on line 21, Form 1040. You deduct your gambling losses for the year on line 27, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings.



You cannot reduce your gambling winnings by your gambling losses and report the difference. You must report the full amount of your winnings as income and claim your losses up to the amount of winnings as an itemized deduction. Therefore, your records should show your winnings separately from your losses.



Diary of winnings and losses. You must keep an accurate diary or similar record of your losses and winnings.

Your diary should contain at least the following information.

- 1) The date and type of your specific wager or wagering activity.
- 2) The name and address or location of the gambling establishment.
- 3) The names of other persons present with you at the gambling establishment.
- 4) The amount(s) you won or lost.

See Publication 529 for more information.

Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially lim-

its one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

Where to report. If you are an employee, you enter impairment-related work expenses on Form 2106 or Form 2106–EZ. Enter on line 27, Schedule A (Form 1040) that part of the amount on line 10 of Form 2106, or line 6 of Form 2106–EZ, that is related to your impairment. Enter the amount that is unrelated to your impairment on line 20, Schedule A (Form 1040).

Repayments Under Claim of Right

If you had to repay more than \$3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid or take a credit against your tax. See *Repayments* in chapter 13 for more information.

Unrecovered Investment in Annuity

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return. See chapter 11 for more information about the tax treatment of pensions and annuities.

Officials Paid on a Fee Basis

If you are a fee-basis official, you can claim your expenses in performing services in that job as an adjustment to income rather than as a miscellaneous itemized deduction. To qualify as a fee-basis official, you must be employed by a state or local government and be paid in whole or in part on a fee basis.

Where to report. If you qualify as a fee-basis official, you should first complete Form 2106 or Form 2106–EZ. Then include your expenses in performing services in that job (line 10 of Form 2106 or line 6 of Form 2106–EZ) on line 32 of Form 1040. Then write "FBO" and the amount of those expenses on the dotted line next to line 32 of Form 1040.

Nondeductible Expenses

Examples of nondeductible expenses are listed next. The list is followed by discussions of additional nondeductible expenses that are more common.

List of Nondeductible Expenses

- Adoption expenses.
- Broker's commissions that you paid in connection with your IRA or other investment property.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Capital expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Hobby losses — But see *Hobby Expenses*, earlier.
- Home repairs, insurance, and rent.
- Illegal bribes and kickbacks—See *Bribes and kickbacks* in chapter 13 of Publication 535.
- Losses from the sale of your home, furniture, personal car, etc.
- Personal disability insurance premiums.
- Personal, living, or family expenses.
- The value of wages never received or lost vacation time.

Campaign Expenses

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees on Personal Account

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs. For exceptions, see *Dues to Chambers of Commerce and Professional Societies* under *Unreimbursed Employee Expenses*, earlier.

Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items, in your car to and from work, you can deduct only the additional cost of hauling the items such as the rent on a trailer to carry the items.

Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Home Security System

You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office. See *Home Office* under *Unreimbursed Employee Expenses*, earlier, and *Security System* under *Deducting Expenses* in Publication 587.

Homeowners' Insurance Premiums

You cannot deduct premiums that you pay or that are placed in escrow for insurance on your home, such as fire and liability or mortgage insurance.

Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse. See chapter 20 for information on alimony.

Lobbying Expenses

You generally cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

- 1) Influence legislation,

- 2) Participate or intervene in any political campaign for, or against, any candidate for public office,
- 3) Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
- 4) Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of those officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

Dues used for lobbying. If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the organization are used to pay nondeductible lobbying expenses, you cannot deduct that part. See *Lobbying Expenses* in Publication 529 for information on exceptions.

Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. See chapter 27.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Lunches With Coworkers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 28 for information on deductible expenses while traveling away from home.

Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if the cost of meals is a deductible entertainment expense, or if you are traveling away from home. See chapter 28 for information on deductible entertainment expenses and expenses while traveling away from home.

Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following.

- 1) Custody of children.
- 2) Breach of promise (to marry) suit.
- 3) Civil or criminal charges resulting from a personal relationship.
- 4) Damages for personal injury.
- 5) Preparation of a title (or defense or perfection of a title).
- 6) Preparation of a will.
- 7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund. Advertisements in convention bulletins and admissions to dinners or programs that benefit a political party or political candidate are not deductible.

Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following.

- 1) Accounting certificate fees paid for the initial right to practice accounting.
- 2) Bar exam fees and incidental expenses in securing admission to the bar.
- 3) Medical and dental license fees paid to get initial licensing.

Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

Example. During the year, you received taxable interest of \$4,800 and tax-exempt interest of \$1,200. In earning this income, you had total expenses of \$500 during the year. You cannot identify the amount of each expense item that is for each income item. Therefore, 80% (\$4,800/\$6,000) of the expense is for the taxable interest and 20% (\$1,200/\$6,000) is for the tax-exempt interest. You can deduct, subject to the 2% limit, expenses of \$400 (80% of \$500).

Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See chapter 28 for more information on deductible travel expenses.

Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

Part Six.

Figuring Your Taxes and Credits

The eight chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than \$1,500 of investment income. They also discuss tax credits that, unlike deductions are subtracted directly from your tax and reduce your tax, dollar for dollar. Chapter 37 discusses the earned income credit and how you may be able to get part of the credit paid to you in advance throughout the year.

31.

How To Figure Your Tax

Introduction

After you have figured your income and deductions as explained in *Parts One through Five*, your next step is to figure your tax. This chapter discusses:

- The general steps you take to figure your tax,
- An additional tax you may have to pay called the alternative minimum tax, and
- The conditions you must meet if you want the IRS to figure your tax.

Figuring Your Tax

Your income tax is based on your taxable income. After you figure your income tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.

This section provides a general outline of how to figure your tax. You can find step-by-step directions in the instructions for Forms 1040EZ, 1040A, and 1040. If you are unsure of which tax form you should file, see *Which Form Should I Use?* in chapter 1.

Tax. Most taxpayers use either the Tax Table or the Tax Rate Schedules to figure their income tax. However, there are special methods if your income includes any of the following items.

- Capital gains (see chapter 17).
- Lump-sum distributions (see chapter 11).
- Farm income (see Schedule J (Form 1040), *Farm Income Averaging*).
- Investment income over \$1,500 for children under age 14 (see chapter 32).

Credits. After you figure your income tax, determine your tax credits. This chapter does not

explain whether you are eligible for these credits. You can find that information in chapters 33 through 38 and your form instructions. See the following table for credits you may be able to subtract from your income tax.

CREDITS	
For information on:	See chapter:
Adoption	38
Child and dependent care	33
Child tax credit	35
Education	36
Elderly or disabled	34
Foreign tax	38
Mortgage interest	38
Prior year minimum tax	38
Qualified electric vehicle	38
Rate reduction	38

Some credits (such as the earned income credit) are not listed above because they are treated as payments. See *Payments*, later.

There are other credits that are not discussed in this publication. These include the following items.

- General business credit, which is made up of several separate business-related credits. These generally are reported on Form 3800, *General Business Credit*, and are discussed in chapter 4 of Publication 334, *Tax Guide for Small Business*.
- Empowerment zone employment credit, which is for certain employers whose employees work and live in an empowerment zone. See Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*, and the instructions for Form 8844, *Empowerment Zone Employment Credit*.
- District of Columbia first-time homebuyer credit, which is for certain persons who buy a main home in the District. See the instructions for Form 8859, *District of Columbia First-Time Homebuyer Credit*.
- Credit for fuel from a nonconventional source, which is for the person who sold the fuel. See the instructions for line 51 of Form 1040 and section 29 of the Internal Revenue Code.

Other taxes. After you subtract your tax credits, determine whether there are any other taxes you must pay. This chapter does not explain these other taxes. You can find that information in other chapters of this publication and your form instructions. See the following table for other taxes you may need to add to your income tax.

OTHER TAXES	
For information on:	See chapter:
Tax on qualified retirement plans and IRAs	11, 18
Advance earned income credit payments	37
Household employment taxes	33
Social security and Medicare tax on unreported tips	7
Uncollected social security and Medicare tax on tips	7

Another tax you may have to pay, the alternative minimum tax, is discussed later in this chapter.

There are other taxes that are not discussed in this publication. These include the following items.

- 1) *Self-employment tax.* You must figure this tax if either of the following applies to you (or your spouse if you file a joint return).
 - a) You were self-employed and your net earnings from self-employment were \$400 or more. The term "net earnings from self-employment" may include certain nonemployee compensation and other amounts reported to you on Form 1099-MISC, *Miscellaneous Income*. If you received a Form 1099-MISC, see the *Instructions to Recipients* on the back. Also see the instructions for Schedule SE (Form 1040), *Self-Employment Tax*, and Publication 533, *Self-Employment Tax*.
 - b) You had church employee income of \$108.28 or more.
- 2) *Recapture taxes.* You may have to pay these taxes if you previously claimed an education credit, an investment credit, a low-income housing credit, a mortgage interest credit, a qualified electric vehicle credit, or an Indian employment credit. For more information about recapture of an education credit, see chapter 36. For more information about other recapture taxes, see the instructions for line 58 of Form 1040.
- 3) *Section 72(m)(5) excess benefits tax.* If you are (or were) a 5% owner of a business and you received a distribution that exceeds the benefits provided for you under the qualified pension or annuity plan formula, you may have to pay this additional tax. See *Tax on Excess Benefits* in Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.
- 4) *Uncollected social security and Medicare tax on group-term life insurance.* If your

former employer provides you with more than \$50,000 of group-term life insurance coverage, you must pay the employee part of social security and Medicare taxes on those premiums. The amount should be shown in box 12 of your Form W-2 with codes M and N.

- 5) *Tax on golden parachute payments.* This tax applies if you, as a key employee, received an "excess parachute payment" (EPP) due to a change in a corporation's ownership or control. See the instructions for line 58 of Form 1040.
- 6) *Tax on accumulation distribution of trusts.* This applies if you are the beneficiary of a trust that accumulated its income instead of distributing it currently. See the instructions for Form 4970, *Tax on Accumulation Distribution of Trusts*.
- 7) *Additional tax on MSAs.* If amounts contributed to, or distributed from, your medical savings account do not meet the rules for these accounts, you may have to pay additional taxes. See Publication 969, *Medical Savings Accounts (MSAs)*, and Forms 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, and 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

Payments. After you determine your total tax, figure the total payments you have already made for the year. Include credits that are treated as payments. This chapter does not explain these payments and credits. You can find that information in other chapters of this publication and your form instructions. See the following table for amounts you can include in your total payments.

PAYMENTS	See
For information on:	chapter:
Child tax credit (additional)	35
Earned income credit	37
Estimated tax paid	5
Excess social security and RRTA tax withheld	38
Federal income tax withheld	5
Regulated investment company credit	38
Tax paid with extension	1

Another credit that is treated as a payment is the credit for federal excise tax paid on fuels. This credit is for persons who have a nontaxable use of certain fuels, such as diesel fuel and kerosene. It is claimed on line 65 of Form 1040. See Publication 378, *Fuel Tax Credits and Refunds*, and Form 4136, *Credit for Federal Tax Paid on Fuels*.

Refund or balance due. To determine whether you are entitled to a refund or owe additional tax, compare your total payments with your total tax. If you are entitled to a refund, see your form instructions for information on having it directly deposited into your financial account instead of receiving a paper check.

Alternative Minimum Tax

This section briefly discusses an additional tax you may have to pay.

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the alternative minimum tax (AMT).

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- \$49,000 if your filing status is married filing a joint return (or a qualifying widow(er) with dependent child),
- \$35,750 if your filing status is single or head of household, or
- \$24,500 if your filing status is married filing a separate return.

Adjustments and tax preference items. The more common adjustments and tax preference items include:

- Addition of **personal exemptions**,
- Addition of the **standard deduction** (if claimed),
- Addition of **itemized deductions** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any **refund of state and local taxes** included in gross income,
- Changes to accelerated **depreciation** of certain property,
- Difference between **gain or loss** on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from **incentive stock options**,
- Change in certain **passive activity loss** deductions,
- Addition of certain **depletion** that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain **intangible drilling costs**, and
- Addition of **tax-exempt interest** on certain private activity bonds.

More information. For more information about the alternative minimum tax, see the instructions for Form 1040, line 41, and Form 6251, *Alternative Minimum Tax—Individuals*.

Tax Figured by IRS

If you file by April 15, 2002, you can have the IRS figure your tax for you on Form 1040EZ, Form 1040A, or Form 1040.

If the IRS figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. To avoid interest or the penalty for late payment, you must pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.

When the IRS cannot figure your tax. The IRS cannot figure your tax for you if any of the following apply.

- 1) You want your refund directly deposited.
- 2) You want any of your refund applied to your 2002 estimated tax.
- 3) Any of your income for the year was from **other than** wages, salaries, tips, interest, dividends, taxable social security benefits, unemployment compensation, IRA distributions, pensions, and annuities.
- 4) Your taxable income is \$100,000 or more.
- 5) You itemize deductions.
- 6) You file any of the following forms.
 - a) Form 2555, *Foreign Earned Income*.
 - b) Form 2555-EZ, *Foreign Earned Income Exclusion*.
 - c) Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*.
 - d) Form 4970, *Tax on Accumulation Distribution of Trusts*.
 - e) Form 4972, *Tax on Lump-Sum Distributions*.
 - f) Form 6198, *At-Risk Limitations*.
 - g) Form 6251, *Alternative Minimum Tax—Individuals*.
 - h) Form 8606, *Nondeductible IRAs and Coverdell ESAs*.
 - i) Form 8615, *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500*.
 - j) Form 8814, *Parents' Election To Report Child's Interest and Dividends*.
 - k) Form 8839, *Qualified Adoption Expenses*.
 - l) Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*.

Filing the Return

After you complete the line entries for the tax form you are filing (discussed next), attach the peel-off label, enter your social security number(s), sign the return, and mail it. If you do not have a peel-off label, fill in your name and address. See chapter 1 for more information.

Form 1040EZ Line Entries

Read lines 1 through 9 and fill in the lines that apply to you. If you are filing a joint return, write your taxable income and your spouse's taxable income to the left of line 6.

Earned income credit. If you can take this credit, as discussed in chapter 37, the IRS can

figure it for you. Print "EIC" in the space to the right of line 9a. Enter the amount of any nontaxable earned income on line 9b.

If your credit for any year after 1996 was reduced or disallowed by the IRS, you may also have to file Form 8862, *Information To Claim Earned Income Credit After Disallowance*, with your return. For details, see that form and its instructions.

Form 1040A Line Entries

Read lines 1 through 25 and fill in the lines that apply to you. If you are filing a joint return, write your taxable income and your spouse's taxable income to the left of line 25. Complete lines 27 through 30, 35, and 37 through 40 if they apply to you. Do not fill in lines 28 and 39a if you want the IRS to figure the credits shown on those lines. Also, enter any write-in information that applies to you in the space to the left of line 41.

Credit for child and dependent care expenses. If you can take this credit, as discussed in chapter 33, complete Schedule 2 and attach it to your return. Enter the amount of the credit on line 27 (Form 1040A). The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, as discussed in chapter 34, attach Schedule 3 (1040A), *Credit for the Elderly or the Disabled for Form 1040A Filers*. Print

"CFE" in the space to the left of line 28 (Form 1040A). The IRS will figure this credit for you. On Schedule 3, check the box in Part I for your filing status and age. Complete Part II and lines 11 and 13 of Part III if they apply.

Earned income credit. If you can take this credit, as discussed in chapter 37, the IRS will figure it for you. Print "EIC" directly to the right of line 39a. Enter the amount of any nontaxable earned income on line 39b. If you have a qualifying child, you must fill in Schedule EIC, *Earned Income Credit*, and attach it to your return.

If your credit for any year after 1996 was reduced or disallowed by the IRS, you may also have to file Form 8862 with your return. For details, see that form and its instructions.

Form 1040 Line Entries

Read lines 1 through 39 and fill in the lines that apply to you.

If you are filing a joint return, write your taxable income and your spouse's taxable income in the space under the words "Adjusted Gross Income" on the front of your return.

Read lines 41 through 65. Fill in the lines that apply to you, but do not fill in the "Total" lines. Do not fill in lines 45 and 61a if you want the IRS to figure the credits shown on those lines.

Fill in any forms or schedules asked for on the lines you completed, and attach them to your return.

Credit for child and dependent care expenses. If you can take this credit, as discussed in chapter 33, complete Form 2441 and attach it to your return. Enter the amount of the credit on line 44. The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, as discussed in chapter 34, attach Schedule R, *Credit for the Elderly or the Disabled*. Print "CFE" on the dotted line next to line 45 of Form 1040. The IRS will figure the credit for you. On Schedule R check the box in Part I for your filing status and age. Complete Part II and lines 11 and 13 of Part III if they apply.

Earned income credit. If you can take this credit, as discussed in chapter 37, the IRS will figure it for you. Print "EIC" directly to the right of line 61a of Form 1040. Enter the amount of any nontaxable earned income in the space provided on line 61b. If you have a qualifying child, you must fill in Schedule EIC and attach it to your return.

If your credit for any year after 1996 was reduced or disallowed by the IRS, you may also have to file Form 8862 with your return. For details, see that form and its instructions.

32.

Tax on Investment Income of Certain Minor Children

Important Change

Tax computation for certain dependents. Generally, the tax computed for a dependent using the 2001 Tax Table or Tax Rate Schedules can be reduced to take into account the new 10% tax rate. To figure the reduced tax, use the *Tax Computation Worksheet for Certain Dependents* in the instructions for Form 1040 (line 40), Form 1040A (line 26), and Form 1040EZ (line 11).

This computation **does not apply** to the following.

- Dependents who received (before any offsets) an advance payment of their 2001 taxes.
- Dependents who file Form 1040NR, *Non-resident Alien Income Tax Return*.

Important Reminder

Parent's election to report child's interest and dividends. You may be able to elect to include your child's interest and dividends on your tax return. If you make this election, the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends*, later.

Introduction

This chapter discusses two special tax rules that apply to certain investment income of a child under age 14.

- 1) If the child's interest, dividends, and other investment income total more than \$1,500, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. (See *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500*, later.)
- 2) The child's parent may be able to choose to include the child's interest and dividend

income (including capital gain distributions) on the parent's return rather than file a return for the child. (See *Parent's Election To Report Child's Interest and Dividends*, later.)

For these rules, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do **not** apply if:

- 1) The child is not required to file a tax return, or
- 2) Neither of the child's parents were living at the end of the tax year.

Useful Items

You may want to see:

Publication

- 929** Tax Rules for Children and Dependents

Form (and Instructions)

- 8615** Tax for Children Under Age 14 With Investment Income of More Than \$1,500
- 8814** Parents' Election To Report Child's Interest and Dividends

Which Parent's Return To Use

If a child's parents are married to each other and file a joint return, use the joint return to figure the tax on the investment income of a child under age 14. For parents who do not file a joint return, the following discussions explain which parent's tax return must be used to figure the tax. Only the parent whose tax return is used can make the election described under *Parent's Election To Report Child's Interest and Dividends*. The tax rate and other return information from that parent's return are used to compute the child's tax as explained later under *Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500*.

Parents are married. If the child's parents file separate returns, use the return of the parent with the greater taxable income.

Parents not living together. If the child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in chapter 2.

Parents are divorced. If the child's parents are divorced or legally separated, and the parent

who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

Custodial parent remarried. If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the noncustodial parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, the earlier discussion under *Parents not living together* applies.

Parents never married. If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Parents are divorced* apply.

Widowed parent remarried. If a widow or widower remarries, the new spouse is treated as the child's other parent. The rules explained earlier under *Custodial parent remarried* apply.

Parent's Election To Report Child's Interest and Dividends

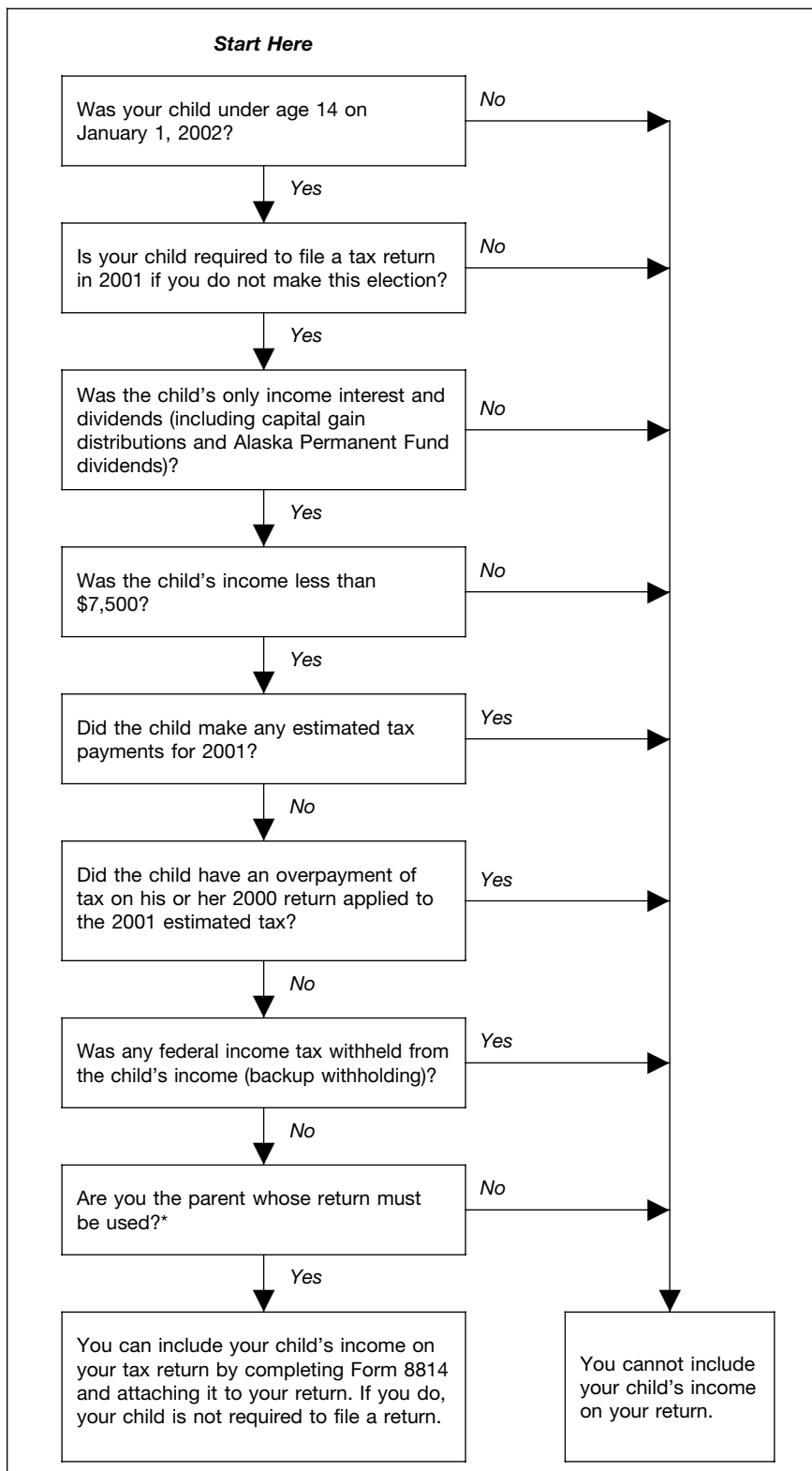
You may be able to elect to include your child's interest and dividend income (including capital gain distributions) on your tax return. If you do, your child will not have to file a return.

You can make this election for 2001 only if **all** the following conditions are met.

- 1) Your child was under age 14 on January 1, 2002.
- 2) Your child is required to file a return for 2001 unless you make this election.
- 3) Your child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends).
- 4) The dividend and interest income was less than \$7,500.
- 5) No estimated tax payment was made for 2001 and no 2000 overpayment was applied to 2001 under your child's name and social security number.
- 6) No federal income tax was taken out of your child's income under the backup withholding rules.
- 7) You are the parent whose return must be used when applying the special tax rules for children under age 14. (See *Which Parent's Return To Use*, earlier.)

These conditions are also shown in *Figure 32–A*.

Figure 32-A. Can You Include Your Child's Income On Your Tax Return?



*See Which Parent's Return To Use

Effect of Making the Election

The federal income tax on your child's income may be more if you make the Form 8814 election rather than file a return for the child.

Rates may be higher. If you use Form 8814, the child's income may be taxed at a higher rate on your return than it would be on the child's own return.

Deductions you cannot take. By making the Form 8814 election, you cannot take any of the following deductions the child would be entitled to on his or her return.

- 1) The higher standard deduction for a blind child.
- 2) The deduction for a penalty on an early withdrawal of your child's savings.
- 3) Itemized deductions (such as your child's investment expenses or charitable contributions).

Reduced deductions or credits. If you use Form 8814, your increased adjusted gross income may reduce certain deductions or credits on your return including the following.

- 1) Deduction for contributions to a traditional individual retirement arrangement (IRA).
- 2) Deduction for student loan interest.
- 3) Itemized deductions for medical expenses, casualty and theft losses, and certain miscellaneous expenses.
- 4) Total itemized deductions.
- 5) Credit for child and dependent care expenses.
- 6) Child tax credit.
- 7) Education tax credits.
- 8) Earned income credit.

Penalty for underpayment of estimated tax. If you make this election for 2001 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 2002, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See chapter 5 for more information.

Figuring Child's Income

Use **Part I** of Form 8814 to figure your child's interest and dividend income to report on your return. Only the amount over \$1,500 is added to your income. This amount is shown on line 6 of Form 8814. Include this amount on line 21 of Form 1040 or Form 1040NR. Write "Form 8814" in the space next to line 21. If you file more than one Form 8814, include the total amounts from line 6 of all your Forms 8814 on line 21.

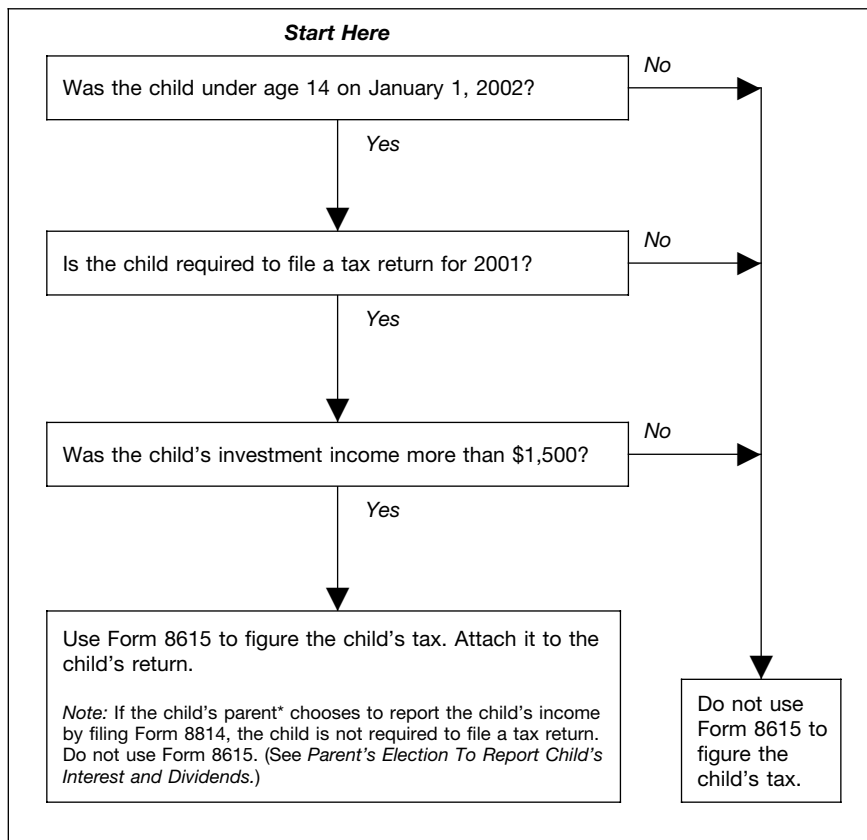
Capital gain distributions. If your child's dividend income included any capital gain distributions, see *Capital gain distributions* under *Figuring Child's Income* in Publication 929.

How to make the election. Make the election by attaching **Form 8814** to your Form 1040 or Form 1040NR. (If you make this election, you cannot file Form 1040A or Form 1040EZ.) Attach a separate Form 8814 for each child for whom you make the election. You can make the

election for one or more children and not for others.

Figure 32–B. **Do You Have To Use Form 8615 To Figure Your Child’s Tax?**

Linda attaches Form 8814 to her Form 1040.



*See Which Parent’s Return To Use

Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500

Part of a child’s 2001 investment income may be subject to tax at the parent’s tax rate if:

- 1) The child was under age 14 on January 1, 2002,
- 2) The child’s investment income was more than \$1,500, and
- 3) The child is required to file a return for 2001.

These conditions are also shown in *Figure 32–B*.

If the parent does not or cannot choose to include the child’s income on the parent’s return, use **Form 8615** to figure the child’s tax. Attach the completed form to the child’s Form 1040, Form 1040A, or Form 1040NR.

The following discussions explain the parental information needed for Form 8615 and the steps to follow in figuring the child’s tax. Form 8615 is illustrated later.

Providing Parental Information (Form 8615, lines A–C)

On lines A and B of Form 8615, enter the parent’s name and social security number. (If the parents filed a joint return, enter the name and social security number listed first on the joint return.) On line C, check the box for the parent’s filing status.

See *Which Parent’s Return To Use* at the beginning of this chapter for information on which parent’s return information must be used on Form 8615.

Parent with different tax year. If the parent and the child do not have the same tax year, complete Form 8615 using the information on the parent’s return for the tax year that ends in the child’s tax year.

Parent’s return information not known timely. If the information needed from the parent’s return is not known by the time the child’s return is due (usually April 15), you can file the return using estimates.

You can use any reasonable estimate. This includes using information from last year’s return. If you use an estimated amount on Form 8615, write “Estimated” on the line next to the amount.

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return*.

Instead of using estimated information, you may want to request an extension of time to file. Extensions are discussed in chapter 1.

Figuring Additional Tax

Use **Part II** of Form 8814 to figure the tax on the \$1,500 of your child’s interest and dividends that you do not include in your income. This tax is added to the tax figured on your income.

This additional tax is the **smaller** of:

- 1) $10\% \times (\text{your child's gross income} - \$750)$, or
- 2) \$75.

Include the amount from line 9 of all your Forms 8814 in the total on line 40, Form 1040, or line 39, Form 1040NR. Check box **a** on Form 1040, line 40, or Form 1040NR, line 39.

Illustrated Example

David and Linda Parks are married and will file separate tax returns for 2001. Their only child, Philip, is 8. Philip received a Form 1099–INT showing \$3,200 taxable interest income and a Form 1099–DIV showing \$300 ordinary dividends. His parents decide to include that income on one of their returns so they will not have to file a return for Philip.

First, David and Linda each figure their taxable income (Form 1040, line 39) without regard to Philip’s income. David’s taxable income is \$41,700 and Linda’s is \$59,300. Because her taxable income is greater, Linda can elect to include Philip’s income on her return.

On Form 8814 (see illustrated form), Linda enters her name and social security number,

then Philip’s name and social security number. She enters Philip’s taxable interest income, \$3,200, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. Linda enters Philip’s ordinary dividends, \$300, on line 2. Philip did not have any capital gain distributions, so she leaves line 3 blank.

Linda adds lines 1a and 2 and enters the result, \$3,500, on line 4. From that amount she subtracts the \$1,500 base amount shown on line 5 and enters the result, \$2,000, on line 6. This is the part of Philip’s income that Linda must add to her income.

Linda includes the \$2,000 in the total on line 21 of her Form 1040 and in the space next to that line prints “Form 8814 – \$2,000.” Adding that amount to her income increases each of the amounts on lines 22, 33, 34, 37, and 39 of her Form 1040 by \$2,000. Linda is not claiming any deductions or credits that are affected by the increase to her income. Therefore, her revised taxable income on line 39 is \$61,300 (\$59,300 + \$2,000).

On Form 8814, Linda subtracts the \$750 shown on line 7 from the \$3,500 on line 4 and enters the result, \$2,750, on line 8. Because that amount is not less than \$750, she checks the “No” box and enters \$75 on line 9. This is the tax on the first \$1,500 of Philip’s income, which Linda did not have to add to her income. She must add this additional tax to the tax figured on her revised taxable income.

The tax on her \$61,300 revised taxable income is \$14,240. She adds \$75, and enters the \$14,315 total on line 40 of Form 1040, and checks box **a**.

**Parents' Election To Report
Child's Interest and Dividends**

▶ See instructions below and on back.
▶ Attach to parents' Form 1040 or Form 1040NR.

Name(s) shown on your return <p style="text-align:center;">Linda Parks</p>	Your social security number <p style="text-align:center;">111 : 00 : 1111</p>
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Caution: The Federal income tax on your child's income, including capital gain distributions, may be less if you file a separate tax return for the child instead of making this election. This is because you cannot take certain tax benefits that your child could take on his or her own return. For details, see **Tax Benefits You May Not Take** on the back.

A Child's name (first, initial, and last) <p style="text-align:center;">Philip Parks</p>	B Child's social security number <p style="text-align:center;">000 : 00 : 0000</p>
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c If more than one Form 8814 is attached, check here

Part I Child's Interest and Dividends To Report on Your Return

1a Enter your child's taxable interest. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions	1a	3,200	
b Enter your child's tax-exempt interest. Do not include this amount on line 1a	1b		
2 Enter your child's ordinary dividends, including any Alaska Permanent Fund dividends. If your child received any ordinary dividends as a nominee, see the instructions	2	300	
3 Enter your child's capital gain distributions. If your child received any capital gain distributions as a nominee, see the instructions	3		
4 Add lines 1a, 2, and 3. If the total is \$1,500 or less, skip lines 5 and 6 and go to line 7. If the total is \$7,500 or more, do not file this form. Your child must file his or her own return to report the income	4	3,500	
5 Base amount	5	1,500	00
6 Subtract line 5 from line 4. If you checked the box on line C above or if you entered an amount on line 3, see the instructions. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. Go to line 7 below ▶	6	2,000	

Part II Tax on the First \$1,500 of Child's Interest and Dividends

7 Amount not taxed.	7	750	00
8 Subtract line 7 from line 4. If the result is zero or less, enter -0-	8	2,750	
9 Tax. Is the amount on line 8 less than \$750? <input checked="" type="checkbox"/> No. Enter \$75 here and see the Note below. <input type="checkbox"/> Yes. Multiply line 8 by 10% (.10). Enter the result here and see the Note below.	9	75	

Note: If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 9 in the tax you enter on Form 1040, line 40, or Form 1040NR, line 39. Be sure to check box **a** on Form 1040, line 40, or Form 1040NR, line 39.

General Instructions

Purpose of Form. Use this form if you elect to report your child's income on your return. If you do, your child will not have to file a return. You can make this election if your child meets **all** of the following conditions.

- Was under age 14 on January 1, 2002.
- Is required to file a 2001 return.
- Had income only from interest and dividends, including Alaska Permanent Fund dividends.
- Had gross income for 2001 that was less than \$7,500.
- Had no estimated tax payments for 2001 (including any overpayment of tax from his or her 2000 return applied to 2001 estimated tax).

- Had no Federal income tax withheld from his or her income.

You must also qualify. See **Parents Who Qualify To Make the Election** below.

How To Make the Election. To make the election, complete and attach Form(s) 8814 to your tax return and file your return by the due date (including extensions). A separate Form 8814 must be filed for **each** child whose income you choose to report.

Parents Who Qualify To Make the Election. You qualify to make this election if you file Form 1040 or Form 1040NR and **any** of the following apply.

- You are filing a joint return for 2001 with the child's other parent.
- You and the child's other parent were married to each other but file separate

returns for 2001 **and** you had the **higher** taxable income.

- You were unmarried, treated as unmarried for Federal income tax purposes, or separated from the child's other parent by a divorce or separate maintenance decree. You must have had custody of your child for most of the year (you were the custodial parent). If you were the custodial parent and you remarried, you may make the election on a joint return with your new spouse. But if you and your new spouse do not file a joint return, you qualify to make the election only if you had **higher** taxable income than your new spouse.

(continued)

Step 1. Figuring the Child's Net Investment Income (Form 8615, Part I)

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. To do that, use Part I of Form 8615.

Line 1 (investment income). If the child had **no earned income**, enter on this line the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 33 of Form 1040, line 19 of Form 1040A, or line 33 of Form 1040NR. Form 1040EZ cannot be used if Form 8615 must be filed.

If the child had **earned income**, figure the amount to enter on line 1 of Form 8615 by using the worksheet in the instructions for the form.

However, if the child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, use the *Alternate Worksheet for Line 1 of Form 8615* in Publication 929 to figure the amount to enter on line 1 of Form 8615.

Investment income defined. Investment income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, the taxable part of social security and pension payments, and certain distributions from trusts. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

Nontaxable income. For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

Income from property received as a gift. A child's investment income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child regardless of when the property was transferred or purchased or who transferred it.

A child's investment income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Example. Amanda Black, age 13, received the following income.

- Dividends — \$600
- Wages — \$2,100
- Taxable interest — \$1,200
- Tax-exempt interest — \$100
- Net capital gains — \$100.

The dividends were on stock given to her by her grandparents.

Amanda's investment income is \$1,900. This is the total of the dividends (\$600), taxable interest (\$1,200), and net capital gains (\$100). Her wages are earned (not investment) income be-

cause they are pay received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

Trust income. If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

Line 2 (deductions). If the child does not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,500 on line 2.

If the child does itemize deductions, enter on line 2 the larger of:

- 1) \$750 plus the child's itemized deductions that are directly connected with the production of investment income, or
- 2) \$1,500.

Directly connected. Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees.

These expenses are added to certain other miscellaneous deductions on Schedule A (Form 1040). Only the amount greater than 2% of the child's adjusted gross income can be deducted. See chapter 30 for more information.

Example 1. Roger, age 12, has investment income of \$8,000, no other income, no adjustments to income, and itemized deductions of \$300 (net of the 2%-of-adjusted-gross-income limit) that are directly connected with his investment income. His adjusted gross income is \$8,000, which is entered on line 1. Line 2 is \$1,500 because that is more than the sum of \$750 and his directly-connected itemized deductions of \$300.

Example 2. Eleanor, 8, has investment income of \$16,000 and an early withdrawal penalty of \$100. She has no other income. She has itemized deductions of \$1,050 (net of the 2% of adjusted gross income limit) that are directly connected with the production of her investment income. Her adjusted gross income, entered on line 1, is \$15,900 (\$16,000 - \$100). Line 2 is \$1,800. This is the larger of:

- 1) \$750 plus the \$1,050 of directly connected itemized deductions, or
- 2) \$1,500.

Step 2. Figuring Tentative Tax at the Parent's Tax Rate (Form 8615, Part II)

The tentative tax is the difference between the tax on the parent's taxable income figured with the child's net investment income (plus the net investment income of any other child whose Form 8615 includes the tax return information of that parent) and the tax figured without it.

When figuring the tentative tax, do not refigure any of the exclusions, deductions, or credits on the parent's return because of the child's net investment income. For example, do not refigure the medical expense deduction.

Figure the tentative tax on lines 6 through 13 of Form 8615.

Note. If the child has any capital gains or losses, get Publication 929 for help in completing Part II of Form 8615.



You may be able to skip lines 7 through 16 of Form 8615. See the Form 8615 instructions for line 6 for details.

Line 7 (net investment income of other children). If the tax return information of the parent is also used on any other child's Form 8615, enter on line 7 the total of the amounts from line 5 of all the other children's Forms 8615. Do not include the amount from line 5 of the Form 8615 being completed.

Example. Paul and Jane Persimmon have three children, Sharon, Jerry, and Mike, who must attach Form 8615 to their tax returns. The children's net investment income amounts on line 5 of their Forms 8615 are:

- Sharon — \$800
- Jerry — \$600
- Mike — \$1,000

Line 7 of Sharon's Form 8615 will show \$1,600 (\$600 + \$1,000), the total of the amounts on line 5 of Jerry's and Mike's Forms 8615.

Line 7 of Jerry's Form 8615 will show \$1,800 (\$800 + \$1,000).

Line 7 of Mike's Form 8615 will show \$1,400 (\$800 + \$600).

Other children's information not available. If the net investment income of the other children is not available when the return is due, either file the return using estimates or get an extension of time to file. See *Parent's return information not known timely*, earlier.

Line 11 (tentative tax). Subtract line 10 from line 9 and enter the result on this line. This is the tentative tax.

If line 7 is blank, skip lines 12a and 12b and enter the amount from line 11 on line 13.

Lines 12a and 12b (dividing the tentative tax). If an amount is entered on line 7, divide the tentative tax shown on line 11 among the children according to each child's share of the total net investment income. This is done on lines 12a, 12b, and 13. Add the amount on line 7 to the amount on line 5 and enter the total on line 12a. Divide the amount on line 5 by the amount on line 12a and enter the result as a decimal on line 12b.

Example. In the earlier example under *Line 7 (net investment income of other children)*, Sharon's Form 8615 shows \$1,600 on line 7. Line 12a is \$2,400, the total of lines 5 and 7 (\$800 + \$1,600). The decimal on line 12b is .333, figured as follows and rounded to three places.

$$\frac{\$800}{\$2,400} = .333$$

Step 3. Figuring the Child's Tax (Form 8615, Part III)

The final step in figuring a child's tax using Form 8615 is to determine the **larger** of:

- 1) The total of:
 - a) The child's share of the tentative tax based on the parent's tax rate, plus
 - b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
- 2) The tax on the child's taxable income, figured at the child's tax rate.

This is the child's tax. It is figured on lines 14 through 18 of Form 8615.



Tax computation for certain dependents. Generally, if the child can be claimed as a dependent on someone else's tax return, you can reduce any tax amount figured using the 2001 Tax Table or Tax Rate Schedules (including any line 15 tax figured on any worksheet or schedule described in the following paragraphs) by one-third of the tax amount or \$300, whichever is smaller.

This reduction **does not apply** to the following dependents.

- A child who received (before any offsets) an advance payment of their 2001 taxes.
- A child who files Form 1040NR.

Alternative minimum tax. A child may be subject to alternative minimum tax (AMT) if he or

she has certain items given preferential treatment under the tax laws or certain adjustments to taxable income that total more than an exemption amount. See *Alternative Minimum Tax* in chapter 31.

AMT is figured on Form 6251. For information on special limits that apply to a child who files Form 6251, *Alternative Minimum Tax—Individuals*, see *Alternative Minimum Tax* in Publication 929.

Illustrated Example

The following example includes a completed Form 8615.

John and Laura Brown have one child, Sara. She is 13 and has \$2,750 taxable interest and dividend income and \$1,500 earned income. She does not itemize deductions and did not receive an advance payment of her 2001 taxes during 2001. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara is under age 14 and has more than \$1,500 investment income, part of her income may be subject to tax at her parents' rate. A completed Form 8615 must be attached to her return.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara's investment income, \$2,750, on line 1. Sara does not itemize deductions, so John enters \$1,500 on line 2. He enters \$1,250 (\$2,750 – \$1,500) on line 3.

Sara's taxable income, as shown on line 25 of her Form 1040A, is \$2,500. This is her total income (\$4,250) minus her standard deduction (\$1,750). Her standard deduction is limited to the amount of her earned income plus \$250. John enters \$2,500 on line 4.

John compares lines 3 and 4 and enters the smaller amount, \$1,250, on line 5.

John enters \$48,000 on line 6. This is the taxable income from line 39 of their joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds line 5 (\$1,250), line 6 (\$48,000), and line 7 (blank), and enters \$49,250 on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on \$49,250. He enters the tax, \$7,901 on line 9. He enters \$7,557 on line 10. This is the tax from line 40 of John and Laura's Form 1040. He enters \$344 on line 11 (\$7,901 – \$7,557).

Because line 7 is blank, John skips lines 12a and 12b and enters \$344 on line 13.

John subtracts line 5 (\$1,250) from line 4 (\$2,500) and enters the result, \$1,250, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on \$1,250 and reduces it as explained earlier. He enters this tax, \$126, on line 15. He adds lines 13 (\$344) and 15 (\$126) and enters \$470 on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on \$2,500 (line 4) and reduces it as explained earlier. He enters this tax, \$251, on line 17.

John compares lines 16 and 17 and enters the larger amount, \$470, on line 18 of Sara's Form 8615. He also enters that amount on line 26 of Sara's Form 1040A.

John also completes Schedule 1 (Form 1040A) for Sara.

Tax for Children Under Age 14 With Investment Income of More Than \$1,500

▶ **Attach only to the child's Form 1040, Form 1040A, or Form 1040NR.**
▶ **See separate instructions.**

Child's name shown on return

Sara L. Brown

Child's social security number

117 : 00 : 1111

Before you begin: If the child, the parent, or any of the parent's other children under age 14 received capital gains (including capital gain distributions) or farm income, see **Pub. 929**, Tax Rules for Children and Dependents. It explains how to figure the tax for lines 9 and 15 using the **Capital Gain Tax Worksheet** in the Form 1040 or Form 1040A instructions, or **Schedule D** or **J** (Form 1040).

<p>A Parent's name (first, initial, and last). Caution: See instructions before completing.</p> <p style="text-align: center;">John J. Brown</p>	<p>B Parent's social security number</p> <p style="text-align: center;">007 : 00 : 0001</p>
<p>C Parent's filing status (check one):</p> <p> <input type="checkbox"/> Single <input checked="" type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input type="checkbox"/> Head of household <input type="checkbox"/> Qualifying widow(er) </p>	

Part I Child's Net Investment Income

1 Enter the child's investment income (see instructions)	1	2,750	
2 If the child did not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,500. If the child did itemize deductions, see instructions	2	1,500	
3 Subtract line 2 from line 1. If zero or less, do not complete the rest of this form but do attach it to the child's return	3	1,250	
4 Enter the child's taxable income from Form 1040, line 39; Form 1040A, line 25; or Form 1040NR, line 38	4	2,500	
5 Enter the smaller of line 3 or line 4. If zero or less, do not complete the rest of this form but do attach it to the child's return	5	1,250	

Part II Tentative Tax Based on the Tax Rate of the Parent

6 Enter the parent's taxable income from Form 1040, line 39; Form 1040A, line 25; Form 1040EZ, line 6; TeleFile Tax Record, line K; Form 1040NR, line 38; or Form 1040NR-EZ, line 14. If zero or less, enter -0-	6	48,000	
7 Enter the total, if any, from Forms 8615, line 5, of all other children of the parent named above. Do not include the amount from line 5 above	7		
8 Add lines 5, 6, and 7. If the total is not more than \$45,200, lines 9 through 16 may not have to be completed (see instructions)	8	49,250	
9 Enter the tax on the amount on line 8 based on the parent's filing status above (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used, check here ▶ <input type="checkbox"/>	9	7,901	
10 Enter the parent's tax from Form 1040, line 40; Form 1040A, line 26, minus any alternative minimum tax; Form 1040EZ, line 11; TeleFile Tax Record, line K; Form 1040NR, line 39; or Form 1040NR-EZ, line 15. Do not include any tax from Form 4972 or 8814. If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) was used to figure the tax, check here . . ▶ <input type="checkbox"/>	10	7,557	
11 Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to Part III	11	344	
12a Add lines 5 and 7	12a		
b Divide line 5 by line 12a. Enter the result as a decimal rounded to at least three places	12b	x .	
13 Multiply line 11 by line 12b.	13	344	

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on lines 14 and 15 and go to line 16.

14 Subtract line 5 from line 4	14	1,250	
15 Enter the tax on the amount on line 14 based on the child's filing status (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used, check here . ▶ <input type="checkbox"/>	15	126	
16 Add lines 13 and 15	16	470	
17 Enter the tax on the amount on line 4 based on the child's filing status (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	17	251	
18 Enter the larger of line 16 or line 17 here and on the child's Form 1040, line 40; Form 1040A, line 26; or Form 1040NR, line 39	18	470	

33.

Child and Dependent Care Credit

Important Reminders

Limit on credit. For 2001, your credit can offset both your regular tax (after reduction by any foreign tax credit) and your alternative minimum tax, if any. Previously, the credit could offset only your regular tax.

Taxpayer identification number needed for each qualifying person. You must include on line 2 of Form 2441 or Schedule 2 (Form 1040A) the name and taxpayer identification number (generally the social security number) of each qualifying person. See *Taxpayer identification number* under *Qualifying Person Test*, later.

You may have to pay employment taxes. If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. Usually, you are *not* a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business. See *Employment Taxes for Household Employers*, later.

Introduction

This chapter discusses the **credit for child and dependent care expenses** and covers the following topics.

- Tests you must meet to claim the credit.
- How to figure the credit.
- How to claim the credit.
- Employment taxes you may have to pay as a household employer.

You may be able to claim the credit if you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself. The credit can be up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work.



This credit should not be confused with the Child Tax Credit discussed in chapter 35.

Dependent care benefits. If you received any dependent care benefits from your employer during the year, you may be able to exclude from your income all or part of them. You must complete Part III of Form 2441 or Schedule 2 (Form 1040A) before you can figure the amount of your credit. See *Employer-Provided*

Dependent Care Benefits under *How To Figure the Credit*, later.

Useful Items

You may want to see:

Publication

- ❑ **501** Exemptions, Standard Deduction, and Filing Information
- ❑ **503** Child and Dependent Care Expenses
- ❑ **926** Household Employer's Tax Guide

Form (and Instructions)

- ❑ **2441** Child and Dependent Care Expenses
- ❑ **Schedule 2 (Form 1040A)** Child and Dependent Care Expenses for Form 1040A Filers
- ❑ **Schedule H (Form 1040)** Household Employment Taxes
- ❑ **W-7** Application for IRS Individual Taxpayer Identification Number
- ❑ **W-10** Dependent Care Provider's Identification and Certification

Tests To Claim the Credit

To be able to claim the credit for child and dependent care expenses, you must file Form 1040 or Form 1040A, not Form 1040EZ, and meet **all** the following tests.

- 1) The care must be for one or more qualifying persons who are identified on the form you use to claim the credit. (See *Qualifying Person Test*.)
- 2) You (and your spouse if you are married) must keep up a home that you live in with the qualifying person or persons. (See *Keeping Up a Home Test*, later.)
- 3) You (and your spouse if you are married) must have earned income during the year. (However, see *Rule for student-spouse or spouse not able to care for self* under *Earned Income Test*, later.)
- 4) You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for work. (See *Work-Related Expense Test*, later.)
- 5) You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. (See *Payments to Relatives* under *Work-Related Expense Test*, later.)
- 6) Your filing status must be single, head of household, qualifying widow(er) with dependent child, or married filing jointly. You must file a joint return if you are married,

unless an exception applies to you. (See *Joint Return Test*, later.)

- 7) You must identify the care provider on your tax return. (See *Provider Identification Test*, later.)
- 8) If you exclude dependent care benefits provided by your employer, the amount you exclude must be less than the dollar limit for qualifying expenses (generally, \$2,400 if one qualifying person was cared for or \$4,800 if two or more qualifying persons were cared for). (See *Reduced Dollar Limit* under *How To Figure the Credit*, later.)

These tests are presented in *Figure 33-A* and are also explained in detail in this chapter.

Qualifying Person Test

Your child and dependent care expenses must be for the care of one or more qualifying persons.

A qualifying person is:

- 1) Your dependent who was under age 13 when the care was provided and for whom you can claim an exemption,
- 2) Your spouse who was physically or mentally not able to care for himself or herself, or
- 3) Your dependent who was physically or mentally not able to care for himself or herself and for whom you can claim an exemption (or could claim an exemption except the person had \$2,900 or more of gross income).

If you are divorced or separated, see *Child of Divorced or Separated Parents*, later, to determine which parent may treat the child as a qualifying person.

Physically or mentally not able to care for oneself. Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

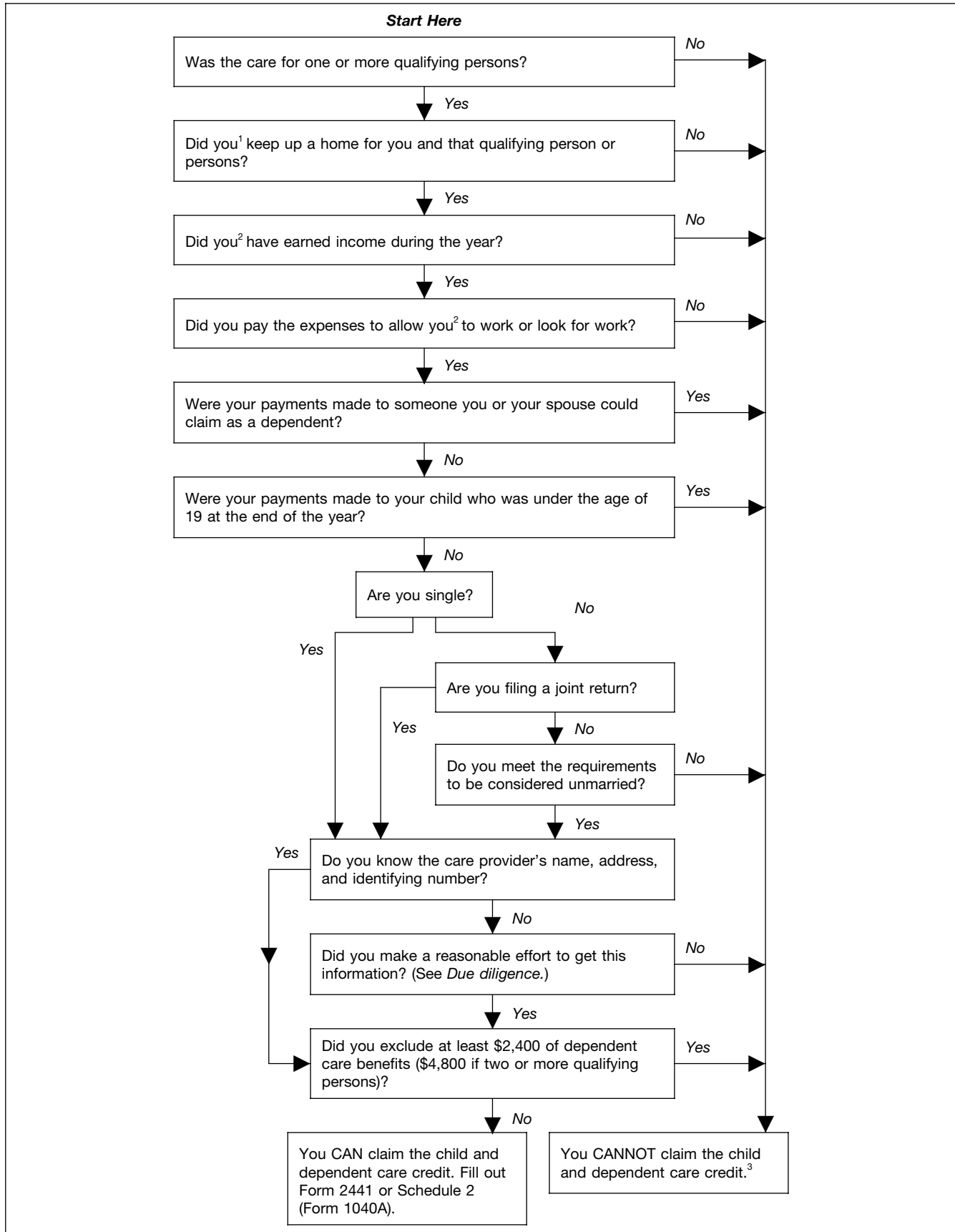
Person qualifying for part of year. You determine a person's qualifying status each day. For example, if the person for whom you pay child and dependent care expenses no longer qualifies on September 16, count only those expenses through September 15. Also see *Dollar Limit* under *How To Figure the Credit*, later.

Taxpayer identification number. You must include on your return the name and taxpayer identification number (generally the social security number) of the qualifying person(s). If the correct information is not shown, the credit may be reduced or disallowed.

Individual taxpayer identification number (ITIN) for aliens. If your qualifying person is a nonresident or resident alien who does not have and cannot get a social security number (SSN), use that person's ITIN. To apply for an ITIN, file Form W-7 with the IRS. The ITIN is entered wherever an SSN is requested on a tax return.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change

Figure 33–A. **Can You Claim the Credit?**



¹This includes your spouse if you were married.

²This also applies to your spouse, unless your spouse was disabled or a full-time student.

³If you had expenses that met the requirements for 2000, except that you did not pay them until 2001, you may be able to claim those expenses in 2001. See *Expenses not paid until the following year* under *How To Figure the Credit*.

the holder's employment or immigration status under U.S. law.

Adoption taxpayer identification number (ATIN). If your qualifying person is a child who was placed in your home for adoption and for whom you do not have an SSN, you must get an ATIN for the child. File Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*.

Child of Divorced or Separated Parents

To be a qualifying person, your child usually must be your dependent for whom you can claim an exemption. But an exception may apply if you are divorced or separated. Under the exception, if you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the non-custodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

This exception applies if **all** of the following are true.

- 1) One or both parents had custody of the child for more than half of the year.
- 2) One or both parents provided more than half of the child's support for the year.
- 3) Either—
 - a) The custodial parent signed **Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents**, or a similar statement, agreeing not to claim the child's exemption for the year, or
 - b) The noncustodial parent provided at least \$600 for the child's support and can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance or written agreement.

For purposes of 3(a), a similar statement includes a divorce decree or separation agreement that went into effect after 1984 that allows the noncustodial parent to claim the child's exemption without any conditions, such as payment of support.

You can use *Figure 33-B* to see whether this exception applies to you. If it applies, only the custodial parent can treat the child as a qualifying person. If the exception does not apply, follow the regular rules for a qualifying person under *Qualifying Person Test*, earlier.

Example. You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the exemption. You pay child care expenses so you can work. Your child is a qualifying person and you, the custodial parent, can claim the credit for those expenses, even though your ex-spouse claims an exemption for the child.

Custodial parent. You are the custodial parent if, during the year, you have custody of your child longer than your child's other parent has custody.

Divorced or separated. For purposes of determining whether your child is a qualifying per-

son, you are considered divorced or separated if **either** of the following applies.

- 1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement.
- 2) You lived apart from your spouse for all of the last 6 months of the year.

Keeping Up a Home Test

To claim the credit, you must keep up a home. You and one or more qualifying persons must live in the home.

You are keeping up a home if you (and your spouse if you are married) pay more than half the cost of running it for the year.

Home. The home you keep up must be the main home for both you and the qualifying person. Your home can be the qualifying person's main home even if he or she does not live there all year because of his or her:

- 1) Birth,
- 2) Death, or
- 3) Temporary absence due to:
 - a) Sickness,
 - b) School,
 - c) Business,
 - d) Vacation,
 - e) Military service, or
 - f) Custody agreement.

Costs of keeping up home. The costs of keeping up a home normally include property taxes, **mortgage interest**, rent, utility charges, home repairs, insurance on the home, and food eaten at home.

Costs not included. The costs of keeping up a home do not include payments for clothing, education, medical treatment, vacations, life insurance, transportation, or **mortgage principal**.

They also do not include the purchase, permanent improvement, or replacement of property. For example, you cannot include the cost of replacing a water heater. However, you can include the cost of repairing a water heater.

Earned Income Test

To claim the credit, you (and your spouse if you are married) must have earned income during the year.

Earned income. Earned income includes wages, salaries, tips, other employee compensation, and net earnings from self-employment. A net loss from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages.

Certain nontaxable earned income included. It also includes nontaxable earned income such as parsonage allowances, meals and lodging furnished for the convenience of the employer, voluntary salary deferrals, military basic quarters and subsistence allowances and

in-kind quarters and subsistence, and military pay earned in a combat zone.

Members of certain religious faiths opposed to social security. Certain income earned by persons who are members of certain religious faiths that are opposed to participation in Social Security Act Programs and have an IRS-approved form that exempts certain income from social security and Medicare taxes may not be considered earned income for this purpose. See *Earned Income Test* in Publication 503.

Not earned income. Earned income does not include pensions or annuities, social security payments, workers' compensation, interest, dividends, or unemployment compensation. It also does not include scholarship or fellowship grants, except amounts paid to you (and reported on Form W-2) for teaching, research, or other services.

Rule for student-spouse or spouse not able to care for self. Your spouse is treated as having earned income for any month that he or she is:

- 1) A full-time student, or
- 2) Physically or mentally not able to care for himself or herself.

Figure the earned income of the nonworking spouse described under (1) or (2) above as explained under *Earned Income Limit*, later.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or physically or mentally not able to care for yourselves, only one of you can be treated as having earned income in that month.

Full-time student. You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.) If you attend school only at night, you are not a full-time student. However, as part of your full-time course of study, you may attend some night classes.

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

Work-Related Expense Test

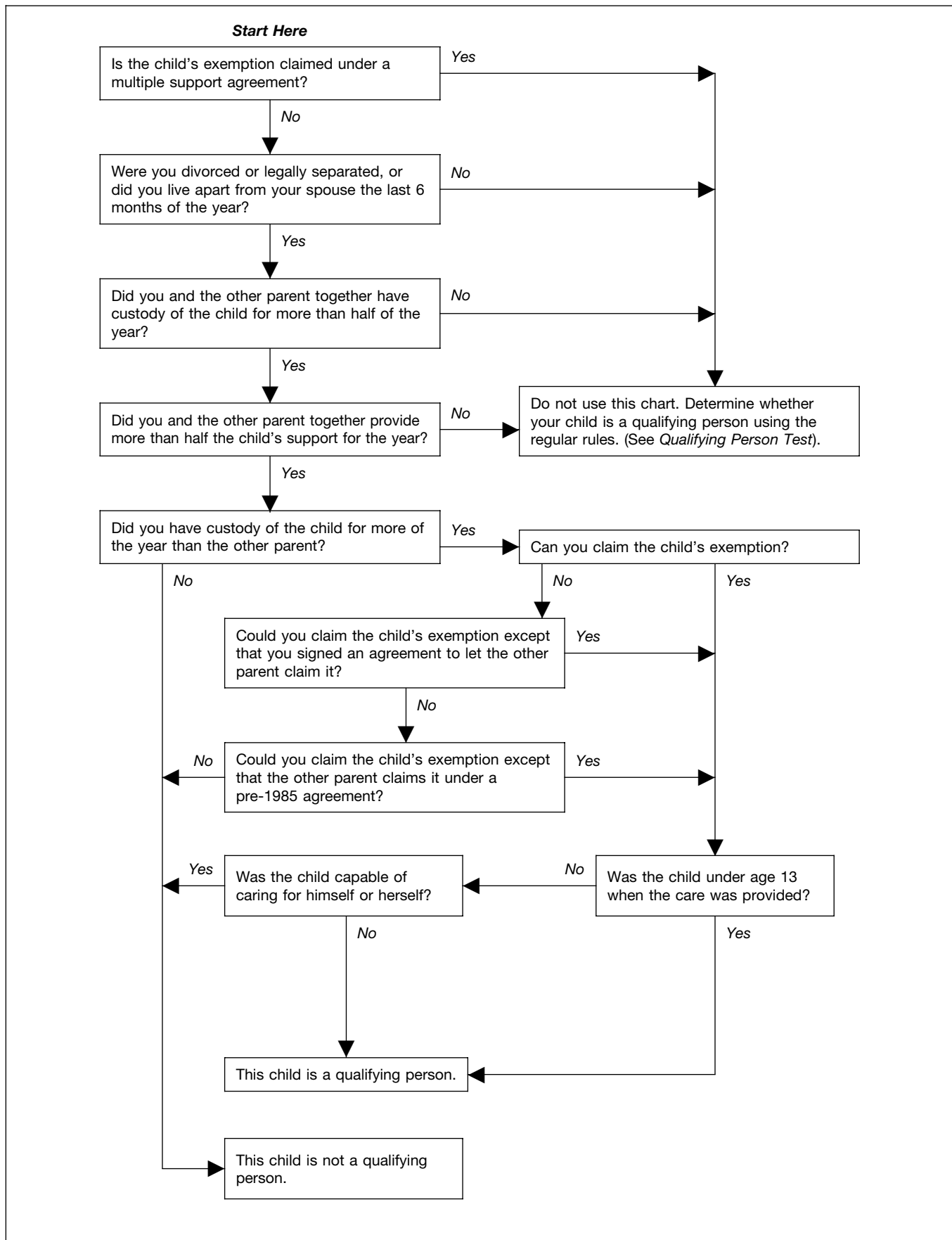
Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true.

- They allow you (and your spouse if you are married) to work or look for work.
- They are for a qualifying person's care.

Working or Looking for Work

To be work related, your expenses must allow you to work or look for work. If you are married, generally both you and your spouse must work

Figure 33–B. Is a Child of Divorced or Separated Parents a Qualifying Person?



or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for himself or herself.

Your work can be for others or in your own business or partnership. It can be either full time or part time.

Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test*, earlier.

Whether your expenses allow you to work or look for work depends on the facts. For example, the cost of a sitter while you and your spouse go out to eat is not normally a work-related expense.

An expense is not considered work related merely because you had it while you were working. The purpose of the expense must be to enable you to work.

Volunteer work. You are not gainfully employed if you do unpaid volunteer work or volunteer work for a nominal salary.

Work for part of year. If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of \$200 a month (\$2,400 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of \$200 a month, your work-related expenses are limited to \$500 a month (2½ months × \$200).

Payments while you are out sick. Do not count as work-related expenses amounts you pay for child and dependent care while you are off work because of illness. These amounts are not paid to allow you to work. This applies even if you get sick pay and are still considered an employee.

Care of a Qualifying Person

To be work related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care.

Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection.

Expenses for **household services** qualify if part of the services is for the care of qualifying persons. See *Household services*, later.

Expenses not for care. Expenses for care do not include amounts you pay for food, clothing, education, and entertainment. However, you can include small amounts paid for these items if they are incident to and cannot be separated from the cost of caring for the qualifying person.

Education. Expenses to attend first grade or a higher grade are not expenses for care. Do not use these expenses to figure your credit.

Example 1. You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool child-care service. You can count the total cost when you figure the credit.

Example 2. You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You can count that part of the expense in figuring your credit if it can be separated from the cost of education. You cannot count any part of the amount you pay the school for your child's education.

Care outside your home. You can count the cost of care provided outside your home if the care is for your dependent under age 13 or any other qualifying person who regularly spends at least 8 hours each day in your home.

Dependent care center. You can count care provided outside your home by a dependent care center only if the center complies with all state and local regulations that apply to these centers.

A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

Camp. The cost of sending your child to an overnight camp is **not** considered a work-related expense.

Transportation. The cost of getting a qualifying person from your home to the care location and back, or from the care location to school and back, is **not** considered a work-related expense. This includes the costs of bus, subway, taxi, or private car. Also, if you pay the transportation cost for the care provider to come to your home, you cannot count this cost as a work-related expense.

Household services. Expenses you pay for household services meet the work-related expense test if they are at least partly for the well-being and protection of a qualifying person.

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener. See *Household Services* in Publication 503 for more information.

In this chapter, the term housekeeper refers to any household employee whose services include the care of a qualifying person.

Taxes paid on wages. The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers*, later.

Payments to Relatives

You can count work-related payments you make to relatives who are not your dependents, even if they live in your home. However, do not count any amounts you pay to:

- 1) A dependent for whom you (or your spouse if you are married) can claim an exemption, or
- 2) Your child who was under age 19 at the end of the year, even if he or she is not your dependent.

Joint Return Test

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit.

Legally separated. You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You are eligible to take the credit on a separate return.

Married and living apart. You are not considered married and are eligible to take the credit if **all** the following apply.

- 1) You file a separate return.
- 2) Your home is the home of a qualifying person for more than half the year.
- 3) You pay more than half the cost of keeping up your home for the year.
- 4) Your spouse does not live in your home for the last 6 months of the year.

Death of spouse. If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse's separate return.

Provider Identification Test

You must identify all persons or organizations that provide care for your child or dependent. Use Part I of Form 2441 or Schedule 2 (Form 1040A) to show the information.

Information needed. To identify the care provider, you must give the provider's:

- 1) Name,
- 2) Address, and
- 3) Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number or individual taxpayer identification number. If the care provider is an organization, then it is the employer identification number (EIN).

You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write "Tax-Exempt" in the space where the tax form calls for the number.

If you cannot provide all of the information or if the information you provide is incorrect you must be able to show that you used due diligence (discussed later) in trying to furnish the necessary information.

Getting the information. You can use **Form W-10** to request the required information from the care provider. If you do not use Form W-10, you can get the information from:

- 1) A copy of the provider's social security card,

- 2) A copy of the provider's driver's license (in a state where the license includes the social security number),
- 3) A copy of the provider's completed Form W-4 if he or she is your household employee,
- 4) A copy of the statement furnished by your employer if the provider is your employer's dependent care plan, or
- 5) A letter or invoice from the provider if it shows the information.



You should keep this information with your tax records. Do not send Form W-10 (or other document containing this information) to the Internal Revenue Service.

Due diligence. If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that you used due diligence in trying to supply the information, you can still claim the credit.

You can show due diligence by getting and keeping the provider's completed Form W-10 or one of the other sources of information listed earlier. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

Provider refusal. If the provider refuses to give you their identifying information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Write "See page 2" in the columns calling for the information you do not have. On the bottom of page 2, explain that you requested the information from the care provider, but the provider did not give you the information. This statement will show that you used due diligence in trying to furnish the necessary information.

How To Figure the Credit

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

Figuring Total Work-Related Expenses

To figure the credit for 2001 work-related expenses, count only those you paid by December 31, 2001.

Expenses prepaid in an earlier year. If you pay for services before they are provided, you can count the prepaid expenses only in the year the care is received. Claim the expenses for the later year as if they were actually paid in that later year.

Expenses not paid until the following year. Do **not** count 2000 expenses that you paid in 2001 as work-related expenses for 2001. You may be able to claim an additional credit for

them on your 2001 return, but you must figure it separately. See *Payments for previous year's expenses* under *Amount of Credit* in Publication 503.



If you had expenses in 2001 that you did not pay until 2002, you cannot count them when figuring your 2001 credit. You may be able to claim a credit for them on your 2002 return.

Expenses reimbursed. If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

Example. You paid work-related expenses of \$3,000. You are reimbursed \$2,000 by a state social services agency. You can use only \$1,000 to figure your credit.

Medical expenses. Some expenses for the care of qualifying persons who are not able to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.



*Amounts excluded from your income under your employer's dependent care benefits plan **cannot** be used to claim a medical expense deduction.*

Employer-Provided Dependent Care Benefits

Dependent care benefits include:

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

Your salary may have been reduced to pay for these benefits. If you received benefits, they should be shown on your W-2 form. See *Statement for employee*, later.

Exclusion. If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies. If it does, you must complete Part III of either Form 2441 or Schedule 2 (Form 1040A) to claim the exclusion even if you cannot take the credit. You cannot use Form 1040EZ.

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

- 1) The total amount of dependent care benefits you received during the year,

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

Statement for employee. Your employer must give you a **Form W-2** (or similar statement), showing in box 10 the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over \$5,000 in your wages shown in box 1 of your Form W-2.

Forfeitures. Forfeitures are amounts credited to your dependent care benefit account (flexible spending account) and included in the amount shown in box 10 of your Form W-2, but not received because you did not incur the expense. When figuring your exclusion, subtract any forfeitures from the total dependent care benefits reported by your employer. To do this, enter the forfeited amount on line 11 of Form 2441 or Schedule 2 (Form 1040A).



Forfeitures do not include amounts that you expect to receive in the future.

Effect of exclusion. If you exclude dependent care benefits from your income, the amount of the excluded benefits:

- 1) Is not included in your work-related expenses, and
- 2) Reduces the dollar limit, discussed later.

Earned Income Limit

The amount of work-related expenses you use to figure your credit cannot be more than:

- 1) Your earned income for the year if you are **single** at the end of the year, or
- 2) The smaller of your or your spouse's earned income for the year if you are **married** at the end of the year.

Earned income is defined under *Earned Income Test*, earlier.



For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.

Separated spouse. If you are legally separated or married and living apart from your spouse (as described under *Joint Return Test*, earlier), you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Surviving spouse. If your spouse died during the year and you file a joint return as a surviving spouse, you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Community property laws. You should disregard community property laws when you figure earned income for this credit.

Student-spouse or spouse not able to care for self. Your spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least \$200 if there is one qualifying person in your home, or at least \$400 if there are two or more.

Spouse works. If your spouse works during that month, use the higher of \$200 (or \$400) or his or her actual earned income for that month.

Spouse qualifies for part of month. If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full \$200 (or \$400) still applies for that month.

Both spouses qualify. If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of \$200 (or \$400) for that month.

Dollar Limit

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is \$2,400 for one qualifying person, or \$4,800 for two or more qualifying persons.

Yearly limit. The dollar limit is a yearly limit. The amount of the dollar limit remains the same no matter how long, during the year, you have a qualifying person in your household. Use the \$2,400 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use \$4,800 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured on lines 20 through 24 of Form 2441 or Schedule 2 (Form 1040A). See *Employer-Provided Dependent Care Benefits*, earlier, for information on excluding these benefits.

Example. George is a widower with one child and earns \$24,000 a year. He pays work-related expenses of \$1,900 for the care of his 4-year-old child and qualifies to claim the credit for child and dependent care expenses. His employer pays an additional \$1,000 under a dependent care benefit plan. This \$1,000 is excluded from George's income.

Although the dollar limit for his work-related expenses is \$2,400 (one qualifying person), George figures his credit on only \$1,400 of the \$1,900 work-related expenses he paid. This is because his dollar limit is reduced as shown next.

George's Reduced Dollar Limit

1) Maximum allowable expenses for one qualifying person	\$2,400
---	---------

2) Minus: Dependent care benefits George excludes from income	-1,000
3) Reduced dollar limit on expenses George can use for the credit	<u>\$1,400</u>

Amount of Credit

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on line 34 of Form 1040 or line 19 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

IF your adjusted gross income is		THEN the percentage is
Over	But not over	
\$0	\$10,000	30%
10,000	12,000	29%
12,000	14,000	28%
14,000	16,000	27%
16,000	18,000	26%
18,000	20,000	25%
20,000	22,000	24%
22,000	24,000	23%
24,000	26,000	22%
26,000	28,000	21%
28,000	No limit	20%

How To Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

Form 1040. You must complete **Form 2441** and attach it to your Form 1040. Enter the credit on line 44 of your Form 1040. An example of a filled-in Form 2441 is at the end of this chapter.

Form 1040A. You must complete **Schedule 2** (Form 1040A) and attach it to your Form 1040A. Enter the credit on line 27 of your Form 1040A.

Limit on credit. The amount of credit you can claim is limited to the amount of your regular tax (after reduction by any allowable foreign tax credit) plus your alternative minimum tax, if any. For more information, see the instructions for Form 2441 or Schedule 2 (Form 1040A).

Tax credit not refundable. You cannot get a refund for any part of the credit that is more than this limit.



Recordkeeping. You should keep records of your work-related expenses. Also, if your dependent or spouse is not able to care for himself or herself, your records should show both the nature and the length of the disability. Other records you should keep to support your claim for the credit are described earlier under *Provider Identification Test*.

Employment Taxes for Household Employers

If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer. If you are a household employer, you will need an employer identification number (EIN) and you may have to pay employment taxes. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees. Usually, you are **not** a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

If you use a placement agency that exercises control over what work is done and how it will be done by a babysitter or companion who works in your home, that person is not your employee. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an agency merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

- 1) Social security and Medicare taxes,
- 2) Federal unemployment tax, and
- 3) Federal income tax withholding.

Social security and Medicare taxes are generally withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and provides for payments of unemployment compensation to workers who have lost their jobs. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

For more information on a household employer's tax responsibilities, see Publication 926 and Schedule H (Form 1040) and its instructions.

State employment taxes. You may also have to pay state unemployment tax. Contact your state unemployment tax office for information. You should also find out whether you need to pay or collect other state employment taxes or carry workers' compensation insurance. A list of state employment tax agencies, including addresses and phone numbers, is in Publication 926.

Example

The following example shows how to figure the credit for child and dependent care expenses for two children when employer dependent care benefits are involved. The filled-in Form 2441 is shown at the end of this chapter.

Illustrated example. Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her adjusted gross

income (AGI) is \$29,000, and the entire amount is earned income.

Joan's younger child (Susan) stays at her employer's on-site child-care center while she works. The benefits from this child-care center qualify to be excluded from her income. Her employer reports the value of this service as \$3,000 for the year. This \$3,000 is shown in box 10 of her Form W-2, but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child (Seth) after school, on holidays, and during the summer. She pays her neighbor \$2,400 for this care.

Joan figures her credit on Form 2441 as follows.

Work-related expenses Joan paid	<u>\$2,400</u>
Dollar limit	<u>\$4,800</u>

Minus: Dependent care benefits excluded from Joan's income	<u>-3,000</u>
Reduced dollar limit	<u>\$1,800</u>
Lesser of expenses paid (\$2,400) or dollar limit (\$1,800)	\$1,800
Percentage for AGI of \$29,000	<u>x .20</u>
Amount of credit (20% of \$1,800)	<u><u>\$ 360</u></u>

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040.
▶ See separate instructions.

Name(s) shown on Form 1040

Joan Thomas

Your social security number

559 00 3436

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**
- **Earned Income**

Part I **Persons or Organizations Who Provided the Care**—You must complete this part.
(If you need more space, use the bottom of page 2.)

1	(a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
	Pat Green	12 Ash Avenue Hometown, TX 75240	240-00-3811	2,400
	ACME Computers	(See W-2)		

Did you receive dependent care benefits?

No —————> Complete only Part II below.

Yes —————> Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 57.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s)**. If you have more than two qualifying persons, see the instructions.

2	(a) Qualifying person's name First Last	(b) Qualifying person's social security number	(c) Qualified expenses you incurred and paid in 2001 for the person listed in column (a)
	Seth Thomas	559 00 1234	2,400
	Susan Thomas	559 00 5678	

3 Add the amounts in column (c) of line 2. Do not enter more than \$2,400 for one qualifying person or \$4,800 for two or more persons. If you completed Part III, enter the amount from line 24	3	1,800																					
4 Enter your earned income	4	29,000																					
5 If married filing a joint return, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); all others , enter the amount from line 4	5	29,000																					
6 Enter the smallest of line 3, 4, or 5	6	1,800																					
7 Enter the amount from Form 1040, line 34	7	29,000																					
8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	X . 20																					
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">If line 7 is:</td> <td style="width: 50%;">If line 7 is:</td> </tr> <tr> <td style="border-bottom: 1px solid black;">Over</td> <td style="border-bottom: 1px solid black;">Over</td> </tr> <tr> <td style="border-bottom: 1px solid black;">But not over</td> <td style="border-bottom: 1px solid black;">But not over</td> </tr> <tr> <td style="border-bottom: 1px solid black;">Decimal amount is</td> <td style="border-bottom: 1px solid black;">Decimal amount is</td> </tr> <tr> <td>\$0—10,000 .30</td> <td>\$20,000—22,000 .24</td> </tr> <tr> <td>10,000—12,000 .29</td> <td>22,000—24,000 .23</td> </tr> <tr> <td>12,000—14,000 .28</td> <td>24,000—26,000 .22</td> </tr> <tr> <td>14,000—16,000 .27</td> <td>26,000—28,000 .21</td> </tr> <tr> <td>16,000—18,000 .26</td> <td>28,000—No limit .20</td> </tr> <tr> <td>18,000—20,000 .25</td> <td></td> </tr> </table>	If line 7 is:	If line 7 is:	Over	Over	But not over	But not over	Decimal amount is	Decimal amount is	\$0—10,000 .30	\$20,000—22,000 .24	10,000—12,000 .29	22,000—24,000 .23	12,000—14,000 .28	24,000—26,000 .22	14,000—16,000 .27	26,000—28,000 .21	16,000—18,000 .26	28,000—No limit .20	18,000—20,000 .25				
If line 7 is:	If line 7 is:																						
Over	Over																						
But not over	But not over																						
Decimal amount is	Decimal amount is																						
\$0—10,000 .30	\$20,000—22,000 .24																						
10,000—12,000 .29	22,000—24,000 .23																						
12,000—14,000 .28	24,000—26,000 .22																						
14,000—16,000 .27	26,000—28,000 .21																						
16,000—18,000 .26	28,000—No limit .20																						
18,000—20,000 .25																							
9 Multiply line 6 by the decimal amount on line 8. Enter the result here and on Form 1040, line 44. But if this amount is more than the amount on Form 1040, line 42, minus any amount on line 43, or you paid 2000 expenses in 2001, see the instructions for the amount to enter on line 44	9	360																					

For Paperwork Reduction Act Notice, see page 3 of the instructions.

Part III Dependent Care Benefits

10	Enter the total amount of dependent care benefits you received for 2001. This amount should be shown in box 10 of your W-2 form(s). Do not include amounts that were reported to you as wages in box 1 of Form(s) W-2	10	3,000
11	Enter the amount forfeited, if any. See the instructions	11	
12	Subtract line 11 from line 10	12	3,000
13	Enter the total amount of qualified expenses incurred in 2001 for the care of the qualifying person(s)	13	5,400
14	Enter the smaller of line 12 or 13	14	3,000
15	Enter your earned income	15	29,000
16	If married filing a joint return, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5); if married filing a separate return, see the instructions for the amount to enter; all others , enter the amount from line 15	16	29,000
17	Enter the smallest of line 14, 15, or 16.	17	3,000
18	Excluded benefits. Enter here the smaller of the following: <ul style="list-style-type: none"> • The amount from line 17 or • \$5,000 (\$2,500 if married filing a separate return and you were required to enter your spouse's earned income on line 16). 	18	3,000
19	Taxable benefits. Subtract line 18 from line 12. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB"	19	-0-

To claim the child and dependent care credit, complete lines 20-24 below.

20	Enter \$2,400 (\$4,800 if two or more qualifying persons)	20	4,800
21	Enter the amount from line 18.	21	3,000
22	Subtract line 21 from line 20. If zero or less, stop . You cannot take the credit. Exception. If you paid 2000 expenses in 2001, see the instructions for line 9	22	1,800
23	Complete line 2 on the front of this form. Do not include in column (c) any benefits shown on line 18 above. Then, add the amounts in column (c) and enter the total here	23	2,400
24	Enter the smaller of line 22 or 23. Also, enter this amount on line 3 on the front of this form and complete lines 4-9	24	1,800

34.

Credit for the Elderly or the Disabled

Introduction

If you qualify, the law provides a number of credits that can reduce the tax you owe for a year. One of these credits is the credit for the elderly or the disabled.

This chapter explains:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

The maximum credit available is \$1,125. You may be able to take this credit if you are:

- Age 65 or older, or
- Retired on permanent and total disability.

Useful Items

You may want to see:

Publication

- 524** Credit for the Elderly or the Disabled
- 554** Older Americans' Tax Guide
- 967** The IRS Will Figure Your Tax

Forms (and Instructions)

- Schedule 3 (Form 1040A)** Credit for the Elderly or the Disabled for Form 1040A Filers
- Schedule R (Form 1040)** Credit for the Elderly or the Disabled

Can You Take the Credit?

You can take the credit for the elderly or the disabled if you meet **both** of the following requirements.

- 1) You are a **qualified individual**.
- 2) Your income is not more than certain limits.

You can use *Figure 34–A* and *Figure 34–B* as guides to see if you qualify.

Use *Figure 34–A* first to see if you are a qualified individual. If you are, go to *Figure 34–B* to make sure your income is not too high to take the credit.



You can take the credit only if you file Form 1040 or Form 1040A. You cannot take the credit if you file Form 1040EZ.

Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and either of the following applies.

- 1) You were age 65 or older at the end of 2001.
- 2) You were under age 65 at the end of 2001 and all three of the following statements are true.
 - a) You retired on permanent and total disability (explained later).
 - b) You received taxable disability income for 2001.
 - c) On January 1, 2001, you had not reached mandatory retirement age (defined later under *Disability Income*).

Age 65. You are considered to be age 65 on the day before your 65th birthday. Therefore, you are 65 at the end of the year if your 65th birthday is on January 1 of the following year.

U.S. Citizen or Resident

You must be a U.S. citizen or resident (or be treated as a resident) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

Exceptions. You may be able to take the credit if you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you and your spouse choose to treat you as a U.S. resident. If you make that choice, both you and your spouse are taxed on your worldwide income.

If you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you may be able to choose to be treated as a U.S. resident for the entire year. In that case, you may be allowed to take the credit. For information on these choices, see chapter 1 of Publication 519, *U.S. Tax Guide for Aliens*.

Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. However, if you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

Head of household. You can file as head of household and qualify to take the credit, even if your spouse lived with you during the first 6 months of the year, if you meet all the tests. See *Head of Household* in chapter 2 for the tests you must meet.

Under Age 65

If you are under age 65, you can qualify for the credit only if you are retired on permanent and total disability. If you retired after January 1, 1977, you are retired on permanent and total disability if you were permanently and totally disabled when you retired.

Even if you do not retire formally, you are considered retired on disability when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement*, later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit.

Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that you are able to engage in substantial gainful activity.

The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These qualified locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes.

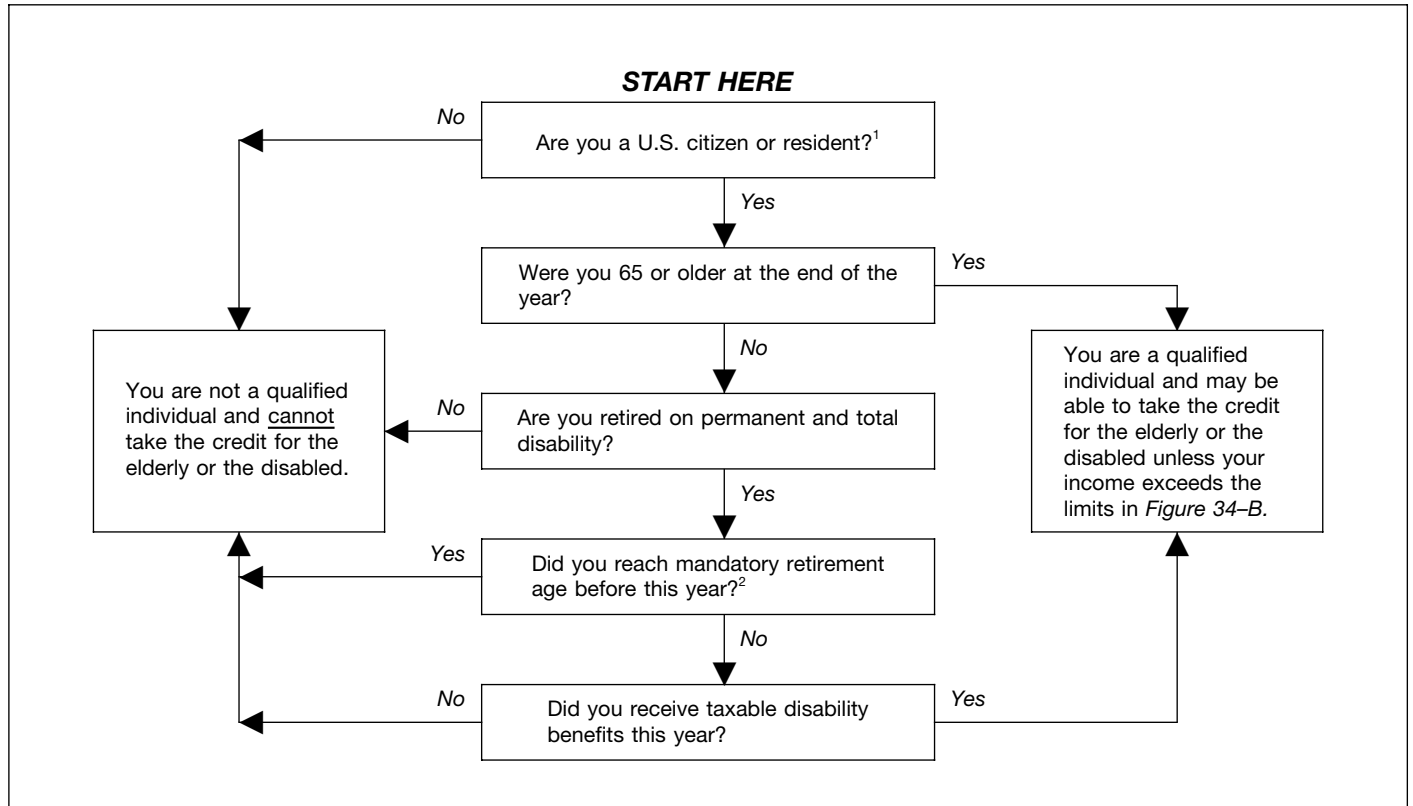
Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

Physician's statement. If you are under age 65, you must have your physician complete a statement certifying that you were permanently and totally disabled on the date you retired. You can use the statement in the instructions for Schedule R (Form 1040) or Schedule 3 (Form 1040A).

You do not have to file this statement with your Form 1040 or Form 1040A, but you **must** keep it for your records.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can substitute VA Form 21–0172, *Certification of Permanent and Total Disability*, for the physician's statement you are required to keep. VA Form 21–0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

Figure 34–A. Are You a Qualified Individual?



¹If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see *U.S. Citizen or Resident under Qualified Individual*. If you and your spouse choose to treat you as a U.S. resident, answer "yes" to this question.

²Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 34–B. Income Limits

IF your filing status is ...	THEN even if you qualify (see <i>Figure 34–A</i>), you CANNOT take the credit if ...	
	Your adjusted gross income (AGI)* is equal to or more than ...	OR your nontaxable social security and other nontaxable pension(s) is equal to or more than ...
Single, Head of household, or Qualifying widow(er) with dependent child	\$17,500	\$5,000
Married filing a joint return and both spouses qualify in <i>Figure 34–A</i>	\$25,000	\$7,500
Married filing a joint return and only one spouse qualifies in <i>Figure 34–A</i>	\$20,000	\$5,000
Married filing a separate return and you did not live with your spouse at any time during the year	\$12,500	\$3,750

*AGI is the amount on Form 1040A, line 19, or Form 1040, line 34.

Physician's statement obtained in earlier year. If you got a physician's statement in an earlier year **and**, due to your continued disabled condition, you were unable to engage in any substantial gainful activity during 2001, you may not need to get another physician's statement for 2001. For a detailed explanation of the conditions you must meet, see the instructions for Part II of Schedule R (Form 1040) or Schedule 3 (Form 1040A). If you meet the required conditions, check the box on line 2 of Part II of Schedule R (Form 1040) or Schedule 3 (Form 1040A).

If you checked box 4, 5, or 6 in Part I of either Schedule R or Schedule 3, print in the space above the box on line 2 in Part II, the first name(s) of the spouse(s) for whom the box is checked.

Disability income. If you are under age 65, you can qualify for the credit only if you have taxable disability income. Disability income must meet both of the following requirements.

- 1) It must be paid under your employer's accident or health plan or pension plan.
- 2) It must be included in your income as wages (or payments instead of wages) for the time you are absent from work because of permanent and total disability.


Payments that are not disability income. Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does not include amounts you receive after you reach mandatory retirement age. **Mandatory retirement age** is the age set by your employer at which you would have had to retire, had you not become disabled.

Income Limits

To determine if you can claim the credit, you must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security and other nontaxable pensions you received. The limits are shown in *Figure 34-B*, earlier.

If both your AGI and nontaxable pensions are less than the income limits, you may be able to claim the credit. See *Figuring the Credit*, next.


 **CAUTION** If either your AGI or your nontaxable pensions are equal to or more than the income limits, you cannot take the credit.

Figuring the Credit

You can figure the credit yourself (see the explanation that follows) or the IRS will figure it for you. See *Credit Figured for You*, later.

Figuring the credit yourself. If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3

(if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3.

 There are four steps in Part III to determine the amount of your credit:

- 1) Determine your **initial amount** (lines 10–12).
- 2) Total any **nontaxable social security** and certain other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c).
- 3) Determine your **excess adjusted gross income** (lines 14–17).
- 4) Determine your **credit** (lines 18–20).

These steps are discussed in more detail next.

Step 1. Determine Initial Amount

To figure the credit, you must first determine your initial amount. See *Table 34-1*.

Initial amounts for persons under age 65. If you are a qualified individual under age 65, your initial amount cannot be more than your taxable disability income.

Step 2. Total Certain Nontaxable Pensions and Benefits


Step 2 is to figure the total amount of nontaxable social security and certain other nontaxable payments (listed below) you received during the year.

Table 34-1. Initial Amounts

IF your filing status is ...	THEN enter on line 10 of Schedule R (Form 1040) or Schedule 3 (Form 1040A)...
Single , head of household, or qualifying widow or widower with dependent child and by the end of 2001, you were	
• 65 or older	\$5,000
• under 65 and retired on permanent and total disability ¹	\$5,000
Married filing a joint return and by the end of 2001	
• both of you were 65 or older	\$7,500
• both of you were under 65 and one of you retired on permanent and total disability ¹	\$5,000
• both of you were under 65 and both of you retired on permanent and total disability ²	\$7,500
• one of you was 65 or older, and the other was under 65 and retired on permanent and total disability ³	\$7,500
• one of you was 65 or older, and the other was under 65 and not retired on permanent and total disability	\$5,000
Married filing a separate return return and did not live with your spouse at any time during the year and, by the end of 2001, you were	
• 65 or older	\$3,750
• under 65 and retired on permanent and total disability ¹	\$3,750

¹Amount cannot be more than the taxable disability income.
²Amount cannot be more than your combined taxable disability income.
³Amount is \$5,000 plus the taxable disability income of the spouse under age 65, but not more than \$7,500.

Enter these nontaxable payments on lines 13a or 13b, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

 **TIP** Worksheets are provided in the Form 1040 or Form 1040A instructions to help you determine if any part of your social security benefits (or equivalent railroad retirement benefits) is taxable.

Include the following nontaxable payments in the amounts you enter on lines 13a and 13b.

- Nontaxable social security payments. This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA-1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under workers' compensation. Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payment you may receive as a guardian.
- Social security equivalent part of tier 1 railroad retirement pension payments that is not taxed. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB-1099.
- Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA). Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any

country or in the National Oceanic and Atmospheric Administration or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.

- Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code.

Do not include amounts that are a return of your cost of a pension or annuity. These amounts do not reduce your initial amount.



You should be sure to take into account all of the nontaxable amounts you receive. These amounts are verified by the IRS through information supplied by other government agencies.

Step 3. Determine Excess Adjusted Gross Income

You also must reduce your initial amount by your excess adjusted gross income. Figure your excess adjusted gross income on lines 14 through 17.

You figure your excess adjusted gross income as follows:

- 1) Subtract from your adjusted gross income (line 34 of Form 1040 or line 19 of Form 1040A) the amount shown for your filing status in the following list:
 - a) **\$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
 - b) **\$10,000** if you are married filing a joint return, or
 - c) **\$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.

- 2) Divide the result of (1) by 2.

Step 4. Determine Your Credit

To determine if you can take the credit, you must add the amounts you figured in Step 2 and Step 3.

IF the total of Steps 2 and 3 is ...	THEN ...
Equal to or more than the amount in Step 1	You cannot take the credit.
Less than the amount in Step 1	You can take the credit.

Figuring the credit. If you can take the credit, subtract the total of Step 2 and Step 3 from the amount in Step 1 and multiply the result by 15%. This is your credit.

In certain cases, the amount of your credit may be limited. See *Limit on Credit*, later.

Example. You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted

gross income is \$14,630. Together you received \$3,200 from social security, which was nontaxable. You figure the credit as follows:

1) Initial amount	.....	\$5,000
2) Subtract the total of:		
a) Nontaxable social security and other nontaxable pensions	.....	\$3,200
b) Excess adjusted gross income	.....	2,315
c) Balance (Not less than -0-)	.....	-0-
4) Credit	.....	<u>-0-</u>

You cannot take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your amount on line 1.

Limit on Credit

The amount of credit you can claim may be limited. Use one of the following worksheets (or the worksheet in the instructions for Schedule 3, Form 1040A, or Schedule R, Form 1040, whichever applies) to determine the amount of credit you can claim if any of the following apply.

- 1) You file Form 1040A and the credit you figured on line 20 of Schedule 3 is more than the tax on Form 1040A, line 26.
- 2) You file Form 1040 and the credit you figured on line 20 of Schedule R is more than the amount on Form 1040, line 42 (regular tax plus any alternative minimum tax), minus any foreign tax credit on Form 1040, line 43.
- 3) You are claiming the credit for child and dependent care expenses on:
 - a) Form 1040A, line 27, or
 - b) Form 1040, line 44.

If (1), (2), and (3) above do not apply, you do not need to use a worksheet to figure a limit on your credit. Claim the full amount of the credit you figured on Schedule 3 (Form 1040A) or Schedule R (Form 1040).

Credit Limit Worksheet (Form 1040)

Credit limit Worksheet (Form 1040)	
1) Enter the amount from Form 1040, line 42, minus any amount on Form 1040, line 43	_____
2) Enter the amount, if any, from Form 1040, line 44	_____
3) Subtract line 2 from line 1	_____
4) Enter the credit you first figured on Schedule R, line 20	_____
5) Credit. Enter the smaller of line 3 or line 4 here and on Form 1040, line 45. If line 3 is the smaller amount, also replace the amount on Schedule R, line 20, with that amount.	_____

Credit Limit Worksheet (Form 1040A)

1) Enter the amount from Form 1040A, line 26	_____
2) Enter the amount, if any from Form 1040A, line 27	_____
3) Subtract line 2 from line 1	_____
4) Enter the credit you first figured on Schedule 3, line 20	_____
5) Credit. Enter the smaller of line 3 or line 4 here and on Form 1040A, line 28. If line 3 is the smaller amount, also replace the amount on Schedule 3, line 20, with that amount.	_____

Credit Figured for You

If you choose to have the Internal Revenue Service (IRS) figure the credit for you, read the following discussion for the form you will file (Form 1040 or 1040A). If you want the IRS to figure your tax, see chapter 31.

Form 1040. If you want the IRS to figure your credit, see *Form 1040 Line Entries under Tax Figured by IRS* in chapter 31.

Form 1040A. If you want the IRS to figure your credit, see *Form 1040A Line Entries under Tax Figured by IRS* in chapter 31.

Examples

The following examples illustrate the credit for the elderly or the disabled. The initial amounts are taken from *Table 34-1*, shown earlier.

Example 1. James Davis is 58 years old, single, and files Form 1040A. In 1998 he retired on permanent and total disability, and he is still permanently and totally disabled. He got the required physician's statement in 1998, and kept it with his records. His physician signed on line B of the statement. This year James checks the box in Part II of Schedule 3. He does not need to get another statement for 2001.

He received the following income for the year:

Nontaxable social security	.....	\$2,500
Interest (taxable)	.....	100
Taxable disability pension	.....	9,400

James' adjusted gross income is \$9,500 (\$9,400 + \$100). He figures the credit on Schedule 3 as follows:

1) Initial amount	.....	\$5,000
2) Taxable disability pension	.....	\$9,400
3) Smaller of (1) or (2)	.....	\$5,000
4) Subtract the total of:		
a) Nontaxable disability benefits (social security)	.....	\$2,500
b) Excess adjusted gross income	.....	3,500
c) Balance (Not less than 0)	.....	\$1,500
5) Credit (15% of \$1,500)	.....	<u>\$225</u>

His credit is \$225. He enters \$225 on line 28 of Form 1040A.

Example 2. William White is 53. His wife Helen is 49. William had a stroke 3 years ago and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of last year, Helen was injured in an accident at work and retired on permanent and total disability.

William received nontaxable social security disability benefits of \$3,000 during the year and a taxable disability pension of \$6,000. Helen earned \$9,200 from her job and received a taxable disability pension of \$1,000. Their joint return on Form 1040 shows adjusted gross income of \$16,200 (\$6,000 + \$9,200 + \$1,000).

Helen got her doctor to complete the physician's statement in the instructions for Schedule R. Helen is not required to include the statement with her return, but she must keep it for her records.

William got a physician's statement for the year he had the stroke. His doctor had signed on line B of that physician's statement to certify that

William was permanently and totally disabled. William has kept the physicians's statement with his records. He checks the box in Part II of Schedule R and writes his first name in the space above line 2.

William and Helen use Schedule R to figure their \$135 credit for the elderly or the disabled. They attach Schedule R to their joint return and enter \$135 on line 45 of Form 1040. See their

filled-in Schedule R and Helen's filled-in physician's statement on the next three pages.

**Schedule R
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Credit for the Elderly or the Disabled

OMB No. 1545-0074

2001

Attachment
Sequence No. **16**

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule R (Form 1040).**

Name(s) shown on Form 1040

William M. White and Helen A. White

Your social security number

220 00 3333

You may be able to take this credit and reduce your tax if by the end of 2001:

- You were age 65 or older **or**
- You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See page R-1.



In most cases, the IRS can figure the credit for you. See page R-1.

Part I Check the Box for Your Filing Status and Age

If your filing status is: **And by the end of 2001:** **Check only one box:**

Single,
Head of household, or
Qualifying widow(er)
with dependent child

- 1 You were 65 or older 1
- 2 You were under 65 and you retired on permanent and total disability 2

Married filing a
joint return

- 3 Both spouses were 65 or older 3
- 4 Both spouses were under 65, but only one spouse retired on permanent and total disability 4
- 5 Both spouses were under 65, and both retired on permanent and total disability 5
- 6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability 6
- 7 One spouse was 65 or older, and the other spouse was under 65 and **not** retired on permanent and total disability 7

Married filing a
separate return

- 8 You were 65 or older and you lived apart from your spouse for all of 2001 8
- 9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2001. 9

**Did you check
box 1, 3, 7,
or 8?**

- Yes** —▶ Skip Part II and complete Part III on back.
- No** —▶ Complete Parts II and III.

Part II Statement of Permanent and Total Disability (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

If: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed or got a statement for tax years after 1983 and your physician signed line B on the statement, **and**

William

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 2001, check this box ▶

- If you checked this box, you do not have to get another statement for 2001.
- If you **did not** check this box, have your physician complete the statement on page R-4. You **must** keep the statement for your records.

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11359K

Schedule R (Form 1040) 2001

Instructions for Physician's Statement

Taxpayer

If you retired after 1976, enter the date you retired in the space provided on the statement below.

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

Physician

A person is permanently and totally disabled if **both** of the following apply:

Physician's Statement (keep for your records)

I certify that Helen A. White
Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. If retired after 1976, enter the date retired. ► November 30, 2001

Physician: Sign your name on **either** line A or B below.

A The disability has lasted or can be expected to last continuously for at least a year . . .

Physician's signature

Date

B There is no reasonable probability that the disabled condition will ever improve . . .

Juanita D. Doctor

2/7/2002

Physician's signature

Date

Physician's name

Juanita D. Doctor

Physician's address

1900 Green St., Hometown, MD 20000

35.

Child Tax Credit

Important Changes

Child tax credit increased. The maximum child tax credit for each qualifying child is increased to \$600 for 2001.

Additional child tax credit expanded. For tax years after 2000, the qualifications for claiming the additional child tax credit have been expanded to include qualifying individuals with fewer than three children. See *Additional Child Tax Credit*, later, for more information.

Introduction

The child tax credit is a credit that can reduce your tax. You may be able to take a credit on your tax return of up to \$600 for each of your qualifying children.

The child tax credit is not the same as the credit for child and dependent care expenses. For information on the credit for child and dependent care expenses, see chapter 33.

This chapter gives you information about the child tax credit. It explains:

- Who is a qualifying child.
- How much is the credit.
- How do I claim the credit.
- Why should I check my tax withholding.

If you have no tax. Credits, such as the child tax credit, the adoption credit, or the credit for child and dependent care expenses, are used to reduce tax. If your tax on line 42 (Form 1040) or line 26 (Form 1040A) is zero, do not figure the child tax credit because there is no tax to reduce. However, you may qualify for the additional child tax credit on line 63 (Form 1040) or line 40 (Form 1040A).

Useful Items

You may want to see:

Form (and Instructions)

- 8812** Additional Child Tax Credit
- W-4** Employee's Withholding Allowance Certificate

Qualifying Child

A qualifying child for purposes of the child tax credit must be all of the following.

- 1) Under age 17 at the end of 2001.
- 2) A citizen or resident of the United States.

- 3) Claimed as your dependent.
- 4) Your:
 - a) Son or daughter,
 - b) Stepson or stepdaughter,
 - c) Adopted child,
 - d) Grandchild, or
 - e) Eligible foster child.

Example. Your son turned 17 on December 30, 2001. He is a citizen of the United States and you claimed him as a dependent on your return. He is **not** a qualifying child for the child tax credit because he was **not** under age 17 at the end of 2001.

Adopted child. A child placed with you by an authorized placement agency for legal adoption is an adopted child even if the adoption is not final.

Grandchild. A grandchild is any descendant of your son, daughter, or adopted child and includes your great-grandchild, great-great-grandchild, etc.

Eligible foster child. An eligible foster child is any child you cared for as your own and who is:

- 1) Your brother, sister, stepbrother, stepsister, or
- 2) A descendent (such as a child) of your brother, sister, stepbrother, stepsister, or
- 3) A child placed with you by an authorized placement agency.

In addition, the child must have lived with you for all of 2001. A child who was born or died in 2001 is considered to have lived with you for all of 2001 if your home was the child's home for the entire time he or she was alive.

Kidnapped child. A kidnapped child is treated as a qualifying child for the child tax credit if the child is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of your family or the child's family. This treatment applies for all years that the child remains kidnapped. However, the last year this treatment can apply is the earlier of:

- 1) The year the child is determined to be dead, or
- 2) The year the child would have reached age 17.

Amount of Credit

The maximum credit you can claim is \$600 for each qualifying child.

Limits on the Credit

You must reduce your child tax credit if either (1) or (2) applies.

- 1) The amount on line 42 (Form 1040) or line 26 (Form 1040A) is less than the credit. If this amount is zero, you cannot take this credit because there is no tax to reduce.

But you may be able to take the **additional child tax credit**. See *Additional Child Tax Credit*, later.

- 2) Your modified adjusted gross income (AGI) is above the amount shown below for your filing status.

- Married filing jointly – \$110,000.
- Single, head of household, or qualifying widow(er) – \$75,000.
- Married filing separately – \$55,000.

Modified AGI. For purposes of the child tax credit, your modified AGI is your AGI plus the following amounts that may apply to you.

- Any amount excluded from income because of the exclusion of income from Puerto Rico.
- Any amount on lines 43 and 48 of Form 2555, *Foreign Earned Income*.
- Any amount on line 18 of Form 2555–EZ, *Foreign Earned Income Exclusion*.
- Any amount on line 15 of Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*.

If you do not have any of the above, modified AGI is the AGI amount on line 34 (Form 1040) or line 20 (Form 1040A).

Claiming the Credit

To claim the child tax credit, you must file Form 1040 or Form 1040A. You must provide the name and identification number (usually a social security number) on your tax return for each qualifying child.

Answer the *Questions* in your form instructions for line 48 (Form 1040) or line 31 (Form 1040A) to find out which child tax credit worksheet you can use to figure the credit.

If you answer "Yes" to question 1, 2, or 3 in your Form 1040 instructions or question 1 or 2 in your Form 1040A instructions, you must complete the child tax credit worksheet in Publication 972, *Child Tax Credit*. Otherwise, you can use the *Child Tax Credit Worksheet* in your Form 1040 or Form 1040A instructions. (See the filled-in example, later.)

Example

Amy Brown files as head of household and has two dependent children under age 17. The children are qualifying children for purposes of the child tax credit. Amy's only income is her salary of \$23,500. She had \$1,439 of social security and Medicare taxes withheld. Amy chooses to itemize her deductions and files Form 1040. Her AGI, shown on line 34 of her Form 1040, is \$23,500. This is her taxable earned income.

Amy does not file Form 2555, 2555–EZ, or 4563. She does not exclude income from Puerto Rico. Her modified AGI is \$23,500.

Amy's tax, shown on line 42 of her Form 1040, is \$1,226. She claims a \$960 credit for child and dependent care expenses on line 44.

She claims a \$1,810 earned income credit on line 61a. She has no other credits.

After answering the *Questions* in the Form 1040 instructions for line 48, she completes the child tax credit worksheet to figure her child tax credit of \$266. Amy's completed questions and child tax credit worksheet are shown later.

Amy reads the *TIP* in the worksheet and finds that she may be able to take the additional child tax credit. See *Additional Child Tax Credit* and Amy's completed Form 8812, later.

Additional Child Tax Credit

This credit is for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

How to claim the additional child tax credit. To claim the additional child tax credit, follow the steps below.

- 1) Make sure you figured the amount, if any, of your child tax credit. See *Claiming the Credit*, earlier.
- 2) Use Form 8812 to see if you can take the additional child tax credit only if you answered "Yes" on line 4 or line 5 of the *Child Tax Credit Worksheet*.
- 3) If you have an additional child tax credit on line 13 of Form 8812, carry it to line 63 (Form 1040) or line 40 (Form 1040A).

Taxable earned income. Generally, for purposes of the additional child tax credit, your taxable earned income is the amount on line 7 of Form 1040 or Form 1040A. See the instructions

for Form 8812 to figure your taxable earned income.

Checking Your Withholding

The child tax credit decreases your tax. You can check your tax withholding by using Worksheet 7 in Publication 919, *How Do I Adjust My Tax Withholding*.

If you are having too much tax withheld, and you prefer to have the money during the year, you may be able to decrease your withholding. You do this by completing a new Form W-4 and giving it to your employer.

Filled-in Questions for Amy Brown
(Page references are to the Form 1040 instructions.)

Questions


Who Must Use Pub. 972



1. Are you excluding income from Puerto Rico **or** are you filing any of the following forms?

- Form 2555 or 2555-EZ (relating to foreign earned income)
- Form 4563 (exclusion of income for residents of American Samoa)


No. *Continue* ↘

Yes.  You must use Pub. 972 to figure your credit.

2. Is the amount on Form 1040, line 34, more than the amount shown below for your filing status?

- Married filing jointly – \$110,000
- Single, head of household, or qualifying widow(er) – \$75,000
- Married filing separately – \$55,000

No. *Continue* ↘

Yes.  You must use Pub. 972 to figure your credit.

3. Are you claiming any of the following credits?

- Adoption credit, Form 8839 (see the instructions for Form 1040, line 49, on page 39)
- Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 50, on page 39)
- District of Columbia first-time homebuyer credit, Form 8859

No. Use the worksheet on page 38 to figure your child tax credit.

Yes. You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

Child Tax Credit Worksheet—Line 48

Keep for Your Records



Do not use this worksheet if you answered “Yes” to question 1, 2, or 3 on page 37. Instead, use Pub. 972.



1. Number of qualifying children: 2 × \$600. Enter the result. 1 1,200

2. Enter the amount from Form 1040, line 42. 2 1,226

3. Add the amounts from Form 1040:

Line 43 _____

Line 44 + 960

Line 45 + _____

Line 46 + _____

Line 47 + _____ Enter the total. 3 960

4. Are the amounts on lines 2 and 3 the same?

Yes.

You cannot take this credit because there is no tax to reduce. However, see the **TIP** below before completing the rest of your Form 1040.

No. Subtract line 3 from line 2. 4 266

5. Is the amount on line 1 more than the amount on line 4?

Yes. Enter the amount from line 4. Also, see the **TIP** below.

No. Enter the amount from line 1.

This is your child tax credit.

5 266

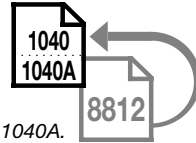
Enter this amount on Form 1040, line 48.



You may be able to take the **additional child tax credit** on Form 1040, line 63, if you answered “Yes” on line 4 or line 5 above.

- First, complete your Form 1040 through line 62.
- Then, use Form 8812 to figure any additional child tax credit.

Additional Child Tax Credit



Department of the Treasury
Internal Revenue Service

Complete and attach to Form 1040 or Form 1040A.

Name(s) shown on return

Amy Brown

Your social security number

012 00 5678

Part I All Filers

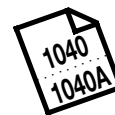
1	Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication	1	1,200
2	Enter the amount from Form 1040, line 48, or Form 1040A, line 31	2	266
3	Subtract line 2 from line 1. If zero, stop ; you cannot take this credit	3	934
4	Enter your total taxable earned income. See the instructions on back	4	23,500
5	Is the amount on line 4 more than \$10,000? <input type="checkbox"/> No. Leave line 5 blank and enter -0- on line 6. <input checked="" type="checkbox"/> Yes. Subtract \$10,000 from the amount on line 4. Enter the result.	5	13,500
6	Multiply the amount on line 5 by 10% (.10) and enter the result Next. Do you have three or more qualifying children? <input checked="" type="checkbox"/> No. If line 6 is zero, stop ; you cannot take this credit. Otherwise, skip Part II and enter the smaller of line 3 or line 6 on line 13. <input type="checkbox"/> Yes. If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.	6	1,350

Part II Certain Filers Who Have Three or More Qualifying Children

7	Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see the instructions on back	7	
8	1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 54, plus any uncollected social security and Medicare or RRTA taxes included on line 58. 1040A filers: Enter -0-.	8	
9	Add lines 7 and 8	9	
10	1040 filers: Enter the total of the amounts from Form 1040, lines 61a and 62. 1040A filers: Enter the total of the amount from Form 1040A, line 39a, plus any excess social security and RRTA taxes withheld that you entered to the left of line 41 (see the instructions on back).	10	
11	Subtract line 10 from line 9. If zero or less, enter -0-	11	
12	Enter the larger of line 6 or line 11 here Next, enter the smaller of line 3 or line 12 on line 13.	12	

Part III Your Additional Child Tax Credit

13	This is your additional child tax credit	13	934
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Enter this amount on
Form 1040, line 63, or
Form 1040A, line 40.

36.

Education Credits

Introduction

This chapter discusses the Hope credit and the lifetime learning credit. It will:

- Give you general information that applies to both of the credits,
- Give you specific information about each of the credits,
- Help you choose which of the credits to claim, and
- Show you how to figure the credit you choose.

Useful Items

You may want to see:

Publication

- 970** Tax Benefits for Higher Education

Form (and Instructions)

- 8863** Education Credits (Hope and Lifetime Learning Credits)

Education Tax Credits

The following two tax credits are available to persons who pay higher education costs.

- The Hope credit.
- The lifetime learning credit.

Table 36–1. Comparison of Education Credits

Hope Scholarship Credit	Lifetime Learning Credit
Up to \$1,500 credit per eligible student	Up to \$1,000 credit per return
Available ONLY for the first two years of postsecondary education	Available for all years of postsecondary education
Available ONLY for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing a degree or other recognized educational credential	Student does not need to be pursuing a degree or other recognized educational credential
Student must be enrolled at least half time for at least one academic period during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction rule does not apply

Table 36–1 compares the Hope and lifetime learning credits. If you are eligible to claim both credits based on the higher education expenses of one student, it will generally be to your benefit to claim the Hope credit.



If a student receives a tax-free withdrawal from an education IRA in a particular tax year, none of that student's expenses can be used as the basis of a higher education credit for that tax year. However, the student can waive the tax-free treatment. See Waiver of tax-free treatment under No double benefit allowed.

Rules That Apply to Both Credits

The amount of each credit is determined by the amount you pay for qualified tuition and related expenses for students and the amount of your modified adjusted gross income. Education credits are subtracted from your tax but they are nonrefundable. This means if the credits are more than your tax, the excess is not refunded to you.



If you are married filing separately you cannot claim the higher education credits.

What expenses qualify. The credits are based on qualified tuition and related expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally the credits are allowed for qualified tuition and related expenses paid for an academic period beginning in the same year as the year the payment is made (but see *Prepaid expenses*, later).

In general, qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution. Student-activity fees and fees for course-related books, supplies, and equipment are included in qualified tuition and related expenses **only if** the fees must be paid **to the institution** as a condition of enrollment or attendance.

Prepaid expenses. If you paid qualified tuition and related expenses in 2001 for an academic period that begins in the first three months of 2002, you can use the prepaid amount in figuring your credit.

For example, if you paid \$2,000 in December 2001 for qualified tuition for the winter 2002 semester beginning in January 2002, you can use that \$2,000 in figuring your 2001 credit.

Payments with borrowed funds. You can claim an education credit for qualified tuition and related expenses paid with the proceeds of a loan. You claim the credit in the year in which the expenses are paid, not in the year in which the loan is repaid.

Expenses that do not qualify. Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living or family expenses.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games, or hobbies, or any non-credit course. However, if the course of instruction or other education is part of the student's degree program or, in the case of the lifetime learning credit, is taken by the student to acquire or improve job skills, these expenses can qualify.

Dependent for whom you claim an exemption. You claim an exemption for a dependent if you list his or her name on line 6c, Form 1040 (or Form 1040A). (See chapter 3 for details on exemptions for dependents.)

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution.

No double benefit allowed. You cannot:

- Deduct higher education expenses on your income tax return and also claim a Hope credit based on those same expenses,
- Claim a Hope credit and a lifetime learning credit based on the same qualified education expenses, or

- Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to qualified expenses*, next.

Adjustments to qualified expenses. If you pay higher education expenses with certain **tax-free** funds, you cannot claim a credit for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance you received. Tax-free educational assistance could include:

- Scholarships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Do not reduce the qualified expenses by amounts paid with the student's:

- Earnings,
- Loans,
- Gifts,
- Inheritances, and
- Personal savings.

Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses.

Waiver of tax-free treatment. The designated beneficiary of a Coverdell ESA (formerly known as an education IRA) can waive the tax-free treatment of the withdrawal and elect to pay any tax that would otherwise be owed on the withdrawal. The beneficiary or the beneficiary's parents may then be eligible to claim a Hope credit or lifetime learning credit for qualified higher education expenses paid in that tax year. See *Coverdell ESAs* in Publication 970.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2001, and you received a refund of those expenses before you file your tax return for 2001, simply reduce the amount of the expenses by the amount of the refund received. If you receive the refund after you file your tax return, see *When must the credit be repaid*, next.

When must the credit be repaid? If, after you file your 2001 tax return, you receive tax-free educational assistance for, or a refund of, an expense you used to figure a higher education credit on that return, you may have to repay all or part of the credit. You must refigure your education credits as if the assistance or refund was received in 2001. Subtract the amount of the refigured credit from the amount of the credit you claimed. See the instructions for your 2001 tax return for information about how and where to report the repayment (recapture).

Who can claim the credit. If there are higher education costs for your dependent for a year,

either you or your dependent, but not both of you, can claim a credit for that dependent's expenses for that year. If you claim an exemption for your dependent on your tax return, only you can claim a credit. If you do not claim an exemption for your dependent on your tax return, only your dependent can claim a credit.

Expenses paid by dependent. If you claim an exemption on your tax return for an eligible student who is your dependent, treat any expenses paid by the student as if you had paid them. Include these expenses when figuring the amount of your Hope or lifetime learning credit.



Qualified tuition and related expenses paid directly to an eligible educational institution for your dependent under a court-approved divorce decree are treated as paid by your dependent.

Expenses paid by others. If someone other than you, your spouse, or your dependent (such as a relative or former spouse) makes a payment directly to an eligible educational institution to pay for an eligible student's qualified tuition and related expenses, the student is treated as receiving the payment from the other person. The student is treated as paying the qualified tuition and related expenses to the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. Ms. Allen makes a payment directly to an eligible educational institution in 2001 for her grandson Todd's qualified tuition and related expenses. For purposes of claiming an education credit, Todd is treated as receiving the money from Ms. Allen and, in turn, paying his qualified tuition and related expenses himself.

If Todd's exemption is not claimed on anyone's return, he can use the payment to claim an education credit.

If anyone, such as his parents, claims an exemption for him on their tax return, whoever lists him as a dependent may be able to use the expenses to claim an education credit.

Nonresident alien. You cannot claim an education credit if you (or your spouse) were a nonresident alien for any part of 2001, and the nonresident alien did not elect to be treated as a resident alien. More information on nonresident aliens can be found in Publication 519, *Tax Guide for U.S. Aliens*.

Does the Amount of Your Income Affect the Amount of Your Credit?

Your education credits are phased out (gradually reduced) if your modified adjusted gross income is between \$40,000 and \$50,000 (\$80,000 and \$100,000 if you file a joint return). You cannot claim **any** higher education credits if your modified adjusted gross income is \$50,000 or more (\$100,000 or more if you file a joint return).

How the phaseout works. The phaseout (reduction) works on a sliding scale. The higher your modified adjusted gross income, the more your credits are reduced. You figure the reduction, if any, in Part III of Form 8863.

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (MAGI) will be their adjusted gross income (AGI) as figured on their federal income tax return.

On Form 1040, AGI is line 34. On Form 1040A, AGI is line 19.

However, you must file using Form 1040 and make adjustments to your AGI if you excluded income earned abroad or from certain U.S. territories or possessions.

If this applies to you, increase your AGI by the following amounts you excluded from your income.

- 1) Foreign earned income of U.S. citizens or residents living abroad.
- 2) Housing costs of U.S. citizens or residents living abroad.
- 3) Income from sources within Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.

At present, no implementation agreement has been signed with Guam or the Northern Mariana Islands to allow exclusion of income from those sources. Until an implementation agreement is signed, there is no exclusion from these sources which must be added to your AGI to determine MAGI.

Hope Credit

You may be able to claim a Hope credit of up to \$1,500 for qualified tuition and related expenses paid for **each** eligible student.

Eligible student for the Hope credit. For purposes of the Hope credit an eligible student is a student who meets **all** of the following requirements.

- 1) Did not have expenses that were used to figure a Hope credit in any 2 earlier years.
- 2) Had not **completed the first 2 years** of postsecondary education (generally, the freshman and sophomore years of college).
- 3) Was **enrolled at least half-time** in a program that leads to a degree, certificate, or other recognized educational credential, for at least one **academic period** beginning in 2001.
- 4) Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2001.

Completion of first 2 years. A student who was awarded 2 years of academic credit for postsecondary work completed before 2001 has completed the first 2 years of postsecondary education. This student would not be an eligible student for purposes of the Hope credit.

Any academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed 2 years of postsecondary education.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standards may not be lower than those established by the Department of Education under the Higher Education Act of 1965.

Amount of credit. The amount of the Hope credit is the sum of:

- 1) 100% of the first \$1,000 qualified tuition and related expenses you paid for each eligible student, **and**
- 2) 50% of the next \$1,000 qualified tuition and related expenses you paid for each eligible student.

The maximum amount of Hope credit you can claim in 2001 is \$1,500 times the number of eligible students. You can claim the full \$1,500 for each eligible student for whom you paid at least \$2,000 of qualified expenses. However, the credit may be reduced based on your modified adjusted gross income. See *Does the Amount of Your Income Affect the Amount of Your Credit?*, earlier.

Example. Jon and Karen are married and file a joint tax return. For 2001, they claim an exemption for their dependent daughter on their tax return and their modified adjusted gross income is \$70,000. Their daughter is in her sophomore (second) year of studies at the local university and Jon and Karen pay qualified tuition and related expenses of \$4,300 in 2001.

Jon and Karen, their daughter, and the local university meet all of the requirements for the Hope credit. Jon and Karen can claim a \$1,500 Hope credit in 2001. This is 100% of the first \$1,000 qualified tuition and related expenses, plus 50% of the next \$1,000.

How to figure the Hope credit. The Hope credit is figured in Parts I and III of Form 8863. An illustrated example using Form 8863 appears later.

Lifetime Learning Credit

You may be able to claim a lifetime learning credit of up to \$1,000 for qualified tuition and related expenses paid for **all** students enrolled in eligible educational institutions.

The lifetime learning credit is different than the Hope credit in the following ways.

- 1) The lifetime learning credit is not based on the student's work load. It is allowed for one or more courses.
- 2) Expenses for graduate-level degree work are eligible.
- 3) Expenses related to a course of instruction or other education that involves sports, games, hobbies, or other noncredit courses are eligible **if** they are part of a

course of instruction to acquire or improve job skills.

- 4) There is no limit on the number of years for which the lifetime learning credit can be claimed for each student. It is not limited to students in the first 2 years of postsecondary education.
- 5) The amount you can claim as a lifetime learning credit does not vary (increase) based on the number of students for whom you pay qualified expenses.

Amount of credit. The amount of the lifetime learning credit is 20% of the first \$5,000 qualified tuition and related expenses you pay for all eligible students. The maximum amount of lifetime learning credit you can claim for 2001 is \$1,000 (20% × \$5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Does the Amount of Your Income Affect the Amount of Your Credit*, earlier.

Example. Bruce and Toni are married and file a joint tax return. For 2001, their modified adjusted gross income is \$50,000. Toni is attending the community college (an eligible educational institution) to earn credits towards an associate's degree in nursing. She already has a bachelor's degree in history and wants to become a nurse. In August 2001, Toni paid \$4,000 for her fall 2001 semester. Bruce and Toni can claim an \$800 (20% × \$4,000) lifetime learning credit on their 2001 joint tax return.

How to figure the lifetime learning credit. The lifetime learning credit is figured in Parts II and III of Form 8863. An illustrated example using Form 8863 appears later.

Choosing Which Credit To Claim

For each student, you can elect for any tax year only **one** of the credits **or** a tax-free withdrawal from a Coverdell ESA. (See *Coverdell ESAs* in chapter 4, Publication 970, for more information.)

For example, if you elect to take the Hope credit for a child on your 2001 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2001 or take a tax-free withdrawal from a Coverdell ESA for 2001.

Lifetime learning credit after Hope credit. You can claim the Hope credit for the first 2 years of a student's postsecondary education and claim the lifetime learning credit for that same student in later tax years.

Tax credits for more than one student. If you pay qualified expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis.

This means that, for example, you can claim the Hope credit for one student and the lifetime learning credit for another student in the same tax year.

How Is the Credit Claimed?

You elect to claim education credits and you figure their amount by completing **Form 8863**. A filled-in Form 8863 is shown in the *Illustrated Example* at the end of this chapter.

An eligible educational institution (such as a college or university) that received payment of qualified tuition and related expenses in 2001, generally must issue **Form 1098-T, Tuition Payments Statement**, to each student by February 1, 2002. The eligible educational institution may ask for a completed **Form W-9S, Request for Student's or Borrower's Social Security Number and Certification**, or similar statement, to obtain the student's name, address, and taxpayer identification number.

Illustrated Example

Dave and Valerie are married and file a joint tax return. For 2001, they claim exemptions for their two dependent children on their tax return. Their modified adjusted gross income is \$72,000. Their tax is \$9,475. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2002. Their daughter, Corey, enrolled full-time at that same college in August 2000 to begin working on her bachelor's degree in physical education. In December 2000, Dave and Valerie paid \$2,000 for each child's tuition for the winter 2001 semester. In July 2001, they paid \$2,200 in tuition costs for each of them for the fall 2001 semester.

Dave and Valerie, their children, and the college meet all of the requirements for the higher education credits. Because Sean is beyond the second (sophomore) year of his postsecondary education, his expenses do not qualify for the Hope credit. But, amounts paid for Sean's expenses in 2001 for academic periods after 2000 and before April 1, 2002, qualify for the lifetime learning credit. Corey is in her first (freshman) year of postsecondary education and expenses paid for her in 2001 for academic periods beginning after 2000 and before April 1, 2002, qualify for the Hope credit.

Dave and Valerie figure their total higher education credits for 2001, \$1,940, as shown in the completed Form 8863. They can claim the full amount because their modified adjusted gross income is not more than \$80,000. They carry the amount from Form 8863 to line 46 of Form 1040, and they attach the **Form 8863** to their return.

Education Credits (Hope and Lifetime Learning Credits)

Department of the Treasury
Internal Revenue Service

▶ See instructions on pages 2 and 3. ▶ Attach to Form 1040 or Form 1040A.

2001

Attachment
Sequence No. **50**

Name(s) shown on return

Dave and Valerie Jones

Your social security number

987 : 00 : 6543

Part I Hope Credit. Caution: The Hope credit may be claimed for no more than 2 tax years for the same student.

1 (a) Student's name (as shown on page 1 of your tax return) First, Last	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Corey Jones	137 : 00 : 9642	2,000	1,000		500
2 Add the amounts in columns (d) and (f)			2	1,000	500
3 Tentative Hope credit. Add the amounts on line 2, columns (d) and (f) ▶					3 1,500

Part II Lifetime Learning Credit

4 Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.	(a) Student's name (as shown on page 1 of your tax return) First Last	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
Sean Jones	246 : 00 : 9731	2,200	
5 Add the amounts on line 4, column (c), and enter the total			5 2,200
6 Enter the smaller of line 5 or \$5,000			6 2,200
7 Tentative lifetime learning credit. Multiply line 6 by 20% (.20) ▶			7 440

Part III Allowable Education Credits

8 Tentative education credits. Add lines 3 and 7.	8	1,940	
9 Enter: \$100,000 if married filing jointly; \$50,000 if single, head of household, or qualifying widow(er)	9	100,000	
10 Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	10	72,000	
11 Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits.	11	28,000	
12 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	12	20,000	
13 If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	×	
14 Multiply line 8 by line 13. ▶	14	1,940	
15 Enter the amount from Form 1040, line 42 (or Form 1040A, line 26)	15	9,475	
16 Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28).	16	-0-	
17 Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits.	17	9,475	
18 Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) ▶	18	1,940	

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

37.

Earned Income Credit

Important Changes for 2001

Earned income amount is more. The amount you can earn and still get the credit has increased for 2001. The amount you earn must be less than:

- \$28,281 with one qualifying child,
- \$32,121 with more than one qualifying child, or
- \$10,710 if you do not have a qualifying child.

Investment income amount is more. The maximum amount of investment income you can have and still get the credit has increased for 2001. You can have investment income up to \$2,450. For most people, investment income is taxable interest and dividends, tax-exempt interest, and capital gain net income. To get more detailed information, see *Rule 5*.

Kidnapped child. You may be able to claim the EIC for persons with a qualifying child even though your child has been kidnapped. To get more detailed information, see *Kidnapped child* under *Rule 7*.

Important Changes for 2002

New definition of earned income. For tax years after 2001, earned income will no longer include employee compensation that is nontaxable. This will change *Rule 6* and *Rule 14*.

Elimination of modified adjusted gross income (AGI). For tax years after 2001, you will no longer need to figure modified AGI. Your EIC will be figured using your AGI, *not* modified AGI. This will change *Rule 15*.

New rules for persons with same qualifying child. For tax years after 2001, new rules will be used to determine which person can claim the EIC on the basis of a qualifying child when two or more persons have the same qualifying child. This will change *Rule 8*. For details, see Publication 553, *Highlights of 2001 Tax Changes*.

New definition of eligible foster child. For tax years after 2001, the definition of an eligible foster child in *Rule 7* will change. The child will have to live with you only for more than half of the year, instead of the whole year.

Reduction of EIC by alternative minimum tax eliminated. For tax years after 2001, your EIC will no longer be reduced by the amount of alternative minimum tax shown on your return.

Important Reminders

Certain people must use Publication 596. Certain people must use Publication 596 to see if they meet the rules to take the EIC and to figure the amount of the credit. You must use Publication 596 if any of the following situations applies to you.

- The amount on Form 1040, line 21, includes an amount from Form 8814, *Parent's Election To Report Child's Interest and Dividends*.
- Your investment income (*Rule 5*) is \$2,450 or more **and** you are filing Form 4797, *Sales of Business Property*.
- You are filing Schedule E, *Supplemental Income and Loss*, (Form 1040).
- You are reporting income or a loss from the rental of personal property not used in a trade or business.
- You are claiming a loss on Form 1040, line 12, 13, or 18.
- You (or your spouse if filing a joint return) received distributions from a pension, annuity, or IRA that are not fully taxable.
- You owe alternative minimum tax (AMT), found on Form 1040, line 41, or included in the total found on Form 1040A, line 35.

For information on how you can get Publication 596, *Earned Income Credit*, or other free IRS publications, see *How To Get Tax Help* in the back of this publication.

Modified AGI (adjusted gross income). Your modified AGI used to limit your credit includes:

- 1) Tax-exempt interest, and
- 2) The nontaxable part of a pension, annuity, or individual retirement arrangement (IRA) distribution, except any amount that is nontaxable because it was a trustee-to-trustee transfer or a rollover distribution.

Also, the amount of business losses that must be added back to AGI to figure modified AGI is 75%.

See *Rule 15* in this chapter or for more detailed information get Publication 596.

Advance payment of the earned income credit in your paycheck. If you qualify for the earned income credit in 2002, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit*, later, for more information.

Earned income credit has no effect on certain welfare benefits. Any refund you receive because of the EIC and any advance EIC payments you receive generally will not be used to

determine whether you are eligible for the following benefit programs, or how much you can receive from these programs.

- Temporary assistance for needy families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps.
- Low-income housing.

Social security numbers. To claim the EIC, you must have a valid social security number (SSN) for you and your spouse (if filing a joint return) and any qualifying children. If an SSN is missing or incorrect, you may not get the credit. See *Rule 1*, later.

Form 8862 to claim EIC after disallowance. If your EIC for any year after 1996 was denied or reduced for any reason other than a mathematical or clerical error, you must attach a completed Form 8862, *Information To Claim Earned Income Credit After Disallowance*, to your next return if you wish to claim the EIC. The date on which your EIC was denied and the date on which you file your 2001 return affect whether you need to attach Form 8862 to your 2001 return or to a later return. See chapter 5 in Publication 596 for more information.

Introduction

The earned income credit (EIC) is a tax credit for certain people who work and have earned income under \$32,121. A tax credit usually means more money in your pocket. It reduces the amount of tax you owe. The EIC may also give you a refund.

How do you get the earned income credit? To claim the EIC, you must:

- 1) Qualify by meeting certain rules, and
- 2) File a tax return, even if you:
 - a) Do not owe any tax,
 - b) Did not earn enough money to file a return, or
 - c) Did not have income taxes withheld from your pay.

When you complete your return, you can figure your EIC by using a worksheet in the instructions for Form 1040, Form 1040A, or Form 1040EZ. Or, if you prefer, you can let the IRS figure the credit for you.

How will this chapter help you?

This chapter will explain the following:

- What rules you must meet to qualify for the EIC,
- How to figure the EIC, and
- How to get advance payment of the EIC in your paycheck.

To learn about the rules you must meet, first read *Do You Qualify for the Credit*, later.

Table 37–1. **Earned Income Credit in a Nutshell**

Part A Rules for Everyone	Part B Rules If You Have a Qualifying Child	Part C Rules If You Do Not Have a Qualifying Child
Rule 1. You must have a valid social security number.	Rule 7. Your child must meet the relationship, age, and residency tests.	Rule 10. You must be at least age 25 but under age 65.
Rule 2. Your filing status cannot be “Married filing separately.”	Rule 8. Your qualifying child cannot be the qualifying child of another person with a higher modified AGI.	Rule 11. You cannot be the dependent of another person.
Rule 3. You must be a U.S. citizen or resident alien all year.	Rule 9. You cannot be a qualifying child of another person.	Rule 12. You cannot be a qualifying child of another person.
Rule 4. You cannot file Form 2555 or Form 2555–EZ (relating to foreign earned income).		Rule 13. You must have lived in the United States more than half the year.
Rule 5. Your investment income must be \$2,450 or less.		
Rule 6. You must have earned income.		
Part D Figuring and Claiming the EIC		
<p>Rule 14. Your earned income must be less than:</p> <ul style="list-style-type: none"> • \$32,121 if you have more than one qualifying child, • \$28,281 if you have one qualifying child, or • \$10,710 if you do not have a qualifying child. 		
<p>Rule 15. Your modified AGI must be less than:</p> <ul style="list-style-type: none"> • \$32,121 if you have more than one qualifying child, • \$28,281 if you have one qualifying child, or • \$10,710 if you do not have a qualifying child. 		

Useful Items

You may want to see:

Publication

- 504** Divorced or Separated Individuals
- 533** Self-Employment Tax
- 596** Earned Income Credit

Form (and Instructions)

- Schedule EIC** Earned Income Credit (Qualifying Child Information)
- Schedule SE (Form 1040)** Self-Employment Tax
- W–5** Earned Income Credit Advance Payment Certificate
- 8862** Information To Claim Earned Income Credit After Disallowance

Do You Qualify for the Credit?

To see if you can claim the EIC, you must first meet all of the rules explained in Part A, *Rules for Everyone*. Then you must meet the rules in Part B, *Rules If you Have a Qualifying Child*, or Part C, *Rules If You Do Not Have a Qualifying Child*. There are two final rules you must meet in Part D, *Figuring and Claiming the EIC*. You

qualify for the credit if you meet all the rules in each part that applies to you. For example:

- If you have a qualifying child, the rules in *Parts A, B, and D* apply to you, or
- If you do not have a qualifying child, the rules in *Parts A, C, and D* apply to you.

Table 37–1, Earned Income Credit in a Nutshell. Use *Table 37–1* as a guide to *Parts A, B, C, and D*. The table is a summary list of all the rules in each part. Each rule listed has a rule number. Use the rule number to find a discussion of that rule in this chapter.

Do you have a qualifying child? Basically, a qualifying child is a child who:

- 1) Is your son, daughter, adopted child, grandchild, stepchild, or eligible foster child, **and**
- 2) Was (at the end of 2001) under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled during the year, **and**
- 3) Lived with you in the United States for more than half of 2001 (for all of 2001 if the child is your eligible foster child).

See *Rule 7* for more detailed information.

If Improper Claim Made in Prior Year

You must file Form 8862 if for any year after 1996 your EIC was denied or reduced for any reason other than a math or clerical error. But do not file Form 8862 if, after your EIC was denied or reduced in an earlier year, you filed Form 8862 (or other documents) and your EIC was then allowed.

If it was determined that your error was due to reckless or intentional disregard of the EIC rules or fraud, you cannot claim the EIC for the next 2 years (10 years in the case of fraud).

More information. See chapter 5 in Publication 596 for more detailed information about the disallowance period and Form 8862.

Part A. Rules for Everyone

This part of the chapter discusses *Rules 1* through 6. You must meet all six rules to qualify for the earned income credit. If you do not meet all six rules, you cannot get the credit and you do not need to read the rest of the chapter.

If you meet all six rules in this part, then read either *Part B* or *Part C* (whichever applies) for more rules you must meet.

Rule 1. You Must Have a Valid Social Security Number (SSN)

To claim the EIC, you (and your spouse if filing a joint return) **must** have a valid SSN. Any qualifying child listed on Schedule EIC must also have a valid SSN. (See *Rule 7* if you have a qualifying child.)

Valid SSN. A valid SSN is one that has been issued by the Social Security Administration (SSA). If your social security card (or your spouse's if filing a joint return) says "Not valid for employment," and your SSN was issued so that you (or your spouse) could get a federally funded benefit, you cannot get the EIC. An example of a federally funded benefit is Medicaid.

If you have a card with the legend "Not valid for employment," and your immigration status has changed so that you are now a U.S. citizen or permanent resident, ask the SSA for a new social security card without the legend.

U. S. citizen. If you were a U. S. citizen when you received your SSN, you have a valid SSN.

SSN missing or incorrect. If an SSN for you or your spouse is missing from your tax return or is incorrect, you may not get the EIC.

Other taxpayer identification number. You cannot get the EIC if, instead of an SSN, you (or your spouse if filing a joint return) have an individual taxpayer identification number (ITIN). ITINs are issued by the Internal Revenue Service to noncitizens who cannot get an SSN.

No SSN. If you do not have a valid SSN, put "No" directly to the right of line 61a (Form 1040), line 39a (Form 1040A), or on line 9b (Form 1040EZ). You cannot claim the EIC.

Getting an SSN. If you (or your spouse if filing a joint return) do not have an SSN, you can apply for one by filing Form SS-5, *Application for a Social Security Card*, with the Social Security Administration.

Filing deadline approaching and still no SSN. If the filing deadline is approaching and you still do not have an SSN, you have two choices.

- 1) Request an automatic 4-month extension of time to file your return. You can get this extension by filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*. You can file a paper Form 4868 or you can file it electronically. Getting an extension does not give you extra time to pay any tax owed. You should pay any amount you expect to owe to avoid interest or penalty charges. For more information, see chapter 1.
- 2) File the return on time without claiming the EIC. After receiving the SSN, file an amended return (Form 1040X, *Amended U.S. Individual Income Tax Return*), claiming the EIC. Attach a filled-in Schedule EIC if you have a qualifying child.

Rule 2. Your Filing Status Cannot Be "Married Filing Separately"

If you are married, you usually must file a joint return to claim the EIC. Your filing status cannot be "Married filing separately."

Spouse did not live with you. If you are married and your spouse did not live in your home at any time during the last 6 months of the year, you may be able to file as head of household, instead of married filing separately. In that case, you may be able to claim the EIC. For detailed information about filing as head of household, see chapter 2.

Rule 3. You Must Be a U.S. Citizen or Resident Alien All Year

You cannot claim the earned income credit if you are a nonresident alien for any part of the year, unless:

- 1) You are married to a U.S. citizen or a resident alien, **and**
- 2) You choose to be treated as a resident for all of 2001 by filing a joint return. If you need more information on making this choice, get Publication 519, *U.S. Tax Guide for Aliens*.

Note. If you make the choice in (2) above, you and your spouse are taxed on your worldwide income. You cannot claim any tax treaty benefits as a resident of a foreign country during a tax year in which the choice is in effect.

Rule 4. You Cannot File Form 2555 or Form 2555-EZ

You cannot claim the earned income credit if you file Form 2555, *Foreign Earned Income*, or Form 2555-EZ, *Foreign Earned Income Exclusion*. You file these forms to exclude income earned in foreign countries from your gross income, or to deduct or exclude a foreign housing amount. U.S. possessions are not foreign countries. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, for more detailed information.

Rule 5. Your Investment Income Must Be \$2,450 or Less

You cannot claim the earned income credit unless your investment income is \$2,450 or less. If your investment income is more than \$2,450, you cannot claim the credit. For most people, investment income is the total of the following amounts.

- Taxable interest (line 8a of Form 1040 or 1040A).
- Tax-exempt interest (line 8b of Form 1040 or 1040A).

- Dividend income (line 9 of Form 1040 or 1040A).
- Capital gain net income (line 13 of Form 1040, if more than zero, or line 10 of Form 1040A).

However, if you are reporting income from the rental of personal property on Form 1040, line 21, or are filing Schedule E (Form 1040), or Form 8814, or are reporting a gain on Form 4797, see *Rule 5* in chapter 1 of Publication 596 for more information.

Rule 6. You Must Have Earned Income

This credit is called the "earned income credit" because, to qualify, you must work and have earned income. If you are married and file a joint return, you meet this rule if at least one spouse works and has earned income. Earned income includes all the income you get from working — even if it is not taxable.


Taxable Earned Income

Taxable earned income includes:

- 1) Wages, salaries, and tips,
- 2) Net earnings from self-employment, and
- 3) Gross income received as a statutory employee.

For some examples of items that are included or not included in earned income, see *Table 37-2*, later. Some of the items listed are discussed in more detail later.

Wages, salaries, and tips. Wages, salaries, and tips you receive for working are reported to you on Form W-2, box 1. You should report these on line 1 (Form 1040EZ) or line 7 (Forms 1040A and 1040).

 **CAUTION** If you were a household employee who did not receive a Form W-2 because your employer paid you less than \$1,300 in 2001, be sure to include the amount you were paid on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ).

Self-employed persons and statutory employees. If you are self-employed or received income as a statutory employee, you must use Form 1040 or Publication 596 to see if you qualify to get the EIC and to figure the amount of the EIC.

Nontaxable Earned Income

This includes anything of value (money, goods, or services) that is not taxable that you received from your employer for your work. Common types of nontaxable earned income are listed in the following paragraphs.

Salary deferrals and reductions.

- Salary deferrals. These are contributions from your pay to certain retirement plans (such as a 401(k) plan or the Federal Thrift Savings Plan). These amounts are shown in box 12 of your Form W-2. The

"Retirement plan" box (box 13) of your Form W-2 should be checked in most cases.

- Salary reductions, such as under a cafeteria plan, unless they are included in box 1 of your Form W-2. A cafeteria plan is a benefit plan offered by your employer that allows you to choose among two or more benefits consisting of cash and benefits that are not taxed. If you choose a benefit that is not taxed (such as accident and health insurance), the amount of the salary reduction is nontaxable earned income when figuring the EIC.
- Mandatory contributions to a state or local retirement plan.

Meals and lodging.

- Military employee basic housing and subsistence allowances, the value of in-kind housing and subsistence, and combat zone compensation. These amounts are shown in box 12 of your Form W-2 with code "Q." See Publication 3, *Armed Forces' Tax Guide*, for detailed information.
- Meals and lodging provided for the convenience of your employer.
- Housing allowance or rental value of a parsonage for the clergy.

Excludable employer-provided benefits.

- Dependent care benefits (line 18 of Form 2441, or Schedule 2 (Form 1040A,)).
- Adoption benefits (Form 8839, *Child and Dependent Care Expenses*, line 26).
- Educational assistance benefits (these may be shown in box 14 of your Form W-2).

Native Americans

If you are a Native American and received amounts for services performed as an employee that are exempt from federal income tax under the Internal Revenue Code or because of a treaty, agreement, Act of Congress, or other federal law, these amounts are nontaxable earned income when figuring the EIC. (However, any tax-exempt income you received for performing services as a self-employed individual is not earned income when figuring the EIC.)

Approved Form 4361 or Form 4029

This section is for persons who have an approved:

- Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, or
- Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits*.

Each approved form exempts certain income from social security taxes. Each form is dis-

cussed in this section in terms of what is or is not earned income for purposes of the EIC.

Form 4361. Even if you have an approved Form 4361, amounts you received for performing ministerial duties as an employee count as earned income. This includes wages, salaries, tips, and "other employee compensation." "Other employee compensation" includes nontaxable compensation such as housing allowances or the rental value of a parsonage that you receive for services as an employee. Amounts you received for performing ministerial duties, but not as an employee, do not count as earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

Form 4029. Even if you have an approved Form 4029, all wages, salaries, tips, and other employee compensation count as earned income. However, amounts you received as a self-employed individual do not count as earned income. Also, in figuring earned income, do not subtract losses on Schedule C, C-EZ, or F from wages on line 7 of Form 1040.

Disability Benefits

If you retired on disability, benefits you receive under your employer's disability retirement plan are considered earned income until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you could have received a pension or annuity if you were not disabled. You must report your taxable disability payments on line 7 of either Form 1040 or Form 1040A until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension and are not considered earned income. Report taxable pension payments on Form 1040, lines 16a and 16b (or Form 1040A, lines 12a and 12b).

Disability insurance payments. Payments you received from a disability insurance policy that you paid the premiums for are not earned income. It does not matter whether you have reached minimum retirement age. If this policy is through your employer, the amount may be shown in box 12 of your Form W-2 with code "J."

Income That is Not Earned Income

Examples of items that are **NOT** earned income include interest and dividends, pensions and annuities, social security and railroad retirement benefits (including disability benefits), alimony and child support, welfare benefits, workers' compensation benefits, unemployment compensation (insurance), nontaxable foster care payments, and veterans' benefits, including VA rehabilitation payments. Do **NOT** include any of these items in your nontaxable or taxable earned income.

Earnings while an inmate. Amounts received for work performed while an inmate in a penal institution are not earned income when figuring

the earned income credit. This includes amounts received through a work release program or while in a halfway house.

Nonqualified deferred compensation plan or a section 457 plan pension or annuity. Amounts you received as a pension or annuity from a nonqualified deferred compensation plan or a section 457 plan and that were included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ) are not earned income. (This amount may be reported in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount of the pension or annuity.)

Workfare payments. Nontaxable workfare payments are not earned income for the EIC. These are cash payments certain people receive from a state or local agency that administers public assistance programs funded under the federal Temporary Assistance for Needy Families (TANF) program in return for certain work activities such as (1) work experience activities (including remodeling or repairing public housing) if sufficient private sector employment is not available, or (2) community service program activities.

Community property. If you are married, but qualify to file as head of household under special rules for married taxpayers living apart (see *Rule 2*), and live in a state that has community property laws, your earned income for the EIC does not include any amount earned by your spouse that is treated as belonging to you under those laws. That amount is not earned income for the EIC, even though you must include it in your gross income on your income tax return. Your earned income includes the entire amount you earned, even if part of it is treated as belonging to your spouse under your state's community property laws.

Part B. Rules If You Have a Qualifying Child

Use *Part B* if you:

- 1) Have a qualifying child, and
- 2) Have met all the rules in *Part A*.

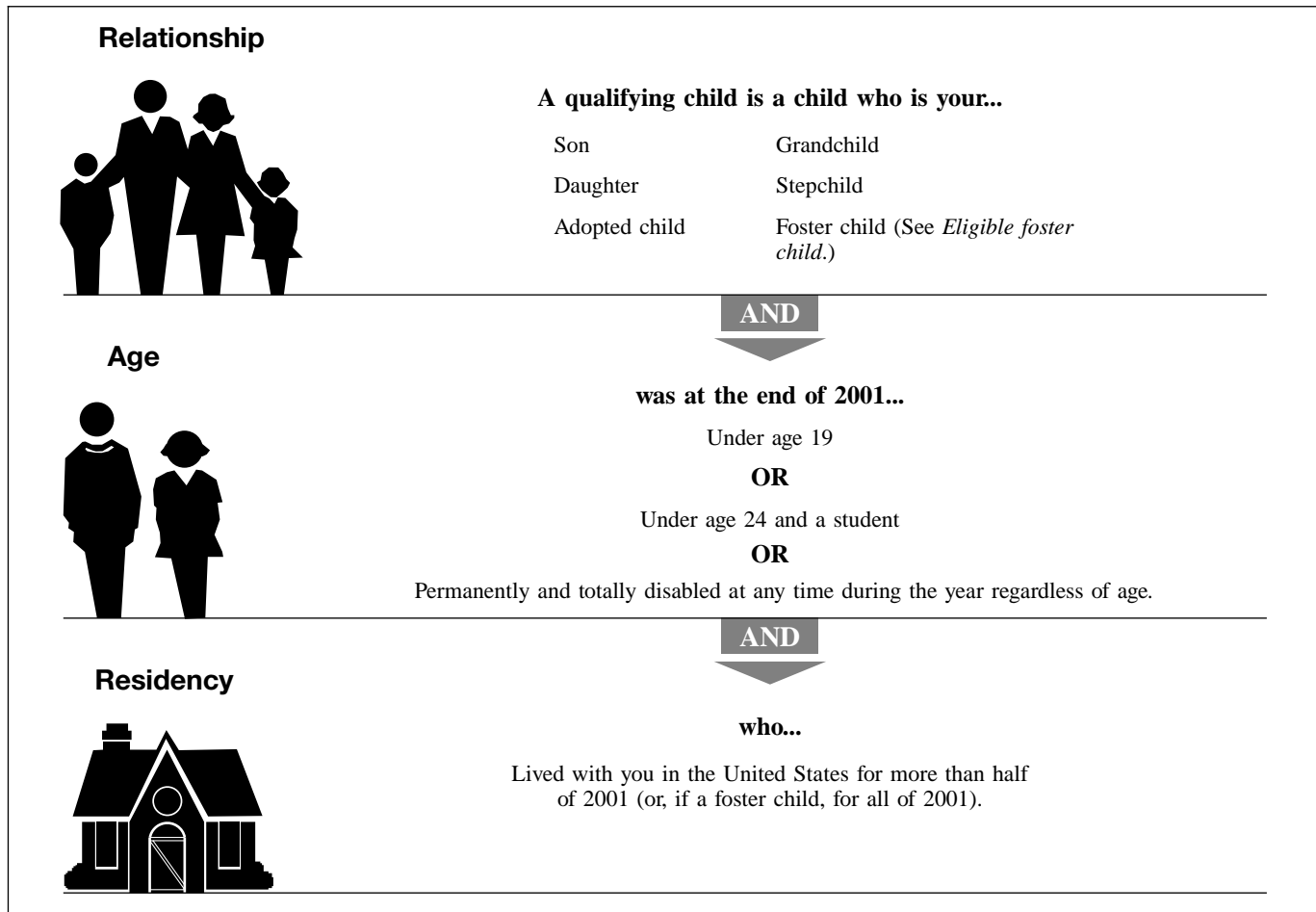
This part of the chapter discusses *Rules 7* through *9*. You must meet all three of these rules, in addition to the rules in *Parts A* and *D*, to qualify for the earned income credit with a qualifying child.

You must file Form 1040 or Form 1040A to claim the EIC with a qualifying child. (You cannot file Form 1040EZ). You must also complete Schedule EIC and attach it to your return. If you meet all the rules in *Part A* and this part, read *Part D* to find out what to do next.



If you do not meet Rule 7, you do not have a qualifying child. Read Part C to find out if you can get the earned income credit without a qualifying child.

Figure 37–1. Tests for Qualifying Child



Rule 7. Your Child Must Meet the Relationship, Age, and Residency Tests

Your child is a qualifying child if your child meets three tests. The three tests are:

- 1) Relationship,
- 2) Age, and
- 3) Residency.

The three tests are illustrated in *Figure 37–1*. The paragraphs that follow contain more information about each test.

Relationship Test

Your child must be either your son, daughter, adopted child, grandchild, stepchild, or eligible foster child. The following definitions clarify the relationship test.

Adopted child. Your adopted child includes a child placed with you for adoption by an authorized placement agency, even if the adoption is not final. An authorized placement agency includes any person authorized by state law to place children for legal adoption.

Grandchild. For the EIC, this means any descendant of your son, daughter, or adopted child. For example, a grandchild includes your great-grandchild, great-great-grandchild, etc.

Child not a dependent. Your child does not have to be your dependent to be a qualifying child, unless he or she is married.

Married child. If your child was married at the end of the year, he or she does not meet the relationship test unless either of these two situations applies to you:

- 1) You can claim the child's exemption, or
- 2) The reason you cannot claim the child's exemption is that you gave that right to your child's other parent:
 - a) When you completed Form 8332 or a similar written statement, or
 - b) In a pre-1985 agreement (such as a separation agreement or divorce decree).

Eligible foster child. For the EIC, a person is your eligible foster child if all the following are true.

- 1) You cared for that child as you would your own child.
- 2) The child lived with you for the **whole** year, except for temporary absences (explained later). (A child who was born or died during the year is considered to have lived with you for the whole year if your home was the child's home for the entire time he or she was alive during the year.)

- 3) The child is your brother, sister, stepbrother, or stepsister; a descendant (including a child or adopted child) of your brother, sister, stepbrother, or stepsister; or a child placed with you by an authorized placement agency.

Example. You and your sister live together. You are 30. Your sister is 15. When your parents died 2 years ago, you took over the care of your sister, but you did not adopt her. She is considered your eligible foster child because she lived with you all year and because you cared for her as you would your own child.

Age Test

Your child must be:

- 1) Under age 19 at the end of 2001,
- 2) A full-time student under age 24 at the end of 2001, or
- 3) Permanently and totally disabled at any time during 2001, regardless of age.

The following example and definitions clarify the age test.

Example. Your son turned 19 on December 10. Unless he was disabled or a full-time student, he is not a qualifying child because, at the end of the year, he was not **under** age 19.

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

Student defined. To qualify as a student, your child must be, during some part of each of any 5 calendar months during the calendar year:

- 1) A full-time student at a school that has a regular teaching staff, course of study, and regularly enrolled student body, or
- 2) A student taking a full-time, on-farm training course given by a school described in (1), or a state, county, or local government. The 5 calendar months need not be consecutive.

School defined. A school can be an elementary school, junior or senior high school, college, university, or technical, trade, or mechanical school. However, on-the-job training courses, correspondence schools, and night schools do not count as schools for the EIC. (But see *Night school*, later.)

Vocational high school students. Students who work on co-op jobs in private industry as a part of a school's regular course of classroom and practical training are considered full-time students.

Night school. Your child is not a full-time student if he or she attends school only at night. However, full-time attendance at a school may include some attendance at night as part of a full-time course of study.

Permanently and totally disabled. Your child is permanently and totally disabled if **both** of the following apply.

- 1) He or she cannot engage in any substantial gainful activity because of a physical or mental condition.
- 2) A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

Residency Test

Your child must have lived with you in the United States for more than half of 2001 (all of 2001 if an eligible foster child). The following definitions clarify the residency test.

Home. Your home can be any location where you regularly live within one of the 50 states or the District of Columbia.

Homeless shelter. You do not need a traditional home. For example, if your child lived with you for more than half the year in one or more homeless shelters, your child meets the residency test.

Military personnel stationed outside the United States. U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period for purposes of the EIC.

Extended active duty. Extended active duty means you are called or ordered to duty for an indefinite period or for a period of more than

90 days. Once you begin serving your extended active duty, you are still considered to have been on extended active duty even if you do not serve more than 90 days.

Birth or death of a child. A child who was born or died in 2001 is treated as meeting the residency test if your home was the child's home the entire time he or she was alive in 2001.

Temporary absences. Count time that you or your child is away from home on a temporary absence due to a special circumstance as time lived at home. Examples of a special circumstance include:

- Illness,
- School attendance,
- Detention in a juvenile facility,
- Business,
- Vacation, and
- Military service.

Kidnapped child. A kidnapped child is treated as living with you for more than half of the year if the child lived with you for more than half the part of the year before the date of the kidnapping. The child must be presumed by law enforcement authorities to have been kidnapped by someone who is not a member of your family or your child's family. This treatment applies for all years that the child remains kidnapped. However, the last year this treatment can apply is the earlier of:

- 1) The year the child is determined to be dead, or
- 2) The year the child would have reached age 18.

If your qualifying child has been kidnapped and meets these requirements, enter "KC," instead of a number, on line 6 of Schedule EIC.

Social security number. Your qualifying child must have a valid social security number (SSN) unless the child was born and died in 2001. You cannot claim the EIC on the basis of a qualifying child if:

- 1) Your qualifying child's SSN is missing from your tax return or is incorrect,
- 2) Your qualifying child's social security card says "Not valid for employment" and was issued only for use in getting a federally funded benefit, or
- 3) Instead of an SSN, your qualifying child has:
 - a) An individual taxpayer identification number (ITIN), which is issued to a noncitizen who cannot get an SSN, or
 - b) An adoption taxpayer identification number (ATIN), which is issued to adopting parents who cannot get an SSN for the child being adopted until the adoption is final.

If you have two qualifying children and only one has a valid SSN, you can claim the EIC only on the basis of that child. For more information about SSNs, see *Rule 1*.

Rule 8. Your Qualifying Child Cannot Be the Qualifying Child of Another Person With a Higher Modified AGI

Sometimes a child meets the rules to be a qualifying child of more than one person. However, only one person can claim the EIC using that child. The paragraphs that follow will help you decide who can claim the EIC when more than one person has the same qualifying child.

Which person can claim the EIC. If you and someone else have the same qualifying child, the person with the higher modified adjusted gross income (AGI) is the only one who may be able to claim the EIC using that child. The person with the lower modified AGI cannot use that child to claim the EIC. This is true even if the person with the higher modified AGI does not claim the EIC or meet all of the rules to claim the EIC. If the other person is your spouse and you file a joint return, this rule does not apply. If three or more persons have the same qualifying child, the person with the highest modified AGI is the only one who may be able to claim the EIC using that child.

Note. For most people modified AGI is the same as AGI (line 34, Form 1040, line 20, Form 1040A, or line 4, Form 1040EZ). Modified AGI is explained in Part D.

If your qualifying child meets the tests to be a qualifying child of any other person for 2001 and you have the higher modified AGI, you meet this rule. If you do not have the higher modified AGI, **STOP.** You cannot claim the EIC either with or without a qualifying child. Put "No" beside line 61a (Form 1040) or line 39a (Form 1040A).

Example 1. You and your son lived with your mother all year. You are 25 years old. Your only income was \$9,300 from a part-time job. Your mother's only income was \$15,000 from her job. Your son is a qualifying child of both you and your mother because he meets the relationship, age, and residency tests for both you and your mother. However, because you both have the same qualifying child, only one of you can claim the EIC. Because your mother's modified AGI (\$15,000) is more than your modified AGI (\$9,300), only your mother may be able to claim the EIC. You cannot claim the EIC for persons either with or without a qualifying child.

Example 2. The facts are the same as in *Example 1*, but your mother had investment income of \$3,000. Your mother cannot claim the EIC because her investment income is more than \$2,450. (See *Rule 5*.) Even though your mother cannot claim the EIC, you cannot claim it either because your mother's modified AGI is more than yours.

Example 3. You and your sister shared a household for the entire year. You have three young children who lived in the household. Your sister does not have any children. However, she cares for your children as if they were her own. You earn \$15,000 and she earns \$20,000. Neither of you had any other income.

The children meet the age and residency tests for both you and your sister. They meet the relationship test for you because they are your children. They also meet the relationship test for your sister because they lived with her for the whole year, she cared for them as if they were her own, and they are her sister's children. Therefore, they qualify as her eligible foster children. Your children are qualifying children of both you and your sister. However, because your sister's modified AGI is higher than yours, she is the only one who can claim the EIC.



You and your sister cannot split the three qualifying children between you. You cannot claim the EIC even though your sister enters the names of only two of the children on her Schedule EIC. (Schedule EIC has spaces for the names of only two qualifying children because the EIC is the same amount for two or more qualifying children.)

Example 4. The facts are the same as in Example 3, except that your oldest child is 20 years old and a full-time college student. Your sister does not care for this child as if the child were her own. Only the two younger children are qualifying children of both you and your sister. Your sister is the only one who may be able to claim the EIC using these two children because her modified AGI is higher than yours. Your oldest child is a qualifying child for you, but not for your sister. Only you may be able to claim the EIC using this child.

Example 5. You, your spouse, and your 10-year-old-son lived together until July 15, 2001, when your spouse moved out of the household. In November 2001, you and your spouse were divorced. Your modified AGI was \$13,000. Your former spouse's modified AGI was \$18,000. Your son is a qualifying child of both you and your former spouse because your son lived with each of you for more than half the year and because he met the relationship and age tests for both of you. However, because your former spouse's modified AGI (\$18,000) was more than your modified AGI (\$13,000), only your former spouse can claim the EIC for 2001. You cannot claim the EIC for persons either with or without a qualifying child.

Rule 9. You Cannot Be a Qualifying Child of Another Person

You are a qualifying child of another person (your parent, guardian, foster parent, etc.) if all of the following statements are true.

- You are that person's son, daughter, adopted child, stepchild, grandchild, or eligible foster child.
- At the end of the year you were under age 19, under age 24 and a full-time student, or any age if you were permanently and totally disabled at any time during the year.
- You lived with that person in the United States for more than half of the year (all year if you were an eligible foster child). For more details about the tests to be a qualifying child, see *Rule 7*.

If you (or your spouse if filing a joint return) are a qualifying child of another person, you cannot claim the EIC. This is true even if the person for whom you are a qualifying child does not claim the EIC or meet all of the rules to claim the EIC. Put "No" beside line 61a (Form 1040) or line 39a (Form 1040A).

Example. You and your daughter lived with your mother all year. You are 22 years old and attended a trade school full time. You had a part-time job and earned \$5,700. You had no other income. Because you meet the relationship, age, and residency tests, you are a qualifying child of your mother. She can claim the EIC if she meets all the other requirements. Because you are your mother's qualifying child, you cannot claim the EIC. This is so even if your mother cannot or does not claim the EIC.

Part C. Rules If You Do Not Have a Qualifying Child

Use *Part C* if you:

- 1) Do not have a qualifying child, and
- 2) Have met all the rules in *Part A*.

This part of the chapter discusses *Rules 10 through 13*. You must meet all four of these rules, in addition to the rules in *Parts A and D*, to qualify for the earned income credit without a qualifying child.



If you have a qualifying child, the rules in this part do not apply to you. You can claim the credit only if you meet all the rules in Parts A, B, and D. See Rule 7 to find out if you have a qualifying child.

Rule 10. You Must Be at Least Age 25 but Under Age 65

You must be at least age 25 but under age 65 at the end of 2001. If you are married filing a joint return, either you or your spouse must be at least age 25 but under age 65 at the end of 2001. It does not matter which spouse meets the age test, as long as one of the spouses does.

If neither you nor your spouse meets the age test, you cannot claim the EIC. Put "No" directly to the right of line 61a (Form 1040), line 39a (Form 1040A), or on line 9b (Form 1040EZ).

Example 1. You are age 28 and unmarried. You meet the age test.

Example 2. You are married and filing a joint return. You are age 23 and your spouse is age 27. You meet the age test because your spouse is at least age 25 but under age 65.

Rule 11. You Cannot Be the Dependent of Another Person

If you are *not* filing a joint return, you meet this rule if:

- You checked box 6a on Form 1040 or 1040A, **or**
- You checked the "No" box on line 5 of Form 1040EZ.

If you are filing a joint return, you meet this rule if:

- You checked both box 6a and box 6b on Form 1040 or 1040A, **or**
- You and your spouse checked the "No" box on line 5 of Form 1040EZ.

If you are not sure whether someone else can claim you (or your spouse if filing a joint return) as a dependent, read the rules for claiming a dependent in chapter 3.

If someone else can claim you (or your spouse if filing a joint return) as a dependent on his or her return, but does not, you still cannot claim the credit.

Example 1. In 2001, you were age 25, single, and living at home with your parents. You worked and were not a student. You earned \$7,500. Your parents cannot claim you as a dependent. When you file your return, you claim an exemption for yourself by checking the "No" box on line 5 of your Form 1040EZ. You meet this rule.

Example 2. The facts are the same as in Example 1, except that you earned \$2,000. Your parents can claim you as a dependent but decide not to. You do not meet this rule. You cannot claim the credit because your parents could have claimed you as a dependent.

Rule 12. You Cannot Be a Qualifying Child of Another Person

You are a qualifying child of another person (your parent, guardian, foster parent, etc.) if all of the following statements are true.

- You are that person's son, daughter, adopted child, stepchild, grandchild, or eligible foster child.
- At the end of the year you were under age 19, under age 24 and a full-time student, or any age if you were permanently and totally disabled at any time during the year.
- You lived with that person in the United States for more than half of the year (all year if you were an eligible foster child).

If you (or your spouse if filing a joint return) are a qualifying child of another person, you cannot claim the EIC. This is true even if the person for whom you are a qualifying child does not claim the EIC or meet all of the rules to claim the EIC. Put "No" beside line 61a (Form 1040), line 39a (Form 1040A), or on line 9b (Form 1040EZ).

Table 37–2. Examples of Taxable and Nontaxable Earned Income

Taxable Earned Income	Nontaxable Earned Income
Wages and salaries.	Salary deferrals and reductions.
Union strike benefits.	Meals and lodging provided for the convenience of your employer.
Taxable long-term disability benefits received before minimum retirement age.	Excludable dependent care benefits and excludable adoption benefits.
Net earnings from self-employment.	Excludable educational assistance benefits.
Tips.	Excluded combat pay.
Gross income received as a statutory employee.	Military basic housing and subsistence allowances.

Example. You lived with your mother all year. You are age 26 and permanently and totally disabled. Your only income was from a community center where you went twice a week to answer telephones. You earned \$1,500 for the year. Because you meet the relationship, age, and residency tests, you are a qualifying child of your mother. She can claim the EIC if she meets all the other requirements. Because you are a qualifying child of your mother, you cannot claim the EIC. This is so even if your mother cannot or does not claim the EIC.

Rule 13. You Must Have Lived in the United States More Than Half of the Year

Your home (and your spouse's if filing a joint return) must have been in the United States for more than half the year.

If not, put "No" directly to the right of line 61a (Form 1040), line 39a (Form 1040A), or on line 9b (Form 1040EZ).

Home. Your home can be any location where you regularly live within one of the 50 states or the District of Columbia.

Homeless shelter. You do not need a traditional home. If you lived in one or more homeless shelters in the United States for more than half the year, you meet this rule.

Military personnel stationed outside the United States. U.S. military personnel stationed outside the United States on extended active duty (defined in *Rule 7*) are considered to live in the United States during that duty period for the EIC.

Part D. Figuring and Claiming the EIC

Use this part if you have met all the rules in *Parts A and B*, or all the rules in *Parts A and C*.

This part of the chapter discusses *Rules 14 and 15*. You must meet both rules, in addition to the rules in *Parts A and B*, or *Parts A and C*, to qualify for the earned income credit.

This part of the chapter also explains how to figure the amount of your credit. You have two choices.

- 1) Have the IRS figure the EIC for you. If you want to do this, see *IRS Will Figure the EIC for You*.
- 2) Figure the EIC yourself. If you want to do this, see *How To Figure the EIC Yourself*.

Rule 14. Your Total Earned Income Must Be Less Than:

- \$32,121 if you have more than one qualifying child,
- \$28,281 if you have one qualifying child, or
- \$10,710 if you do not have a qualifying child.

Earned income is explained in *Rule 6* in *Part A* and some examples are shown in *Table 37–2*. You figure your total earned income by adding together your taxable earned income and your nontaxable earned income.

Self-employed persons and statutory employees. If you are self-employed or received income as a statutory employee, you must use Form 1040 or Publication 596 to see if you qualify to get the EIC and to figure the amount of your total earned income and the amount of EIC.

Church employee. In this publication, this term means an employee (other than a minister or member of a religious order) of a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

Taxable earned income. You figure your taxable earned income by starting with the amount on the *Wages* line on your tax return (line 7, Forms 1040 and 1040A, or line 1, Form 1040EZ). You then subtract the following amounts from the amount on the *Wages* line on your tax return.

- Any taxable scholarship or fellowship grant not reported on a Form W–2.
- Any amount you received for work done while an inmate in a penal institution that is included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ).

- Any amounts you received as a pension or annuity from a nonqualified deferred compensation plan or a section 457 plan and that were included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ).
- Any amount on line 2 of Schedule SE that was also reported on line 7 (Form 1040), if you are a member of the clergy.
- Any amount you included on both line 5a of Schedule SE and line 7 (Form 1040).

Nontaxable earned income. You figure your nontaxable earned income by adding the amounts of any nontaxable earned income items you had during the year. Examples of nontaxable earned income items are shown in *Rule 6* and *Table 37–2*.

Total earned income. You figure your total earned income by adding together your taxable earned income and your nontaxable earned income. You will need this amount when you figure the amount of your EIC.

If your total earned income is more than:

- \$32,121 if you have more than one qualifying child,
- \$28,281 if you have one qualifying child, or
- \$10,710 if you do not have a qualifying child,

you cannot get the EIC. You do not need to read the rest of this chapter. You can go back and finish the rest of your tax return.

Rule 15. Your Modified AGI Must Be Less Than:

- \$32,121 if you have more than one qualifying child,
- \$28,281 if you have one qualifying child, or
- \$10,710 if you do not have a qualifying child.

Modified adjusted gross income (AGI). Modified AGI for most people is the same as AGI. AGI is the amount on line 34 (Form 1040), line 20 (Form 1040A), or line 4 (Form 1040EZ). To find your modified AGI, you must add certain amounts such as tax-exempt interest and some other gains and losses. But if you are filing Schedule C, C–EZ, D, E, or F, or if you claim a loss from the rental of personal property not used in a trade or business, you **must** get Publication 596 to figure your modified AGI. You must also get Publication 596 if you (or your spouse if filing a joint return) received any distributions from a pension, annuity, or IRA that are not fully taxable.

Community property. If you are married, but qualify to file as head of household under special rules for married taxpayers living apart (see *Rule 2*), and live in a state that has community property laws, your adjusted gross income (AGI) for the EIC includes that portion of both your and your spouse's wages that you are required to include in gross income. This is dif-

ferent from the community property rules that apply under *Rule 6*.

Example. Bob will file Form 1040A. His AGI (line 20) is \$12,000. He will report \$300 of tax-exempt interest from a municipal bond on line 8b. His modified AGI for the EIC is \$12,300 (\$12,000 + \$300).

IRS Will Figure the EIC for You

The IRS will figure the amount of your EIC for you if you follow the steps explained in this section. If you have a qualifying child, complete and attach Schedule EIC.



Please do not ask the IRS to figure your EIC unless you are eligible for it. Read the rules in Parts A, B, C, and D to see if you qualify.



If you want the IRS to also figure the amount of your income tax, see chapter 31.

Form 1040

If you file Form 1040 and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** directly to the right of line 61a. Also, if you have any earned income that is not taxed, enter the amount of that income on line 61b. See *Table 37–2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you (including line 56), but do not fill in lines 66, 67, 68, and 70. If you do not have a qualifying child, stop here.
- 3) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 2 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040A

If you file Form 1040A and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** directly to the right of line 39a. Also, if you have earned income that is not taxed, enter the amount of that income on line 39b. See *Table 37–2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you (including line 36), but do not fill in lines 41, 42, 43, and 45. If you do not have a qualifying child, stop here.
- 3) If you have a qualifying child, complete Schedule EIC according to its instructions.

Be sure to enter the child's social security number on line 2 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040EZ

If you file Form 1040EZ and want the IRS to figure your credit for you, follow these steps.

- 1) Print **EIC** on line 9b. Also, if you have earned income that is not taxed, enter the amount on line 9b. See *Table 37–2* for examples of earned income that is not taxed. Then, if you have any of the situations listed later under *Special Instructions*, follow those instructions.
- 2) Complete all other parts of your return that apply to you, but do not fill in lines 10, 12a, or 13.

Special Instructions

Use the following special instructions, if the situation applies to you.

Qualifying child information (Schedule EIC). Whether the IRS figures your credit or you figure it yourself, you must give the IRS information about your qualifying child. To do this, complete Schedule EIC and attach it to your Form 1040 or Form 1040A.

The information you enter on Schedule EIC must show that the child meets all the tests for a qualifying child. (See *Rule 7*.) The schedule has space for information about only two qualifying children because the amount of your credit is the same whether you have two, three, or more qualifying children.



Do not file Form 1040EZ if you have a qualifying child and qualify for the credit. You must file Form 1040 or Form 1040A.

Minister or member of a religious order. If you are filing Schedule SE and line 2 of that schedule includes an amount that is also included on Form 1040, line 7, print "Clergy" directly to the right of line 61a (Form 1040). Also show the amount included on both lines (for example, "Clergy \$800"). If you received a housing allowance or were provided housing and you were required to include the allowance or the rental value of the parsonage on Schedule SE, line 2, do not include it as nontaxable earned income on line 61b of Form 1040.

Household employee. If you were a household employee who did not receive a Form W–2 because your employer paid you less than \$1,300 in 2001, print "HSH" and the amount paid that was not reported on Form W–2 in the space to the right of the words "W–2 form(s)" on line 1 (Form 1040EZ), or on the dotted line next to line 7 (Form 1040), or in the space to the left of line 7 (Form 1040A). Also, be sure to include that amount in the total for line 1 of Form 1040EZ or line 7 of either Form 1040 or Form 1040A.

Inmates. If you were an inmate in a penal institution and the total on line 7 (Form 1040 or Form 1040A), or line 1 (Form 1040EZ) includes

an amount paid to you for work performed while an inmate, print "PRI" and the amount paid on the dotted line next to line 7 (Form 1040), in the space to the left of line 7 (Form 1040A), or in the space to the right of the words "W–2 form(s)" on line 1 (Form 1040EZ).

Deferred compensation plans. If you received a pension or annuity from a nonqualified deferred compensation plan or a section 457 plan, put "DFC" and the amount subtracted on the dotted line next to line 7 (Form 1040). This amount may be reported in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount of the pension or annuity.

How To Figure the EIC Yourself

This part of this chapter explains how to use the EIC Worksheet and how to report the credit on your return. To figure the amount of your earned income credit, you can use the Earned Income Credit Worksheet (EIC Worksheet) in the instruction booklet for Form 1040, Form 1040A, or Form 1040EZ, and the *Earned Income Credit (EIC) Table* in the tax form instruction booklet. However, certain people must use Publication 596 to see if they meet the rules to take the EIC and to figure the amount of the credit. You must use Publication 596 if any of the following situations applies to you.

- The amount on Form 1040, line 21, includes an amount from Form 8814 (relating to a child's interest and dividends).
- Your investment income (Rule 5) is \$2,450 or more **and** you are filing Form 4797 (relating to the sale of business property).
- You are filing Schedule E, *Supplemental Income and Loss*, (Form 1040).
- You are reporting income or a loss from the rental of personal property not used in a trade or business.
- You are claiming a loss on Form 1040, line 12, 13, or 18.
- You (or your spouse if filing a joint return) received distributions from a pension, annuity, or IRA that are not fully taxable.
- You owe alternative minimum tax (AMT), found on Form 1040, line 41, or included in the total found on Form 1040A, line 35.

The amount of your earned income credit depends on:

- Whether you have no qualifying child, one qualifying child, or two or more qualifying children,
- The amount of your earned income (defined in *Rule 7*) and modified AGI (defined in *Rule 15*), and
- Whether you owe AMT.

Form 1040 and EIC Worksheet. If you file Form 1040 and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 61a and**

61b and look for **Worksheet A** or **Worksheet B**.

- 2) Complete the EIC Worksheet that applies to your situation according to its instructions. If you were self-employed or a church employee or used Schedule C or C–EZ as a statutory employee, complete Worksheet B. Find the amount of your credit in the EIC Table in your instruction booklet.
- 3) Enter the amount of your earned income credit from Worksheet A or B on Form 1040, line 61a.
- 4) Enter the amount and type of any nontaxable earned income on Form 1040, line 61b.
- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return. If you do not have a qualifying child, stop here.
- 6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 2 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040A and EIC Worksheet. If you file Form 1040A and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 39a and 39b** and look for the **EIC Worksheet**.
- 2) Complete the EIC Worksheet according to its instructions. Find the amount of your credit in the EIC Table in your form instruction booklet.
- 3) Enter the amount of your earned income credit from line 6 of the EIC Worksheet on Form 1040A, line 39a.
- 4) Enter the amount of any nontaxable earned income on Form 1040A, line 39b.
- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return. If you do not have a qualifying child, stop here.
- 6) If you have a qualifying child, complete Schedule EIC according to its instructions. Be sure to enter the child's social security number on line 2 of that schedule. If you do not, your credit may be reduced or disallowed. Attach Schedule EIC to your return.

Form 1040EZ and EIC Worksheet. If you file Form 1040EZ and want to figure the credit yourself, follow these steps.

- 1) Go to your form instruction booklet and turn to the instructions for **Lines 9a and 9b** and look for the **EIC Worksheet**.
- 2) Complete the EIC Worksheet according to its instructions. Find the amount of your credit in the EIC Table in your form instruction booklet.

- 3) Enter the amount of your earned income credit from line 6 of the EIC Worksheet on Form 1040EZ, line 9a.
- 4) Enter the amount of any nontaxable earned income on Form 1040EZ, line 9b.
- 5) Keep the EIC Worksheet for your records. Do not attach it to your income tax return.

Examples

The following two comprehensive examples (complete with filled-in forms) may be helpful when figuring the earned income credit. The two examples are:

- 1) John and Janet Smith with one qualifying child and using Form 1040A, and
- 2) Kelly Green, age 30, a student, with no qualifying child and using Form 1040EZ.

Example 1. John and Janet Smith (Form 1040A)

John and Janet Smith are married and will file a joint return. They have one child—Amy, who is 3 years old. Amy lived with John and Janet for all of 2001. John worked and earned \$9,500. Janet worked part of the year and earned \$1,500. Their total earned income and modified AGI is \$11,000. John and Janet qualify for the earned income credit and fill out the EIC Worksheet and Schedule EIC. The Smiths will attach Schedule EIC to Form 1040A when they send their completed return to the IRS.

They took the following steps to complete Schedule EIC and the EIC Worksheet.

Completing Schedule EIC

The Smiths complete Schedule EIC because they have a qualifying child. They enter "John and Janet Smith" and John's SSN (the SSN that appears first on their Form 1040A) on the line at the top of Schedule EIC. The Smiths fill out *Qualifying Child Information* (lines 1–6).

Line 1. The Smiths enter the first name and last name for Amy in the column "Child 1."

Line 2. They enter Amy's SSN. (See *Rule 7*, earlier.)

Line 3. They enter the year of birth for Amy (1998).

Lines 4a and 4b. The Smiths skip these lines because Amy was not born before 1982.

Line 5. The Smiths enter "Daughter" for Amy. This column shows Amy's relationship to John and Janet.

Line 6. The Smiths enter "12" for Amy. This is how many months Amy lived with them in 2001.

Completing the EIC Worksheet

Next, the Smiths will complete the EIC Worksheet to figure their earned income credit amount.

Line 1. The Smiths enter \$11,000 (their total earned income).

Line 2. The Smiths go to the **Earned Income Credit Table** in the Form 1040A instructions. The Smiths find their income of \$11,000 within the range of \$10,750 to \$13,100. They follow this line across to the column "One child" and find \$2,428 and enter it on this line 2.

Line 3. The Smiths enter their modified AGI of \$11,000.

Line 4. The Smiths check the "Yes" box because lines 1 and 3 are the same (\$11,000). They skip line 5 and enter the amount from line 2 (\$2,428) on line 6.

Line 6. The Smiths' EIC is \$2,428.

Example 2. Kelly Green (Form 1040EZ)

Kelly Green is age 30 and a full-time student. She lived with her parents in the United States for all of 2001. She had a part-time job and earned \$6,040. She earned \$20 interest on a savings account. She is not eligible to be claimed as a dependent on her parents' return. Although she lived with her parents, she is not their qualifying child because she does not meet the age test. She does not have any children.

Kelly qualifies for the earned income credit. Kelly will file Form 1040EZ and complete the EIC Worksheet.

Completing the EIC Worksheet

Kelly figures the amount of her earned income credit on the *EIC Worksheet* as follows.

Line 1. She enters \$6,040 (her total earned income).

Line 2. Kelly goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her earned income of \$6,040 in the range of \$6,000 to \$6,050. Kelly follows this line across to the column "No children" and finds \$358. She enters \$358 on line 2.

Line 3. Kelly enters \$6,060 (her modified AGI).

Line 4. Kelly checks the "No" box because lines 1 and 3 are not the same (\$6,040 and \$6,060).

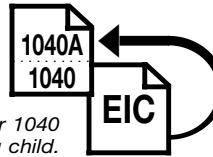
Line 5. Kelly checks the "No" box because the amount on line 3 (\$6,060) is not less than \$5,770. She goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her modified adjusted gross income of \$6,060 in the range of \$6,050 to \$6,100. Kelly follows this line across to the column "No children" and finds \$355. She enters \$355 on line 5. She looks at the amounts on lines 5 and 2. \$355 is the smaller amount.

Line 6. She enters \$355 here and on Form 1040EZ, line 9a. The \$355 is Kelly's earned income credit.

Filled-in Schedule EIC—John and Janet Smith
(Page references are to the Schedule EIC instructions.)

SCHEDULE EIC
(Form 1040A or 1040)

Earned Income Credit
Qualifying Child Information



OMB No. 1545-0074

2001

Attachment
 Sequence No. **43**

Department of the Treasury
 Internal Revenue Service

*Complete and attach to Form 1040A or 1040
 only if you have a qualifying child.*

Name(s) shown on return

John and Janet

Smith

Your social security number

2 2 2 : 0 0 : 2 2 2 2

Before you begin: See the instructions for Form 1040A, lines 39a and 39b, or Form 1040, lines 61a and 61b, to make sure that (a) you can take the EIC and (b) you have a qualifying child.



- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information

Child 1

Child 2

1 Child's name	First name	Last name	First name	Last name	
	If you have more than two qualifying children, you only have to list two to get the maximum credit.	Amy	Smith		
2 Child's SSN					
	The child must have an SSN as defined on page 42 of the Form 1040A instructions or page 44 of the Form 1040 instructions unless the child was born and died in 2001. If your child was born and died in 2001 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.		0 0 0 : 0 0 : 2 2 2 4		
3 Child's year of birth	Year <u>1 9 9 8</u>		Year _____		
	<i>If born after 1982, skip lines 4a and 4b; go to line 5.</i>		<i>If born after 1982, skip lines 4a and 4b; go to line 5.</i>		
4 If the child was born before 1983—					
	a Was the child under age 24 at the end of 2001 and a student?		<input type="checkbox"/> Yes. <input type="checkbox"/> No. <i>Go to line 5.</i> <i>Continue</i>		
b Was the child permanently and totally disabled during any part of 2001?		<input type="checkbox"/> Yes. <input type="checkbox"/> No. <i>Continue</i> The child is not a qualifying child.		<input type="checkbox"/> Yes. <input type="checkbox"/> No. <i>Continue</i> The child is not a qualifying child.	
5 Child's relationship to you	(for example, son, daughter, grandchild, foster child, etc.)		Daughter		
6 Number of months child lived with you in the United States during 2001					
	• If the child lived with you for more than half of 2001 but less than 7 months, enter "7". • If the child was born or died in 2001 and your home was the child's home for the entire time he or she was alive during 2001, enter "12".		_____ months <i>Do not enter more than 12 months.</i>		
		1 2 months		_____ months	
		<i>Do not enter more than 12 months.</i>		<i>Do not enter more than 12 months.</i>	



You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2001, (b) is claimed as your dependent on line 6c of Form 1040A or Form 1040, and (c) is a U.S. citizen or resident alien. For more details, see the instructions for line 40 of Form 1040A or line 63 of Form 1040.

Filled-in EIC Worksheet—John and Janet Smith
(Page references are to the Form 1040A Instructions)

Earned Income Credit (EIC) Worksheet—Lines 39a and 39b

Keep for Your Records



Part 1

All Filers

1. Enter your total earned income from Step 8, Box D, on page 41.

1	11,000
----------	--------

2. Look up the amount on line 1 above in the EIC Table on pages 44–46 to find the credit. Enter the credit here.

2	2,428
----------	-------

If line 2 is zero, You cannot take the credit. Put “No” directly to the right of line 39a.

3. Enter your modified adjusted gross income from Step 6, Box A, on page 40.

3	11,000
----------	--------

4. Are the amounts on lines 3 and 1 the same?
 Yes. Skip line 5; enter the amount from line 2 on line 6.
 No. Go to line 5.

Part 2

Filers Who Answered “No” on Line 4

5. Is the amount on line 3 less than:
• \$5,950 if you do not have a qualifying child or
• \$13,100 if you have one or more qualifying children?
 Yes. Leave line 5 blank; enter the amount from line 2 on line 6.
 No. Look up the amount on line 3 in the EIC Table on pages 44–46 to find the credit. Enter the credit here.

5	
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Look at the amounts on lines 5 and 2. Then, enter the smaller amount on line 6.

Part 3

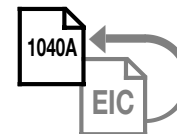
Your Earned Income Credit

6. **This is your earned income credit.**

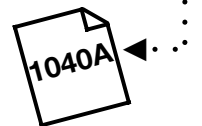
6	2,428
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Reminder—

- ✓ Be sure you entered the amount of any nontaxable earned income (Step 7, Box B, on page 41) on Form 1040A, line 39b.
- ✓ If you have a qualifying child, complete and attach Schedule EIC.



Enter this amount on Form 1040A, line 39a.



If your EIC for a year after 1996 was reduced or disallowed, see page 42 to find out if you must file Form 8862 to take the credit for 2001.

Advance Earned Income Credit

Would you like to get part of your earned income credit now instead of waiting until after the end of the year? If you work for someone and expect to qualify for the earned income credit in 2002, you can choose to get part of the credit in advance. Give your employer a 2002 **Form W-5, Earned Income Credit Advance Payment Certificate**, and your employer will include part of the credit regularly in your pay. The advance payment is only available if you have at least one qualifying child.

Who can get the advance payment of the earned income credit? To get part of the earned income credit paid to you throughout the year in your paycheck, you must meet all the following rules.

- 1) You must expect that your earned income and modified AGI will each be less than a certain amount. The amount in 2001 was \$28,281. The amount for 2002 will be higher. (See the 2002 Form W-5 for the 2002 amount.)
- 2) You must have a qualifying child.
- 3) You must expect to meet all the rules in *Parts A, B, and D* of this chapter or in the instructions for Form W-5.

Persons who are not entitled to receive advance payments. Under certain circumstances, even if you meet these rules, you may

not be entitled to get EIC. If your wages are not subject to federal income tax, social security tax, or Medicare tax withholding, you cannot get the advance payment of the earned income credit. If you are a farm worker and are paid on a daily basis, your employer is not required to pay you the advance amount of the credit.

How To Get Advance Payments for 2002

To get part of the credit in advance, you must fill out a 2002 Form W-5. After you have read the instructions and answered the questions on Form W-5, give the lower part of the form to your employer. Keep the top part for your records.

More than one employer. If you have more than one employer, give a certificate to only one of them. If you are married and both you and your spouse are employed and expect to qualify for the credit, you may give a Form W-5 to your employer and your spouse may give one to his or her employer.



If you receive advance earned income credit payments in 2002, you must file Form 1040 or Form 1040A for tax year 2002. You must file a return to report what you already received and to take advantage of any additional earned income credit that you may qualify for.

Receipt of advance payments you do not qualify for. If you receive advance payments and later find out that you do not qualify for the

EIC, you will have to pay back any advance payment you are not entitled to when you file your Form 1040 or Form 1040A.

When to give your employer a new Form W-5. The 2002 Form W-5 you give to your employer is valid until December 31, 2002. If you expect to qualify for the earned income credit in 2003 and you want to receive advance payments, you must give your employer a **new** Form W-5 in 2003. Do this each year you think you are eligible for the credit.

If you no longer want to get advance payments or if your situation changes and you no longer qualify for the earned income credit, you must give your employer a new Form W-5. Check the **No** box on line 1 of the new form.

If your spouse files a Form W-5 with his or her employer, you must file a new Form W-5 with your employer. Check the **Yes** box on line 4.

Advance Payments Received in 2001

If you received advance payments of the earned income credit in 2001, you must file a tax return to report the payments. Report the amount on line 56 (Form 1040), or line 35 (Form 1040A). Your Form W-2, box 9, will show the amount you received.



You cannot use Form 1040EZ to report your advance payments.

EIC Eligibility Checklist

*You may claim the EIC if you answer YES to all the following questions.**

	YES	NO
1. Do you, your spouse, and your qualifying child each have a valid SSN? (See Rule 1.)	<input type="checkbox"/>	<input type="checkbox"/>
2. Is your filing status married filing jointly, head of household, qualifying widow(er), or single? (See Rule 2.) Caution: If you are a nonresident alien, answer YES only if your filing status is married filing jointly and you are married to a U.S. citizen or resident alien. (See Rule 3.)	<input type="checkbox"/>	<input type="checkbox"/>
3. Answer YES if you are not filing Form 2555 or Form 2555–EZ. Otherwise, answer NO . (See Rule 4.)	<input type="checkbox"/>	<input type="checkbox"/>
4. Is your investment income \$2,450 or less? (See Rule 5.)	<input type="checkbox"/>	<input type="checkbox"/>
5. Is your total earned income at least \$1 but less than: <ul style="list-style-type: none"> • \$10,710 if you do not have a qualifying child. • \$28,281 if you have one qualifying child, or • \$32,121 if you have more than one qualifying child? (See Rules 6 and 14.)	<input type="checkbox"/>	<input type="checkbox"/>
6. Is your modified AGI less than: <ul style="list-style-type: none"> • \$10,710 if you do not have a qualifying child. • \$28,281 if you have one qualifying child, or • \$32,121 if you have more than one qualifying child? (See Rule 15.)	<input type="checkbox"/>	<input type="checkbox"/>
7. Answer YES if you (and your spouse if filing a joint return) are not a qualifying child of another person. (See Rules 9 and 12.) STOP If you have a qualifying child, answer questions 8 and 9 and skip 10–12. If you do not have a qualifying child, skip answers 8 and 9 and answer 10–12.*	<input type="checkbox"/>	<input type="checkbox"/>
8. Does your child meet the age, residency, and relationship tests for a qualifying child? (See Rule 7.)	<input type="checkbox"/>	<input type="checkbox"/>
9. Is your child a qualifying child only for you? Answer YES if your qualified child is also a qualifying child for another person but your modified AGI is higher than the other person's. (See Rule 8.)	<input type="checkbox"/>	<input type="checkbox"/>
10. Was your main home (and your spouse's if filing a joint return) in the United States for more than half the year? (See Rule 13.)	<input type="checkbox"/>	<input type="checkbox"/>
11. Were you (or your spouse if filing a joint return) at least age 25 but under 65 at the end of 2001? (See Rule 10.)	<input type="checkbox"/>	<input type="checkbox"/>
12. Answer YES if you (and your spouse if filing a joint return) cannot be claimed as a dependent on anyone else's return. Answer NO if you (and your spouse if filing a joint return) can be claimed as a dependent on someone else's return. (See Rule 11.)	<input type="checkbox"/>	<input type="checkbox"/>
<p>* PERSONS WITH A QUALIFYING CHILD: If you answered YES to questions 1 through 9, you can claim the EIC. Remember to fill out Schedule EIC and attach it to your Form 1040 or Form 1040A. You cannot use Form 1040EZ.</p> <p>PERSONS WITHOUT A QUALIFYING CHILD: If you answered YES to questions 1 through 7, and 10 through 12, you can claim the EIC.</p> <p>If you answered NO to any question that applies to you: You cannot claim the EIC.</p>		

Earned Income Credit (EIC) Worksheet—Lines 9a and 9b

Keep for Your Records



Part 1

All Filers

1. Enter your total earned income from Step 4, Box D, on page 16.

1	6,040
----------	-------

2. Look up the amount on line 1 above in the EIC Table on page 19 to find the credit. Enter the credit here.

2	358
----------	-----

If line 2 is zero, You cannot take the credit.
Print "No" to the right of the words "page 15" on line 9a.

3. Enter your modified adjusted gross income from Step 2, Box A, on page 15.

3	6,060
----------	-------

4. Are the amounts on lines 3 and 1 the same?
 Yes. Skip line 5; enter the amount from line 2 on line 6.
 No. Go to line 5.

Part 2

Filers Who Answered "No" on Line 4

5. Is the amount on line 3 less than \$5,950?
 Yes. Leave line 5 blank; enter the amount from line 2 on line 6.
 No. Look up the amount on line 3 in the EIC Table on page 19 to find the credit. Enter the credit here.

5	355
----------	-----

Look at the amounts on lines 5 and 2. Then, enter the smaller amount on line 6.

Part 3

Your Earned Income Credit

6. **This is your earned income credit.**

6	355
----------	-----

Reminder—

✓ Be sure you entered the amount of any nontaxable earned income (Step 3, Box B, on page 16) on Form 1040EZ, line 9b.

Enter this amount on Form 1040EZ, line 9a.



If your EIC for a year after 1996 was reduced or disallowed, see page 16 to find out if you must file Form 8862 to take the credit for 2001.

38.

Other Credits

Important Change

Rate reduction credit. You may qualify for the rate reduction credit if you did not receive the maximum advance payment in 2001. See *Rate Reduction Credit*, later.

Excess withholding of social security tax and tier 1 railroad retirement tax. Social security and tier 1 railroad retirement tax (RRTA) are both withheld at a rate of 6.2% of wages. The maximum wages subject to this tax increased to \$80,400 in 2001. If you had two or more employers and they withheld too much social security or RRTA tax during 2001, you may be entitled to a credit of the excess withholding. For more information about the credit, see *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld under Refundable Credits*, later.

Introduction

This chapter discusses the following credits.

- Rate reduction credit.
- Adoption credit.
- Foreign tax credit.
- Mortgage interest credit.
- Credit for prior year minimum tax.
- Credit for electric vehicles.
- Credit for excess social security tax or railroad retirement tax withheld.
- Credit for tax on undistributed capital gain.

Several other credits are discussed in other chapters in this publication.

- Child and dependent care credit (chapter 33).
- Credit for the elderly or the disabled (chapter 34).
- Child tax credit (chapter 35).
- Education credits (chapter 36).
- Earned income credit (chapter 37).

Nonrefundable credits. The first part of this chapter, *Nonrefundable Credits*, covers six credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

Refundable credits. The second part of this chapter, *Refundable Credits*, covers two credits that are treated as payments and are refundable to you. These credits are added to the federal income tax withheld and any estimated tax pay-

ments you made. If this total is more than your total tax, the excess will be refunded to you.

Useful Items

You may want to see:

Publication

- 514** Foreign Tax Credit for Individuals
- 564** Mutual Fund Distributions
- 936** Home Mortgage Interest Deduction
- 968** Tax Benefits of Adoption

Form (and Instructions)

- 1116** Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)
- 8396** Mortgage Interest Credit
- 8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts
- 8828** Recapture of Federal Mortgage Subsidy
- 8834** Qualified Electric Vehicle Credit
- 8839** Qualified Adoption Expenses

Nonrefundable Credits

The following credits are discussed in this part.

- Rate reduction credit.
- Adoption credit.
- Foreign tax credit.
- Mortgage interest credit.
- Credit for prior year minimum tax.
- Credit for electric vehicles.

Rate Reduction Credit

For 2001, the lowest tax rate is 10%. Most individuals received the benefits of the new 10% rate in an advance payment of income tax based on their 2000 tax returns. You can use the worksheet in your form instructions to determine whether you can claim the rate reduction credit based on your 2001 return.

Advance payment. Any advance payment of income tax that you received (before offset) during 2001 was based on your 2000 tax return. This payment is not subject to federal income tax. If you filed a joint return for 2000, you and your spouse are each considered to have received one-half of the advance payment.

This advance payment reduces your rate reduction credit. You cannot claim the credit if the advance payment is equal to the amount shown for your 2001 filing status.

- Single or married filing separately—\$300.
- Head of household—\$500.
- Married filing jointly or qualifying widow(er)—\$600.

If your advance payment does not equal the amount shown, you may be able to claim the rate reduction credit.

Offsets. You are considered to have received the full amount of the advance payment even though all or part of that amount was used to offset (pay) certain past-due amounts. For information on offsets, see *Offsets against debts*, in chapter 1.

How to figure the credit. Use the *Rate Reduction Credit Worksheet* in your form instructions to figure your credit based on your 2001 tax return. If the credit is more than your advance payment, you can claim the difference as the rate reduction credit. If the credit is not more than your advance payment, you cannot claim the rate reduction credit. You do not have to pay back the advance payment that is more than your credit.



If you are filing a joint return for 2001, you must add your and your spouse's advance payments (before offsets) to determine the total advance payment received.

Example 1. For 2001, you are single and, based on your 2001 tax return, you qualify for a rate reduction credit of \$250. During 2001, you received \$300 as an advance payment of income tax. Since the advance payment is more than your rate reduction credit, you cannot claim the credit. You do not have to pay back any of your advance payment.

Example 2. You get married during 2001 and file a joint return for that year. Based on your 2001 tax return, you qualify for the maximum rate reduction credit of \$600. During 2001, you received \$225 and your spouse received \$300 as advance payments of income tax based on your individual tax returns for 2000. You must reduce your maximum rate reduction credit by the advance payments you and your spouse received. Your credit for 2001 is \$75.

Dependents. If you, or your spouse if filing a joint return, can be claimed as a dependent on someone else's return, you cannot claim the credit. Figure your tax using the *Tax Computation Worksheet for Certain Dependents* in your form instructions unless you, or your spouse if filing a joint return, received an advance payment of income tax during 2001.

Nonresident alien. If you were a nonresident alien at the end of the year you cannot claim the credit. See your Form 1040NR instructions for how to figure your tax.

Adoption Credit

You may be able to take a tax credit of up to \$5,000 for qualifying expenses paid to adopt an eligible child. The credit can be as much as \$6,000 if the expenses are for the adoption of a child with special needs.

If your modified adjusted gross income (AGI) is more than \$75,000, your credit is reduced. If your modified AGI is \$115,000 or more, you cannot claim the credit.

Qualifying expenses. Qualifying adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and

lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child.

Nonqualifying expenses. Qualifying adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- Paid using funds received from any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or any other person or organization.

Eligible child. The term "eligible child" means any individual:

- 1) Under 18 years old, or
- 2) Physically or mentally incapable of caring for himself or herself.

Child with special needs. An eligible child is a child with special needs if:

- 1) He or she is a citizen or resident of the United States (including the District of Columbia and U.S. possessions) and
- 2) A state determines that the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adoptive parents.

Factors used by states to determine if a child has special needs could include:

- The child's ethnic background,
- The child's age,
- Whether the child is a member of a minority or sibling group, or
- Whether the child has a medical condition or physical, mental, or emotional handicap.



A foreign child cannot be treated as a child with special needs.

When to claim the credit. Generally, you cannot take any credit before the year the adoption becomes final. See Publication 968 for information on when to claim expenses paid before the year the adoption becomes final.

How to claim the credit. To claim the credit, you must complete Form 8839 and attach it to your Form 1040 or Form 1040A. Enter the credit on line 49, Form 1040, or line 31, Form 1040A.

Foreign Tax Credit

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction (see chapter 24).

You cannot take a credit (or deduction) for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

Limit on the credit. Your foreign tax credit cannot be more than your U.S. tax liability (line 40, Form 1040) multiplied by a fraction. The numerator of the fraction is your taxable income from sources outside the United States. The denominator is your total taxable income from U.S. and foreign sources. See Publication 514 for more information.

How to claim the credit. Complete Form 1116 and attach it to your Form 1040. Enter the credit on line 43, Form 1040.

Election not to file Form 1116. You will not be subject to the limit and may be able to claim the credit without using Form 1116 if all the following requirements are met.

- 1) You are an individual.
- 2) Your only foreign source income for the tax year is passive income (dividends, interest, royalties, etc.) that is reported to you on a payee statement (such as a Form 1099-DIV, *Dividends and Distributions*, or 1099-INT, *Interest Income*).
- 3) Your qualified foreign taxes for the tax year are not more than \$300 (\$600 if filing a joint return) and are reported on a payee statement.
- 4) You elect this procedure for the tax year.

If you qualify and elect not to file Form 1116, enter the amount of your foreign taxes paid on line 43, Form 1040.



If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.

Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments may entitle a certificate holder to a mortgage interest credit. The certificate must be used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

Who qualifies. You may be able to claim a mortgage interest credit if you were issued a **mortgage credit certificate (MCC)** under a qualified MCC program. The MCC must relate to your main home.

Amount of credit. If your mortgage is equal to (or smaller than) the certified indebtedness amount (loan) shown on your MCC, you multiply the certified credit rate, shown on your MCC, by all the interest you paid on your mortgage during the year.

If your mortgage is larger than the certified indebtedness amount shown on your MCC, you multiply the certified credit rate, shown on your MCC, by only the interest allocated to the certified indebtedness amount shown on your MCC.



If the certificate credit rate is more than 20%, the credit cannot be more than \$2,000.

Carryforward. If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the \$2,000 limit because your certificate credit rate is more than 20%, no amount over the \$2,000 (or your prorated share of the \$2,000 if you must allocate the credit) may be carried forward.

Reduced home mortgage interest deduction. If you claim the credit and itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction. Reduce your deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 2002. For more information about the home mortgage interest deduction, see chapter 25.

Recapture of federal mortgage subsidy. If your home was financed with a mortgage from a qualified mortgage bond program or you received an MCC, you may be subject to a recapture rule. The recapture would generally occur if you sold or disposed of your home during the first 9 years after the date you closed your mortgage loan. See Publication 523, *Selling Your Home*, for more information.

How to claim the credit. Figure your 2001 credit and any carryforward to 2002 on Form 8396, and attach it to your Form 1040. Be sure to include any credit carryforward from 1998, 1999, and 2000.

Include the credit in your total for line 50, Form 1040, and check box b.

Credit for Prior Year Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax in addition to any other tax on these items. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. If in prior years you paid alternative minimum tax because of these tax postponement items, you may be able to claim a credit for prior year minimum tax against your current year's regular tax. The amount of the credit cannot reduce your current year's tax below your current year's tentative alternative minimum tax.

You may be able to take a credit against your regular tax if you:

- 1) Paid alternative minimum tax in 2000,
- 2) Had an unused minimum tax credit that you are carrying forward from 2000 to 2001, or
- 3) Had unallowed qualified electric vehicle credits in 2000.

How to claim the credit. Figure your 2001 credit and any carryforward to 2002 on Form 8801, and attach it to your Form 1040. Include the credit in your total for line 50, Form 1040, and check box c. You can carry forward any

unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

Credit for Electric Vehicles

You may be allowed a tax credit if you placed a qualified electric vehicle in service during the year.

Qualified electric vehicle. This is a motor vehicle that:

- 1) Has at least four wheels and is manufactured primarily for use on public streets, roads, and highways,
- 2) Is powered *primarily* by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current,
- 3) Is originally used by you, and
- 4) Is acquired for your own use, not for resale.

Amount of credit. The credit is equal to 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost by any section 179 deduction before figuring the credit. Get Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, for information on the section 179 deduction.

The credit is limited to \$4,000 for each vehicle placed in service in 2001.

Special rules. You cannot take the credit if you use the vehicle predominately outside the United States.

The credit will be subject to recapture if, within 3 years after the date you place the vehicle in service, the vehicle is used predominately outside the United States or is modified so that it is no longer eligible for the credit.

How to claim the credit. To claim the credit, complete Form 8834, and attach it to your Form 1040. Include the credit in your total for line 50, Form 1040. Check box d, and print "8834" on the line next to box d.

Refundable Credits

The following credits are refundable and are treated as payments of tax.

- Credit for excess social security tax or railroad retirement tax withheld.
- Credit for tax on undistributed capital gain.

Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

Most employers must withhold social security tax from your wages. If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 2001, you may have had too much social security tax or RRTA withheld from your pay. You can claim the excess as a credit against your income tax. The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld in 2001.

Type of Tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social Security or RRTA tier 1	\$80,400	\$4,984.80
RRTA tier 2	\$59,700	\$2,925.30



All wages are subject to Medicare tax withholding.

One employer. If any one employer withheld social security or RRTA tax that exceeded the amounts in the preceding table, you cannot claim the extra amount withheld by that employer as a credit against your income tax. Your employer must adjust this for you.

Joint return. If you are filing a joint return, you cannot add the social security or RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the credit separately for both you and your spouse to determine if either of you has excess withholding.

How to claim the credit. If you file Form 1040, enter the credit on line 62. If you file Form 1040A, include the credit in the total on line 41 and put "Excess SST" and the amount of the credit in the space to the left of the line.

How to figure the credit if you did not work for a railroad. If you did not work for a railroad during 2001, figure the credit as follows:

1. Add all social security tax withheld (but not more than \$4,984.80 for each employer). Enter the total here _____
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 58 _____
3. Add lines 1 and 2. If \$4,984.80 or less, stop here. You cannot claim the credit _____
4. Social security tax limit 4,984.80
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 41) _____

Example. You are married and file a joint return with your spouse who had no gross income in 2001. During 2001 you worked for the Brown Shoe Company and earned \$45,000 in wages. Social security tax of \$2,790 was withheld. You also worked for another employer in 2001 and earned \$40,000 in wages. \$2,480 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than \$80,400 you can claim a credit of \$285.20 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than \$4,984.80 for each employer). Enter the total here \$5,270.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 58 _____ -0-
3. Add lines 1 and 2. If \$4,984.80 or less, stop here. You cannot claim the credit 5,270.00
4. Social security tax limit 4,984.80
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 41) \$ 285.20

How to figure the credit if you worked for a railroad. If you were a railroad employee during 2001, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than \$4,984.80 for each employer). Enter the total here _____
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 58 _____
3. Add lines 1 and 2. If \$4,984.80 or less, enter -0- on line 5 and go to line 6 _____
4. Social security and tier 1 RRTA tax limit 4,984.80
5. Subtract line 4 from line 3 _____
6. Add all tier 2 RRTA tax withheld (but not more than \$2,925.30 for each employer). Enter the total here _____
7. Enter any uncollected tier 2 railroad retirement tax on tips or group-term life insurance included in the total on Form 1040, line 58 _____
8. Add lines 6 and 7. If \$2,925.30 or less, enter -0- on line 10 and go to line 11 _____
9. RRTA tier 2 limit 2,925.30
10. Subtract line 9 from line 8 _____
11. Credit. Add lines 5 and 10. Enter the result here and on Form 1040, line 62 (or Form 1040A, line 41) _____

Credit for Tax on Undistributed Capital Gain

You must include in your income any amounts that regulated investment companies (commonly called mutual funds) or real estate investment trusts (REITs) allocated to you as capital gain distributions, even if you did not actually receive them. If the mutual fund or REIT paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The mutual fund or REIT will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*, showing the undistributed capital gains and the tax paid, if any. Claim the credit for the tax paid by entering the amount on line 65, Form 1040, and checking box a. Attach Copy B of Form 2439 to your return. See *Capital Gain Distributions* in chapter 9 for more information on undistributed capital gains.

2001 Tax Table

Caution. Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

Use if your taxable income is less than \$100,000.
If \$100,000 or more, use the Tax Rate Schedules.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 39 of Form 1040 is \$25,300. First, they find the \$25,300–25,350 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is \$3,799. This is the tax amount they should enter on line 40 of their Form 1040.

Sample Table

At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
Your tax is—					
25,200	25,250	3,784	3,784	4,112	3,784
25,250	25,300	3,791	3,791	4,126	3,791
25,300	25,350	3,799	3,799	4,139	3,799
25,350	25,400	3,806	3,806	4,153	3,806

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
Your tax is—																	
0	5	0	0	0	0	1,300	1,325	197	197	197	197	2,700	2,725	407	407	407	407
5	15	2	2	2	2	1,325	1,350	201	201	201	201	2,725	2,750	411	411	411	411
15	25	3	3	3	3	1,350	1,375	204	204	204	204	2,750	2,775	414	414	414	414
25	50	6	6	6	6	1,375	1,400	208	208	208	208	2,775	2,800	418	418	418	418
50	75	9	9	9	9	1,400	1,425	212	212	212	212	2,800	2,825	422	422	422	422
75	100	13	13	13	13	1,425	1,450	216	216	216	216	2,825	2,850	426	426	426	426
100	125	17	17	17	17	1,450	1,475	219	219	219	219	2,850	2,875	429	429	429	429
125	150	21	21	21	21	1,475	1,500	223	223	223	223	2,875	2,900	433	433	433	433
150	175	24	24	24	24	1,500	1,525	227	227	227	227	2,900	2,925	437	437	437	437
175	200	28	28	28	28	1,525	1,550	231	231	231	231	2,925	2,950	441	441	441	441
200	225	32	32	32	32	1,550	1,575	234	234	234	234	2,950	2,975	444	444	444	444
225	250	36	36	36	36	1,575	1,600	238	238	238	238	2,975	3,000	448	448	448	448
250	275	39	39	39	39	1,600	1,625	242	242	242	242	3,000					
275	300	43	43	43	43	1,625	1,650	246	246	246	246	3,000	3,050	454	454	454	454
300	325	47	47	47	47	1,650	1,675	249	249	249	249	3,050	3,100	461	461	461	461
325	350	51	51	51	51	1,675	1,700	253	253	253	253	3,100	3,150	469	469	469	469
350	375	54	54	54	54	1,700	1,725	257	257	257	257	3,150	3,200	476	476	476	476
375	400	58	58	58	58	1,725	1,750	261	261	261	261	3,200	3,250	484	484	484	484
400	425	62	62	62	62	1,750	1,775	264	264	264	264	3,250	3,300	491	491	491	491
425	450	66	66	66	66	1,775	1,800	268	268	268	268	3,300	3,350	499	499	499	499
450	475	69	69	69	69	1,800	1,825	272	272	272	272	3,350	3,400	506	506	506	506
475	500	73	73	73	73	1,825	1,850	276	276	276	276	3,400	3,450	514	514	514	514
500	525	77	77	77	77	1,850	1,875	279	279	279	279	3,450	3,500	521	521	521	521
525	550	81	81	81	81	1,875	1,900	283	283	283	283	3,500	3,550	529	529	529	529
550	575	84	84	84	84	1,900	1,925	287	287	287	287	3,550	3,600	536	536	536	536
575	600	88	88	88	88	1,925	1,950	291	291	291	291	3,600	3,650	544	544	544	544
600	625	92	92	92	92	1,950	1,975	294	294	294	294	3,650	3,700	551	551	551	551
625	650	96	96	96	96	1,975	2,000	298	298	298	298	3,700	3,750	559	559	559	559
650	675	99	99	99	99	2,000						3,750	3,800	566	566	566	566
675	700	103	103	103	103	2,000	2,025	302	302	302	302	3,800	3,850	574	574	574	574
700	725	107	107	107	107	2,025	2,050	306	306	306	306	3,850	3,900	581	581	581	581
725	750	111	111	111	111	2,050	2,075	309	309	309	309	3,900	3,950	589	589	589	589
750	775	114	114	114	114	2,075	2,100	313	313	313	313	3,950	4,000	596	596	596	596
775	800	118	118	118	118	2,100	2,125	317	317	317	317	4,000					
800	825	122	122	122	122	2,125	2,150	321	321	321	321	4,000	4,050	604	604	604	604
825	850	126	126	126	126	2,150	2,175	324	324	324	324	4,050	4,100	611	611	611	611
850	875	129	129	129	129	2,175	2,200	328	328	328	328	4,100	4,150	619	619	619	619
875	900	133	133	133	133	2,200	2,225	332	332	332	332	4,150	4,200	626	626	626	626
900	925	137	137	137	137	2,225	2,250	336	336	336	336	4,200	4,250	634	634	634	634
925	950	141	141	141	141	2,250	2,275	339	339	339	339	4,250	4,300	641	641	641	641
950	975	144	144	144	144	2,275	2,300	343	343	343	343	4,300	4,350	649	649	649	649
975	1,000	148	148	148	148	2,300	2,325	347	347	347	347	4,350	4,400	656	656	656	656
1,000						2,325	2,350	351	351	351	351	4,400	4,450	664	664	664	664
1,000	1,025	152	152	152	152	2,350	2,375	354	354	354	354	4,450	4,500	671	671	671	671
1,025	1,050	156	156	156	156	2,375	2,400	358	358	358	358	4,500	4,550	679	679	679	679
1,050	1,075	159	159	159	159	2,400	2,425	362	362	362	362	4,550	4,600	686	686	686	686
1,075	1,100	163	163	163	163	2,425	2,450	366	366	366	366	4,600	4,650	694	694	694	694
1,100	1,125	167	167	167	167	2,450	2,475	369	369	369	369	4,650	4,700	701	701	701	701
1,125	1,150	171	171	171	171	2,475	2,500	373	373	373	373	4,700	4,750	709	709	709	709
1,150	1,175	174	174	174	174	2,500	2,525	377	377	377	377	4,750	4,800	716	716	716	716
1,175	1,200	178	178	178	178	2,525	2,550	381	381	381	381	4,800	4,850	724	724	724	724
1,200	1,225	182	182	182	182	2,550	2,575	384	384	384	384	4,850	4,900	731	731	731	731
1,225	1,250	186	186	186	186	2,575	2,600	388	388	388	388	4,900	4,950	739	739	739	739
1,250	1,275	189	189	189	189	2,600	2,625	392	392	392	392	4,950	5,000	746	746	746	746
1,275	1,300	193	193	193	193	2,625	2,650	396	396	396	396	<i>(Continued on next page)</i>					
						2,650	2,675	399	399	399	399						
						2,675	2,700	403	403	403	403						

* This column must also be used by a qualifying widow(er).

2001 Tax Table—Continued Caution. Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
5,000						8,000						11,000					
5,000	5,050	754	754	754	754	8,000	8,050	1,204	1,204	1,204	1,204	11,000	11,050	1,654	1,654	1,654	1,654
5,050	5,100	761	761	761	761	8,050	8,100	1,211	1,211	1,211	1,211	11,050	11,100	1,661	1,661	1,661	1,661
5,100	5,150	769	769	769	769	8,100	8,150	1,219	1,219	1,219	1,219	11,100	11,150	1,669	1,669	1,669	1,669
5,150	5,200	776	776	776	776	8,150	8,200	1,226	1,226	1,226	1,226	11,150	11,200	1,676	1,676	1,676	1,676
5,200	5,250	784	784	784	784	8,200	8,250	1,234	1,234	1,234	1,234	11,200	11,250	1,684	1,684	1,684	1,684
5,250	5,300	791	791	791	791	8,250	8,300	1,241	1,241	1,241	1,241	11,250	11,300	1,691	1,691	1,691	1,691
5,300	5,350	799	799	799	799	8,300	8,350	1,249	1,249	1,249	1,249	11,300	11,350	1,699	1,699	1,699	1,699
5,350	5,400	806	806	806	806	8,350	8,400	1,256	1,256	1,256	1,256	11,350	11,400	1,706	1,706	1,706	1,706
5,400	5,450	814	814	814	814	8,400	8,450	1,264	1,264	1,264	1,264	11,400	11,450	1,714	1,714	1,714	1,714
5,450	5,500	821	821	821	821	8,450	8,500	1,271	1,271	1,271	1,271	11,450	11,500	1,721	1,721	1,721	1,721
5,500	5,550	829	829	829	829	8,500	8,550	1,279	1,279	1,279	1,279	11,500	11,550	1,729	1,729	1,729	1,729
5,550	5,600	836	836	836	836	8,550	8,600	1,286	1,286	1,286	1,286	11,550	11,600	1,736	1,736	1,736	1,736
5,600	5,650	844	844	844	844	8,600	8,650	1,294	1,294	1,294	1,294	11,600	11,650	1,744	1,744	1,744	1,744
5,650	5,700	851	851	851	851	8,650	8,700	1,301	1,301	1,301	1,301	11,650	11,700	1,751	1,751	1,751	1,751
5,700	5,750	859	859	859	859	8,700	8,750	1,309	1,309	1,309	1,309	11,700	11,750	1,759	1,759	1,759	1,759
5,750	5,800	866	866	866	866	8,750	8,800	1,316	1,316	1,316	1,316	11,750	11,800	1,766	1,766	1,766	1,766
5,800	5,850	874	874	874	874	8,800	8,850	1,324	1,324	1,324	1,324	11,800	11,850	1,774	1,774	1,774	1,774
5,850	5,900	881	881	881	881	8,850	8,900	1,331	1,331	1,331	1,331	11,850	11,900	1,781	1,781	1,781	1,781
5,900	5,950	889	889	889	889	8,900	8,950	1,339	1,339	1,339	1,339	11,900	11,950	1,789	1,789	1,789	1,789
5,950	6,000	896	896	896	896	8,950	9,000	1,346	1,346	1,346	1,346	11,950	12,000	1,796	1,796	1,796	1,796
6,000						9,000						12,000					
6,000	6,050	904	904	904	904	9,000	9,050	1,354	1,354	1,354	1,354	12,000	12,050	1,804	1,804	1,804	1,804
6,050	6,100	911	911	911	911	9,050	9,100	1,361	1,361	1,361	1,361	12,050	12,100	1,811	1,811	1,811	1,811
6,100	6,150	919	919	919	919	9,100	9,150	1,369	1,369	1,369	1,369	12,100	12,150	1,819	1,819	1,819	1,819
6,150	6,200	926	926	926	926	9,150	9,200	1,376	1,376	1,376	1,376	12,150	12,200	1,826	1,826	1,826	1,826
6,200	6,250	934	934	934	934	9,200	9,250	1,384	1,384	1,384	1,384	12,200	12,250	1,834	1,834	1,834	1,834
6,250	6,300	941	941	941	941	9,250	9,300	1,391	1,391	1,391	1,391	12,250	12,300	1,841	1,841	1,841	1,841
6,300	6,350	949	949	949	949	9,300	9,350	1,399	1,399	1,399	1,399	12,300	12,350	1,849	1,849	1,849	1,849
6,350	6,400	956	956	956	956	9,350	9,400	1,406	1,406	1,406	1,406	12,350	12,400	1,856	1,856	1,856	1,856
6,400	6,450	964	964	964	964	9,400	9,450	1,414	1,414	1,414	1,414	12,400	12,450	1,864	1,864	1,864	1,864
6,450	6,500	971	971	971	971	9,450	9,500	1,421	1,421	1,421	1,421	12,450	12,500	1,871	1,871	1,871	1,871
6,500	6,550	979	979	979	979	9,500	9,550	1,429	1,429	1,429	1,429	12,500	12,550	1,879	1,879	1,879	1,879
6,550	6,600	986	986	986	986	9,550	9,600	1,436	1,436	1,436	1,436	12,550	12,600	1,886	1,886	1,886	1,886
6,600	6,650	994	994	994	994	9,600	9,650	1,444	1,444	1,444	1,444	12,600	12,650	1,894	1,894	1,894	1,894
6,650	6,700	1,001	1,001	1,001	1,001	9,650	9,700	1,451	1,451	1,451	1,451	12,650	12,700	1,901	1,901	1,901	1,901
6,700	6,750	1,009	1,009	1,009	1,009	9,700	9,750	1,459	1,459	1,459	1,459	12,700	12,750	1,909	1,909	1,909	1,909
6,750	6,800	1,016	1,016	1,016	1,016	9,750	9,800	1,466	1,466	1,466	1,466	12,750	12,800	1,916	1,916	1,916	1,916
6,800	6,850	1,024	1,024	1,024	1,024	9,800	9,850	1,474	1,474	1,474	1,474	12,800	12,850	1,924	1,924	1,924	1,924
6,850	6,900	1,031	1,031	1,031	1,031	9,850	9,900	1,481	1,481	1,481	1,481	12,850	12,900	1,931	1,931	1,931	1,931
6,900	6,950	1,039	1,039	1,039	1,039	9,900	9,950	1,489	1,489	1,489	1,489	12,900	12,950	1,939	1,939	1,939	1,939
6,950	7,000	1,046	1,046	1,046	1,046	9,950	10,000	1,496	1,496	1,496	1,496	12,950	13,000	1,946	1,946	1,946	1,946
7,000						10,000						13,000					
7,000	7,050	1,054	1,054	1,054	1,054	10,000	10,050	1,504	1,504	1,504	1,504	13,000	13,050	1,954	1,954	1,954	1,954
7,050	7,100	1,061	1,061	1,061	1,061	10,050	10,100	1,511	1,511	1,511	1,511	13,050	13,100	1,961	1,961	1,961	1,961
7,100	7,150	1,069	1,069	1,069	1,069	10,100	10,150	1,519	1,519	1,519	1,519	13,100	13,150	1,969	1,969	1,969	1,969
7,150	7,200	1,076	1,076	1,076	1,076	10,150	10,200	1,526	1,526	1,526	1,526	13,150	13,200	1,976	1,976	1,976	1,976
7,200	7,250	1,084	1,084	1,084	1,084	10,200	10,250	1,534	1,534	1,534	1,534	13,200	13,250	1,984	1,984	1,984	1,984
7,250	7,300	1,091	1,091	1,091	1,091	10,250	10,300	1,541	1,541	1,541	1,541	13,250	13,300	1,991	1,991	1,991	1,991
7,300	7,350	1,099	1,099	1,099	1,099	10,300	10,350	1,549	1,549	1,549	1,549	13,300	13,350	1,999	1,999	1,999	1,999
7,350	7,400	1,106	1,106	1,106	1,106	10,350	10,400	1,556	1,556	1,556	1,556	13,350	13,400	2,006	2,006	2,006	2,006
7,400	7,450	1,114	1,114	1,114	1,114	10,400	10,450	1,564	1,564	1,564	1,564	13,400	13,450	2,014	2,014	2,014	2,014
7,450	7,500	1,121	1,121	1,121	1,121	10,450	10,500	1,571	1,571	1,571	1,571	13,450	13,500	2,021	2,021	2,021	2,021
7,500	7,550	1,129	1,129	1,129	1,129	10,500	10,550	1,579	1,579	1,579	1,579	13,500	13,550	2,029	2,029	2,029	2,029
7,550	7,600	1,136	1,136	1,136	1,136	10,550	10,600	1,586	1,586	1,586	1,586	13,550	13,600	2,036	2,036	2,036	2,036
7,600	7,650	1,144	1,144	1,144	1,144	10,600	10,650	1,594	1,594	1,594	1,594	13,600	13,650	2,044	2,044	2,044	2,044
7,650	7,700	1,151	1,151	1,151	1,151	10,650	10,700	1,601	1,601	1,601	1,601	13,650	13,700	2,051	2,051	2,051	2,051
7,700	7,750	1,159	1,159	1,159	1,159	10,700	10,750	1,609	1,609	1,609	1,609	13,700	13,750	2,059	2,059	2,059	2,059
7,750	7,800	1,166	1,166	1,166	1,166	10,750	10,800	1,616	1,616	1,616	1,616	13,750	13,800	2,066	2,066	2,066	2,066
7,800	7,850	1,174	1,174	1,174	1,174	10,800	10,850	1,624	1,624	1,624	1,624	13,800	13,850	2,074	2,074	2,074	2,074
7,850	7,900	1,181	1,181	1,181	1,181	10,850	10,900	1,631	1,631	1,631	1,631	13,850	13,900	2,081	2,081	2,081	2,081
7,900	7,950	1,189	1,189	1,189	1,189	10,900	10,950	1,639	1,639	1,639	1,639	13,900	13,950	2,089	2,089	2,089	2,089
7,950	8,000	1,196	1,196	1,196	1,196	10,950	11,000	1,646	1,646	1,646	1,646	13,950	14,000	2,096	2,096	2,096	2,096

* This column must also be used by a qualifying widow(er).

(Continued on next page)

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
14,000						17,000						20,000					
14,000	14,050	2,104	2,104	2,104	2,104	17,000	17,050	2,554	2,554	2,554	2,554	20,000	20,050	3,004	3,004	3,004	3,004
14,050	14,100	2,111	2,111	2,111	2,111	17,050	17,100	2,561	2,561	2,561	2,561	20,050	20,100	3,011	3,011	3,011	3,011
14,100	14,150	2,119	2,119	2,119	2,119	17,100	17,150	2,569	2,569	2,569	2,569	20,100	20,150	3,019	3,019	3,019	3,019
14,150	14,200	2,126	2,126	2,126	2,126	17,150	17,200	2,576	2,576	2,576	2,576	20,150	20,200	3,026	3,026	3,026	3,026
14,200	14,250	2,134	2,134	2,134	2,134	17,200	17,250	2,584	2,584	2,584	2,584	20,200	20,250	3,034	3,034	3,034	3,034
14,250	14,300	2,141	2,141	2,141	2,141	17,250	17,300	2,591	2,591	2,591	2,591	20,250	20,300	3,041	3,041	3,041	3,041
14,300	14,350	2,149	2,149	2,149	2,149	17,300	17,350	2,599	2,599	2,599	2,599	20,300	20,350	3,049	3,049	3,049	3,049
14,350	14,400	2,156	2,156	2,156	2,156	17,350	17,400	2,606	2,606	2,606	2,606	20,350	20,400	3,056	3,056	3,056	3,056
14,400	14,450	2,164	2,164	2,164	2,164	17,400	17,450	2,614	2,614	2,614	2,614	20,400	20,450	3,064	3,064	3,064	3,064
14,450	14,500	2,171	2,171	2,171	2,171	17,450	17,500	2,621	2,621	2,621	2,621	20,450	20,500	3,071	3,071	3,071	3,071
14,500	14,550	2,179	2,179	2,179	2,179	17,500	17,550	2,629	2,629	2,629	2,629	20,500	20,550	3,079	3,079	3,079	3,079
14,550	14,600	2,186	2,186	2,186	2,186	17,550	17,600	2,636	2,636	2,636	2,636	20,550	20,600	3,086	3,086	3,086	3,086
14,600	14,650	2,194	2,194	2,194	2,194	17,600	17,650	2,644	2,644	2,644	2,644	20,600	20,650	3,094	3,094	3,094	3,094
14,650	14,700	2,201	2,201	2,201	2,201	17,650	17,700	2,651	2,651	2,651	2,651	20,650	20,700	3,101	3,101	3,101	3,101
14,700	14,750	2,209	2,209	2,209	2,209	17,700	17,750	2,659	2,659	2,659	2,659	20,700	20,750	3,109	3,109	3,109	3,109
14,750	14,800	2,216	2,216	2,216	2,216	17,750	17,800	2,666	2,666	2,666	2,666	20,750	20,800	3,116	3,116	3,116	3,116
14,800	14,850	2,224	2,224	2,224	2,224	17,800	17,850	2,674	2,674	2,674	2,674	20,800	20,850	3,124	3,124	3,124	3,124
14,850	14,900	2,231	2,231	2,231	2,231	17,850	17,900	2,681	2,681	2,681	2,681	20,850	20,900	3,131	3,131	3,131	3,131
14,900	14,950	2,239	2,239	2,239	2,239	17,900	17,950	2,689	2,689	2,689	2,689	20,900	20,950	3,139	3,139	3,139	3,139
14,950	15,000	2,246	2,246	2,246	2,246	17,950	18,000	2,696	2,696	2,696	2,696	20,950	21,000	3,146	3,146	3,146	3,146
15,000						18,000						21,000					
15,000	15,050	2,254	2,254	2,254	2,254	18,000	18,050	2,704	2,704	2,704	2,704	21,000	21,050	3,154	3,154	3,154	3,154
15,050	15,100	2,261	2,261	2,261	2,261	18,050	18,100	2,711	2,711	2,711	2,711	21,050	21,100	3,161	3,161	3,161	3,161
15,100	15,150	2,269	2,269	2,269	2,269	18,100	18,150	2,719	2,719	2,719	2,719	21,100	21,150	3,169	3,169	3,169	3,169
15,150	15,200	2,276	2,276	2,276	2,276	18,150	18,200	2,726	2,726	2,726	2,726	21,150	21,200	3,176	3,176	3,176	3,176
15,200	15,250	2,284	2,284	2,284	2,284	18,200	18,250	2,734	2,734	2,734	2,734	21,200	21,250	3,184	3,184	3,184	3,184
15,250	15,300	2,291	2,291	2,291	2,291	18,250	18,300	2,741	2,741	2,741	2,741	21,250	21,300	3,191	3,191	3,191	3,191
15,300	15,350	2,299	2,299	2,299	2,299	18,300	18,350	2,749	2,749	2,749	2,749	21,300	21,350	3,199	3,199	3,199	3,199
15,350	15,400	2,306	2,306	2,306	2,306	18,350	18,400	2,756	2,756	2,756	2,756	21,350	21,400	3,206	3,206	3,206	3,206
15,400	15,450	2,314	2,314	2,314	2,314	18,400	18,450	2,764	2,764	2,764	2,764	21,400	21,450	3,214	3,214	3,214	3,214
15,450	15,500	2,321	2,321	2,321	2,321	18,450	18,500	2,771	2,771	2,771	2,771	21,450	21,500	3,221	3,221	3,221	3,221
15,500	15,550	2,329	2,329	2,329	2,329	18,500	18,550	2,779	2,779	2,779	2,779	21,500	21,550	3,229	3,229	3,229	3,229
15,550	15,600	2,336	2,336	2,336	2,336	18,550	18,600	2,786	2,786	2,786	2,786	21,550	21,600	3,236	3,236	3,236	3,236
15,600	15,650	2,344	2,344	2,344	2,344	18,600	18,650	2,794	2,794	2,794	2,794	21,600	21,650	3,244	3,244	3,244	3,244
15,650	15,700	2,351	2,351	2,351	2,351	18,650	18,700	2,801	2,801	2,801	2,801	21,650	21,700	3,251	3,251	3,251	3,251
15,700	15,750	2,359	2,359	2,359	2,359	18,700	18,750	2,809	2,809	2,809	2,809	21,700	21,750	3,259	3,259	3,259	3,259
15,750	15,800	2,366	2,366	2,366	2,366	18,750	18,800	2,816	2,816	2,816	2,816	21,750	21,800	3,266	3,266	3,266	3,266
15,800	15,850	2,374	2,374	2,374	2,374	18,800	18,850	2,824	2,824	2,824	2,824	21,800	21,850	3,274	3,274	3,274	3,274
15,850	15,900	2,381	2,381	2,381	2,381	18,850	18,900	2,831	2,831	2,831	2,831	21,850	21,900	3,281	3,281	3,281	3,281
15,900	15,950	2,389	2,389	2,389	2,389	18,900	18,950	2,839	2,839	2,839	2,839	21,900	21,950	3,289	3,289	3,289	3,289
15,950	16,000	2,396	2,396	2,396	2,396	18,950	19,000	2,846	2,846	2,846	2,846	21,950	22,000	3,296	3,296	3,296	3,296
16,000						19,000						22,000					
16,000	16,050	2,404	2,404	2,404	2,404	19,000	19,050	2,854	2,854	2,854	2,854	22,000	22,050	3,304	3,304	3,304	3,304
16,050	16,100	2,411	2,411	2,411	2,411	19,050	19,100	2,861	2,861	2,861	2,861	22,050	22,100	3,311	3,311	3,311	3,311
16,100	16,150	2,419	2,419	2,419	2,419	19,100	19,150	2,869	2,869	2,869	2,869	22,100	22,150	3,319	3,319	3,319	3,319
16,150	16,200	2,426	2,426	2,426	2,426	19,150	19,200	2,876	2,876	2,876	2,876	22,150	22,200	3,326	3,326	3,326	3,326
16,200	16,250	2,434	2,434	2,434	2,434	19,200	19,250	2,884	2,884	2,884	2,884	22,200	22,250	3,334	3,334	3,334	3,334
16,250	16,300	2,441	2,441	2,441	2,441	19,250	19,300	2,891	2,891	2,891	2,891	22,250	22,300	3,341	3,341	3,341	3,341
16,300	16,350	2,449	2,449	2,449	2,449	19,300	19,350	2,899	2,899	2,899	2,899	22,300	22,350	3,349	3,349	3,349	3,349
16,350	16,400	2,456	2,456	2,456	2,456	19,350	19,400	2,906	2,906	2,906	2,906	22,350	22,400	3,356	3,356	3,356	3,356
16,400	16,450	2,464	2,464	2,464	2,464	19,400	19,450	2,914	2,914	2,914	2,914	22,400	22,450	3,364	3,364	3,364	3,364
16,450	16,500	2,471	2,471	2,471	2,471	19,450	19,500	2,921	2,921	2,921	2,921	22,450	22,500	3,371	3,371	3,371	3,371
16,500	16,550	2,479	2,479	2,479	2,479	19,500	19,550	2,929	2,929	2,929	2,929	22,500	22,550	3,379	3,379	3,379	3,379
16,550	16,600	2,486	2,486	2,486	2,486	19,550	19,600	2,936	2,936	2,936	2,936	22,550	22,600	3,386	3,386	3,386	3,386
16,600	16,650	2,494	2,494	2,494	2,494	19,600	19,650	2,944	2,944	2,944	2,944	22,600	22,650	3,394	3,394	3,394	3,394
16,650	16,700	2,501	2,501	2,501	2,501	19,650	19,700	2,951	2,951	2,951	2,951	22,650	22,700	3,401	3,401	3,401	3,401
16,700	16,750	2,509	2,509	2,509	2,509	19,700	19,750	2,959	2,959	2,959	2,959	22,700	22,750	3,409	3,409	3,409	3,409
16,750	16,800	2,516	2,516	2,516	2,516	19,750	19,800	2,966	2,966	2,966	2,966	22,750	22,800	3,416	3,416	3,416	3,416
16,800	16,850	2,524	2,524	2,524	2,524	19,800	19,850	2,974	2,974	2,974	2,974	22,800	22,850	3,424	3,424	3,424	3,424
16,850	16,900	2,531	2,531	2,531	2,531	19,850	19,900	2,981	2,981	2,981	2,981	22,850	22,900	3,431	3,431	3,431	3,431
16,900	16,950	2,539	2,539	2,539	2,539	19,900	19,950	2,989	2,989	2,989	2,989	22,900	22,950	3,439	3,439	3,439	3,439
16,950	17,000	2,546	2,546	2,546	2,546	19,950	20,000	2,996	2,996	2,996	2,996	22,950	23,000	3,446	3,446	3,446	3,446

2001 Tax Table—Continued Caution. Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
23,000						26,000						29,000					
23,000	23,050	3,454	3,454	3,507	3,454	26,000	26,050	3,904	3,904	4,332	3,904	29,000	29,050	4,601	4,354	5,157	4,354
23,050	23,100	3,461	3,461	3,521	3,461	26,050	26,100	3,911	3,911	4,346	3,911	29,050	29,100	4,614	4,361	5,171	4,361
23,100	23,150	3,469	3,469	3,534	3,469	26,100	26,150	3,919	3,919	4,359	3,919	29,100	29,150	4,628	4,369	5,184	4,369
23,150	23,200	3,476	3,476	3,548	3,476	26,150	26,200	3,926	3,926	4,373	3,926	29,150	29,200	4,642	4,376	5,198	4,376
23,200	23,250	3,484	3,484	3,562	3,484	26,200	26,250	3,934	3,934	4,387	3,934	29,200	29,250	4,656	4,384	5,212	4,384
23,250	23,300	3,491	3,491	3,576	3,491	26,250	26,300	3,941	3,941	4,401	3,941	29,250	29,300	4,669	4,391	5,226	4,391
23,300	23,350	3,499	3,499	3,589	3,499	26,300	26,350	3,949	3,949	4,414	3,949	29,300	29,350	4,683	4,399	5,239	4,399
23,350	23,400	3,506	3,506	3,603	3,506	26,350	26,400	3,956	3,956	4,428	3,956	29,350	29,400	4,697	4,406	5,253	4,406
23,400	23,450	3,514	3,514	3,617	3,514	26,400	26,450	3,964	3,964	4,442	3,964	29,400	29,450	4,711	4,414	5,267	4,414
23,450	23,500	3,521	3,521	3,631	3,521	26,450	26,500	3,971	3,971	4,456	3,971	29,450	29,500	4,724	4,421	5,281	4,421
23,500	23,550	3,529	3,529	3,644	3,529	26,500	26,550	3,979	3,979	4,469	3,979	29,500	29,550	4,738	4,429	5,294	4,429
23,550	23,600	3,536	3,536	3,658	3,536	26,550	26,600	3,986	3,986	4,483	3,986	29,550	29,600	4,752	4,436	5,308	4,436
23,600	23,650	3,544	3,544	3,672	3,544	26,600	26,650	3,994	3,994	4,497	3,994	29,600	29,650	4,766	4,444	5,322	4,444
23,650	23,700	3,551	3,551	3,686	3,551	26,650	26,700	4,001	4,001	4,511	4,001	29,650	29,700	4,779	4,451	5,336	4,451
23,700	23,750	3,559	3,559	3,699	3,559	26,700	26,750	4,009	4,009	4,524	4,009	29,700	29,750	4,793	4,459	5,349	4,459
23,750	23,800	3,566	3,566	3,713	3,566	26,750	26,800	4,016	4,016	4,538	4,016	29,750	29,800	4,807	4,466	5,363	4,466
23,800	23,850	3,574	3,574	3,727	3,574	26,800	26,850	4,024	4,024	4,552	4,024	29,800	29,850	4,821	4,474	5,377	4,474
23,850	23,900	3,581	3,581	3,741	3,581	26,850	26,900	4,031	4,031	4,566	4,031	29,850	29,900	4,834	4,481	5,391	4,481
23,900	23,950	3,589	3,589	3,754	3,589	26,900	26,950	4,039	4,039	4,579	4,039	29,900	29,950	4,848	4,489	5,404	4,489
23,950	24,000	3,596	3,596	3,768	3,596	26,950	27,000	4,046	4,046	4,593	4,046	29,950	30,000	4,862	4,496	5,418	4,496
24,000						27,000						30,000					
24,000	24,050	3,604	3,604	3,782	3,604	27,000	27,050	4,054	4,054	4,607	4,054	30,000	30,050	4,876	4,504	5,432	4,504
24,050	24,100	3,611	3,611	3,796	3,611	27,050	27,100	4,064	4,061	4,621	4,061	30,050	30,100	4,889	4,511	5,446	4,511
24,100	24,150	3,619	3,619	3,809	3,619	27,100	27,150	4,078	4,069	4,634	4,069	30,100	30,150	4,903	4,519	5,459	4,519
24,150	24,200	3,626	3,626	3,823	3,626	27,150	27,200	4,092	4,076	4,648	4,076	30,150	30,200	4,917	4,526	5,473	4,526
24,200	24,250	3,634	3,634	3,837	3,634	27,200	27,250	4,106	4,084	4,662	4,084	30,200	30,250	4,931	4,534	5,487	4,534
24,250	24,300	3,641	3,641	3,851	3,641	27,250	27,300	4,119	4,091	4,676	4,091	30,250	30,300	4,944	4,541	5,501	4,541
24,300	24,350	3,649	3,649	3,864	3,649	27,300	27,350	4,133	4,099	4,689	4,099	30,300	30,350	4,958	4,549	5,514	4,549
24,350	24,400	3,656	3,656	3,878	3,656	27,350	27,400	4,147	4,106	4,703	4,106	30,350	30,400	4,972	4,556	5,528	4,556
24,400	24,450	3,664	3,664	3,892	3,664	27,400	27,450	4,161	4,114	4,717	4,114	30,400	30,450	4,986	4,564	5,542	4,564
24,450	24,500	3,671	3,671	3,906	3,671	27,450	27,500	4,174	4,121	4,731	4,121	30,450	30,500	4,999	4,571	5,556	4,571
24,500	24,550	3,679	3,679	3,919	3,679	27,500	27,550	4,188	4,129	4,744	4,129	30,500	30,550	5,013	4,579	5,569	4,579
24,550	24,600	3,686	3,686	3,933	3,686	27,550	27,600	4,202	4,136	4,758	4,136	30,550	30,600	5,027	4,586	5,583	4,586
24,600	24,650	3,694	3,694	3,947	3,694	27,600	27,650	4,216	4,144	4,772	4,144	30,600	30,650	5,041	4,594	5,597	4,594
24,650	24,700	3,701	3,701	3,961	3,701	27,650	27,700	4,229	4,151	4,786	4,151	30,650	30,700	5,054	4,601	5,611	4,601
24,700	24,750	3,709	3,709	3,974	3,709	27,700	27,750	4,243	4,159	4,799	4,159	30,700	30,750	5,068	4,609	5,624	4,609
24,750	24,800	3,716	3,716	3,988	3,716	27,750	27,800	4,257	4,166	4,813	4,166	30,750	30,800	5,082	4,616	5,638	4,616
24,800	24,850	3,724	3,724	4,002	3,724	27,800	27,850	4,271	4,174	4,827	4,174	30,800	30,850	5,096	4,624	5,652	4,624
24,850	24,900	3,731	3,731	4,016	3,731	27,850	27,900	4,284	4,181	4,841	4,181	30,850	30,900	5,109	4,631	5,666	4,631
24,900	24,950	3,739	3,739	4,029	3,739	27,900	27,950	4,298	4,189	4,854	4,189	30,900	30,950	5,123	4,639	5,679	4,639
24,950	25,000	3,746	3,746	4,043	3,746	27,950	28,000	4,312	4,196	4,868	4,196	30,950	31,000	5,137	4,646	5,693	4,646
25,000						28,000						31,000					
25,000	25,050	3,754	3,754	4,057	3,754	28,000	28,050	4,326	4,204	4,882	4,204	31,000	31,050	5,151	4,654	5,707	4,654
25,050	25,100	3,761	3,761	4,071	3,761	28,050	28,100	4,339	4,211	4,896	4,211	31,050	31,100	5,164	4,661	5,721	4,661
25,100	25,150	3,769	3,769	4,084	3,769	28,100	28,150	4,353	4,219	4,909	4,219	31,100	31,150	5,178	4,669	5,734	4,669
25,150	25,200	3,776	3,776	4,098	3,776	28,150	28,200	4,367	4,226	4,923	4,226	31,150	31,200	5,192	4,676	5,748	4,676
25,200	25,250	3,784	3,784	4,112	3,784	28,200	28,250	4,381	4,234	4,937	4,234	31,200	31,250	5,206	4,684	5,762	4,684
25,250	25,300	3,791	3,791	4,126	3,791	28,250	28,300	4,394	4,241	4,951	4,241	31,250	31,300	5,219	4,691	5,776	4,691
25,300	25,350	3,799	3,799	4,139	3,799	28,300	28,350	4,408	4,249	4,964	4,249	31,300	31,350	5,233	4,699	5,789	4,699
25,350	25,400	3,806	3,806	4,153	3,806	28,350	28,400	4,422	4,256	4,978	4,256	31,350	31,400	5,247	4,706	5,803	4,706
25,400	25,450	3,814	3,814	4,167	3,814	28,400	28,450	4,436	4,264	4,992	4,264	31,400	31,450	5,261	4,714	5,817	4,714
25,450	25,500	3,821	3,821	4,181	3,821	28,450	28,500	4,449	4,271	5,006	4,271	31,450	31,500	5,274	4,721	5,831	4,721
25,500	25,550	3,829	3,829	4,194	3,829	28,500	28,550	4,463	4,279	5,019	4,279	31,500	31,550	5,288	4,729	5,844	4,729
25,550	25,600	3,836	3,836	4,208	3,836	28,550	28,600	4,477	4,286	5,033	4,286	31,550	31,600	5,302	4,736	5,858	4,736
25,600	25,650	3,844	3,844	4,222	3,844	28,600	28,650	4,491	4,294	5,047	4,294	31,600	31,650	5,316	4,744	5,872	4,744
25,650	25,700	3,851	3,851	4,236	3,851	28,650	28,700	4,504	4,301	5,061	4,301	31,650	31,700	5,329	4,751	5,886	4,751
25,700	25,750	3,859	3,859	4,249	3,859	28,700	28,750	4,518	4,309	5,074	4,309	31,700	31,750	5,343	4,759	5,899	4,759
25,750	25,800	3,866	3,866</														

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
32,000						35,000						38,000					
32,000	32,050	5,426	4,804	5,982	4,804	35,000	35,050	6,251	5,254	6,807	5,254	38,000	38,050	7,076	5,704	7,632	5,926
32,050	32,100	5,439	4,811	5,996	4,811	35,050	35,100	6,264	5,261	6,821	5,261	38,050	38,100	7,089	5,711	7,646	5,939
32,100	32,150	5,453	4,819	6,009	4,819	35,100	35,150	6,278	5,269	6,834	5,269	38,100	38,150	7,103	5,719	7,659	5,953
32,150	32,200	5,467	4,826	6,023	4,826	35,150	35,200	6,292	5,276	6,848	5,276	38,150	38,200	7,117	5,726	7,673	5,967
32,200	32,250	5,481	4,834	6,037	4,834	35,200	35,250	6,306	5,284	6,862	5,284	38,200	38,250	7,131	5,734	7,687	5,981
32,250	32,300	5,494	4,841	6,051	4,841	35,250	35,300	6,319	5,291	6,876	5,291	38,250	38,300	7,144	5,741	7,701	5,994
32,300	32,350	5,508	4,849	6,064	4,849	35,300	35,350	6,333	5,299	6,889	5,299	38,300	38,350	7,158	5,749	7,714	6,008
32,350	32,400	5,522	4,856	6,078	4,856	35,350	35,400	6,347	5,306	6,903	5,306	38,350	38,400	7,172	5,756	7,728	6,022
32,400	32,450	5,536	4,864	6,092	4,864	35,400	35,450	6,361	5,314	6,917	5,314	38,400	38,450	7,186	5,764	7,742	6,036
32,450	32,500	5,549	4,871	6,106	4,871	35,450	35,500	6,374	5,321	6,931	5,321	38,450	38,500	7,199	5,771	7,756	6,049
32,500	32,550	5,563	4,879	6,119	4,879	35,500	35,550	6,388	5,329	6,944	5,329	38,500	38,550	7,213	5,779	7,769	6,063
32,550	32,600	5,577	4,886	6,133	4,886	35,550	35,600	6,402	5,336	6,958	5,336	38,550	38,600	7,227	5,786	7,783	6,077
32,600	32,650	5,591	4,894	6,147	4,894	35,600	35,650	6,416	5,344	6,972	5,344	38,600	38,650	7,241	5,794	7,797	6,091
32,650	32,700	5,604	4,901	6,161	4,901	35,650	35,700	6,429	5,351	6,986	5,351	38,650	38,700	7,254	5,801	7,811	6,104
32,700	32,750	5,618	4,909	6,174	4,909	35,700	35,750	6,443	5,359	6,999	5,359	38,700	38,750	7,268	5,809	7,824	6,118
32,750	32,800	5,632	4,916	6,188	4,916	35,750	35,800	6,457	5,366	7,013	5,366	38,750	38,800	7,282	5,816	7,838	6,132
32,800	32,850	5,646	4,924	6,202	4,924	35,800	35,850	6,471	5,374	7,027	5,374	38,800	38,850	7,296	5,824	7,852	6,146
32,850	32,900	5,659	4,931	6,216	4,931	35,850	35,900	6,484	5,381	7,041	5,381	38,850	38,900	7,309	5,831	7,866	6,159
32,900	32,950	5,673	4,939	6,229	4,939	35,900	35,950	6,498	5,389	7,054	5,389	38,900	38,950	7,323	5,839	7,879	6,173
32,950	33,000	5,687	4,946	6,243	4,946	35,950	36,000	6,512	5,396	7,068	5,396	38,950	39,000	7,337	5,846	7,893	6,187
33,000						36,000						39,000					
33,000	33,050	5,701	4,954	6,257	4,954	36,000	36,050	6,526	5,404	7,082	5,404	39,000	39,050	7,351	5,854	7,907	6,201
33,050	33,100	5,714	4,961	6,271	4,961	36,050	36,100	6,539	5,411	7,096	5,411	39,050	39,100	7,364	5,861	7,921	6,214
33,100	33,150	5,728	4,969	6,284	4,969	36,100	36,150	6,553	5,419	7,109	5,419	39,100	39,150	7,378	5,869	7,934	6,228
33,150	33,200	5,742	4,976	6,298	4,976	36,150	36,200	6,567	5,426	7,123	5,426	39,150	39,200	7,392	5,876	7,948	6,242
33,200	33,250	5,756	4,984	6,312	4,984	36,200	36,250	6,581	5,434	7,137	5,434	39,200	39,250	7,406	5,884	7,962	6,256
33,250	33,300	5,769	4,991	6,326	4,991	36,250	36,300	6,594	5,441	7,151	5,444	39,250	39,300	7,419	5,891	7,976	6,269
33,300	33,350	5,783	4,999	6,339	4,999	36,300	36,350	6,608	5,449	7,164	5,458	39,300	39,350	7,433	5,899	7,989	6,283
33,350	33,400	5,797	5,006	6,353	5,006	36,350	36,400	6,622	5,456	7,178	5,472	39,350	39,400	7,447	5,906	8,003	6,297
33,400	33,450	5,811	5,014	6,367	5,014	36,400	36,450	6,636	5,464	7,192	5,486	39,400	39,450	7,461	5,914	8,017	6,311
33,450	33,500	5,824	5,021	6,381	5,021	36,450	36,500	6,649	5,471	7,206	5,499	39,450	39,500	7,474	5,921	8,031	6,324
33,500	33,550	5,838	5,029	6,394	5,029	36,500	36,550	6,663	5,479	7,219	5,513	39,500	39,550	7,488	5,929	8,044	6,338
33,550	33,600	5,852	5,036	6,408	5,036	36,550	36,600	6,677	5,486	7,233	5,527	39,550	39,600	7,502	5,936	8,058	6,352
33,600	33,650	5,866	5,044	6,422	5,044	36,600	36,650	6,691	5,494	7,247	5,541	39,600	39,650	7,516	5,944	8,072	6,366
33,650	33,700	5,879	5,051	6,436	5,051	36,650	36,700	6,704	5,501	7,261	5,554	39,650	39,700	7,529	5,951	8,086	6,379
33,700	33,750	5,893	5,059	6,449	5,059	36,700	36,750	6,718	5,509	7,274	5,568	39,700	39,750	7,543	5,959	8,099	6,393
33,750	33,800	5,907	5,066	6,463	5,066	36,750	36,800	6,732	5,516	7,288	5,582	39,750	39,800	7,557	5,966	8,113	6,407
33,800	33,850	5,921	5,074	6,477	5,074	36,800	36,850	6,746	5,524	7,302	5,596	39,800	39,850	7,571	5,974	8,127	6,421
33,850	33,900	5,934	5,081	6,491	5,081	36,850	36,900	6,759	5,531	7,316	5,609	39,850	39,900	7,584	5,981	8,141	6,434
33,900	33,950	5,948	5,089	6,504	5,089	36,900	36,950	6,773	5,539	7,329	5,623	39,900	39,950	7,598	5,989	8,154	6,448
33,950	34,000	5,962	5,096	6,518	5,096	36,950	37,000	6,787	5,546	7,343	5,637	39,950	40,000	7,612	5,996	8,168	6,462
34,000						37,000						40,000					
34,000	34,050	5,976	5,104	6,532	5,104	37,000	37,050	6,801	5,554	7,357	5,651	40,000	40,050	7,626	6,004	8,182	6,476
34,050	34,100	5,989	5,111	6,546	5,111	37,050	37,100	6,814	5,561	7,371	5,664	40,050	40,100	7,639	6,011	8,196	6,489
34,100	34,150	6,003	5,119	6,559	5,119	37,100	37,150	6,828	5,569	7,384	5,678	40,100	40,150	7,653	6,019	8,209	6,503
34,150	34,200	6,017	5,126	6,573	5,126	37,150	37,200	6,842	5,576	7,398	5,692	40,150	40,200	7,667	6,026	8,223	6,517
34,200	34,250	6,031	5,134	6,587	5,134	37,200	37,250	6,856	5,584	7,412	5,706	40,200	40,250	7,681	6,034	8,237	6,531
34,250	34,300	6,044	5,141	6,601	5,141	37,250	37,300	6,869	5,591	7,426	5,719	40,250	40,300	7,694	6,041	8,251	6,544
34,300	34,350	6,058	5,149	6,614	5,149	37,300	37,350	6,883	5,599	7,439	5,733	40,300	40,350	7,708	6,049	8,264	6,558
34,350	34,400	6,072	5,156	6,628	5,156	37,350	37,400	6,897	5,606	7,453	5,747	40,350	40,400	7,722	6,056	8,278	6,572
34,400	34,450	6,086	5,164	6,642	5,164	37,400	37,450	6,911	5,614	7,467	5,761	40,400	40,450	7,736	6,064	8,292	6,586
34,450	34,500	6,099	5,171	6,656	5,171	37,450	37,500	6,924	5,621	7,481	5,774	40,450	40,500	7,749	6,071	8,306	6,599
34,500	34,550	6,113	5,179	6,669	5,179	37,500	37,550	6,938	5,629	7,494	5,788	40,500	40,550	7,763	6,079	8,319	6,613
34,550	34,600	6,127	5,186	6,683	5,186	37,550	37,600	6,952	5,636	7,508	5,802	40,550	40,600	7,777	6,086	8,333	6,627
34,600	34,650	6,141	5,194	6,697	5,194	37,600	37,650	6,966	5,644	7,522	5,816	40,600	40,650	7,791	6,094	8,347	6,641
34,650	34,700	6,154	5,201	6,711	5,201	37,650	37,700	6,979	5,651	7,536	5,829	40,650	40,700	7,804	6,101	8,361	6,654
34,700	34,750	6,168	5,209	6,724	5,209	37,700	37,750	6,993	5,659	7,549	5,843	40,700	40,750	7,818	6,109	8,374	6,668
34,750	34,800	6,182	5,216	6,738	5,216	37,750	37,800	7,007	5,666	7,563	5,857	40,750	40,800	7,832	6,116	8,388	6,682
34,800	34,850	6,196	5,224	6,752	5,224	37,800	37,850	7,021	5,674	7,577	5,871	40,800	40,850	7,846	6,124	8,402	6,696
34,850	34,900	6,209	5,231	6,766	5,231	37,850	37,900	7,034	5,681	7,591	5,884	40,850	40,900	7,859	6,131	8,416	6,709
34,900	34,950	6,223	5,239	6,779	5,239	37,900	37,950	7,048	5,689	7,604	5,898	40,900	40,950	7,873	6,139	8,429	6,723
34,950	35,000	6,237	5,246	6,793	5,246	37,950	38,000	7,									

2001 Tax Table—Continued Caution. Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
41,000						44,000						47,000					
41,000	41,050	7,901	6,154	8,457	6,751	44,000	44,050	8,726	6,604	9,282	7,576	47,000	47,050	9,551	7,282	10,107	8,401
41,050	41,100	7,914	6,161	8,471	6,764	44,050	44,100	8,739	6,611	9,296	7,589	47,050	47,100	9,564	7,296	10,121	8,414
41,100	41,150	7,928	6,169	8,484	6,778	44,100	44,150	8,753	6,619	9,309	7,603	47,100	47,150	9,578	7,309	10,134	8,428
41,150	41,200	7,942	6,176	8,498	6,792	44,150	44,200	8,767	6,626	9,323	7,617	47,150	47,200	9,592	7,323	10,148	8,442
41,200	41,250	7,956	6,184	8,512	6,806	44,200	44,250	8,781	6,634	9,337	7,631	47,200	47,250	9,606	7,337	10,162	8,456
41,250	41,300	7,969	6,191	8,526	6,819	44,250	44,300	8,794	6,641	9,351	7,644	47,250	47,300	9,619	7,351	10,176	8,469
41,300	41,350	7,983	6,199	8,539	6,833	44,300	44,350	8,808	6,649	9,364	7,658	47,300	47,350	9,633	7,364	10,189	8,483
41,350	41,400	7,997	6,206	8,553	6,847	44,350	44,400	8,822	6,656	9,378	7,672	47,350	47,400	9,647	7,378	10,203	8,497
41,400	41,450	8,011	6,214	8,567	6,861	44,400	44,450	8,836	6,664	9,392	7,686	47,400	47,450	9,661	7,392	10,217	8,511
41,450	41,500	8,024	6,221	8,581	6,874	44,450	44,500	8,849	6,671	9,406	7,699	47,450	47,500	9,674	7,406	10,231	8,524
41,500	41,550	8,038	6,229	8,594	6,888	44,500	44,550	8,863	6,679	9,419	7,713	47,500	47,550	9,688	7,419	10,244	8,538
41,550	41,600	8,052	6,236	8,608	6,902	44,550	44,600	8,877	6,686	9,433	7,727	47,550	47,600	9,702	7,433	10,258	8,552
41,600	41,650	8,066	6,244	8,622	6,916	44,600	44,650	8,891	6,694	9,447	7,741	47,600	47,650	9,716	7,447	10,272	8,566
41,650	41,700	8,079	6,251	8,636	6,929	44,650	44,700	8,904	6,701	9,461	7,754	47,650	47,700	9,729	7,461	10,286	8,579
41,700	41,750	8,093	6,259	8,649	6,943	44,700	44,750	8,918	6,709	9,474	7,768	47,700	47,750	9,743	7,474	10,299	8,593
41,750	41,800	8,107	6,266	8,663	6,957	44,750	44,800	8,932	6,716	9,488	7,782	47,750	47,800	9,757	7,488	10,313	8,607
41,800	41,850	8,121	6,274	8,677	6,971	44,800	44,850	8,946	6,724	9,502	7,796	47,800	47,850	9,771	7,502	10,327	8,621
41,850	41,900	8,134	6,281	8,691	6,984	44,850	44,900	8,959	6,731	9,516	7,809	47,850	47,900	9,784	7,516	10,341	8,634
41,900	41,950	8,148	6,289	8,704	6,998	44,900	44,950	8,973	6,739	9,529	7,823	47,900	47,950	9,798	7,529	10,354	8,648
41,950	42,000	8,162	6,296	8,718	7,012	44,950	45,000	8,987	6,746	9,543	7,837	47,950	48,000	9,812	7,543	10,368	8,662
42,000						45,000						48,000					
42,000	42,050	8,176	6,304	8,732	7,026	45,000	45,050	9,001	6,754	9,557	7,851	48,000	48,050	9,826	7,557	10,382	8,676
42,050	42,100	8,189	6,311	8,746	7,039	45,050	45,100	9,014	6,761	9,571	7,864	48,050	48,100	9,839	7,571	10,396	8,689
42,100	42,150	8,203	6,319	8,759	7,053	45,100	45,150	9,028	6,769	9,584	7,878	48,100	48,150	9,853	7,584	10,409	8,703
42,150	42,200	8,217	6,326	8,773	7,067	45,150	45,200	9,042	6,776	9,598	7,892	48,150	48,200	9,867	7,598	10,423	8,717
42,200	42,250	8,231	6,334	8,787	7,081	45,200	45,250	9,056	6,787	9,612	7,906	48,200	48,250	9,881	7,612	10,437	8,731
42,250	42,300	8,244	6,341	8,801	7,094	45,250	45,300	9,069	6,801	9,626	7,919	48,250	48,300	9,894	7,626	10,451	8,744
42,300	42,350	8,258	6,349	8,814	7,108	45,300	45,350	9,083	6,814	9,639	7,933	48,300	48,350	9,908	7,639	10,464	8,758
42,350	42,400	8,272	6,356	8,828	7,122	45,350	45,400	9,097	6,828	9,653	7,947	48,350	48,400	9,922	7,653	10,478	8,772
42,400	42,450	8,286	6,364	8,842	7,136	45,400	45,450	9,111	6,842	9,667	7,961	48,400	48,450	9,936	7,667	10,492	8,786
42,450	42,500	8,299	6,371	8,856	7,149	45,450	45,500	9,124	6,856	9,681	7,974	48,450	48,500	9,949	7,681	10,506	8,799
42,500	42,550	8,313	6,379	8,869	7,163	45,500	45,550	9,138	6,869	9,694	7,988	48,500	48,550	9,963	7,694	10,519	8,813
42,550	42,600	8,327	6,386	8,883	7,177	45,550	45,600	9,152	6,883	9,708	8,002	48,550	48,600	9,977	7,708	10,533	8,827
42,600	42,650	8,341	6,394	8,897	7,191	45,600	45,650	9,166	6,897	9,722	8,016	48,600	48,650	9,991	7,722	10,547	8,841
42,650	42,700	8,354	6,401	8,911	7,204	45,650	45,700	9,179	6,911	9,736	8,029	48,650	48,700	10,004	7,736	10,561	8,854
42,700	42,750	8,368	6,409	8,924	7,218	45,700	45,750	9,193	6,924	9,749	8,043	48,700	48,750	10,018	7,749	10,574	8,868
42,750	42,800	8,382	6,416	8,938	7,232	45,750	45,800	9,207	6,938	9,763	8,057	48,750	48,800	10,032	7,763	10,588	8,882
42,800	42,850	8,396	6,424	8,952	7,246	45,800	45,850	9,221	6,952	9,777	8,071	48,800	48,850	10,046	7,777	10,602	8,896
42,850	42,900	8,409	6,431	8,966	7,259	45,850	45,900	9,234	6,966	9,791	8,084	48,850	48,900	10,059	7,791	10,616	8,909
42,900	42,950	8,423	6,439	8,979	7,273	45,900	45,950	9,248	6,979	9,804	8,098	48,900	48,950	10,073	7,804	10,629	8,923
42,950	43,000	8,437	6,446	8,993	7,287	45,950	46,000	9,262	6,993	9,818	8,112	48,950	49,000	10,087	7,818	10,643	8,937
43,000						46,000						49,000					
43,000	43,050	8,451	6,454	9,007	7,301	46,000	46,050	9,276	7,007	9,832	8,126	49,000	49,050	10,101	7,832	10,657	8,951
43,050	43,100	8,464	6,461	9,021	7,314	46,050	46,100	9,289	7,021	9,846	8,139	49,050	49,100	10,114	7,846	10,671	8,964
43,100	43,150	8,478	6,469	9,034	7,328	46,100	46,150	9,303	7,034	9,859	8,153	49,100	49,150	10,128	7,859	10,684	8,978
43,150	43,200	8,492	6,476	9,048	7,342	46,150	46,200	9,317	7,048	9,873	8,167	49,150	49,200	10,142	7,873	10,698	8,992
43,200	43,250	8,506	6,484	9,062	7,356	46,200	46,250	9,331	7,062	9,887	8,181	49,200	49,250	10,156	7,887	10,712	9,006
43,250	43,300	8,519	6,491	9,076	7,369	46,250	46,300	9,344	7,076	9,901	8,194	49,250	49,300	10,169	7,901	10,726	9,019
43,300	43,350	8,533	6,499	9,089	7,383	46,300	46,350	9,358	7,089	9,914	8,208	49,300	49,350	10,183	7,914	10,739	9,033
43,350	43,400	8,547	6,506	9,103	7,397	46,350	46,400	9,372	7,103	9,928	8,222	49,350	49,400	10,197	7,928	10,753	9,047
43,400	43,450	8,561	6,514	9,117	7,411	46,400	46,450	9,386	7,117	9,942	8,236	49,400	49,450	10,211	7,942	10,767	9,061
43,450	43,500	8,574	6,521	9,131	7,424	46,450	46,500	9,399	7,131	9,956	8,249	49,450	49,500	10,224	7,956	10,781	9,074
43,500	43,550	8,588	6,529	9,144	7,438	46,500	46,550	9,413	7,144	9,969	8,263	49,500	49,550	10,238	7,969	10,794	9,088
43,550	43,600	8,602	6,536	9,158	7,452	46,550	46,600	9,427	7,158	9,983	8,277	49,550	49,600	10,252	7,983	10,808	9,102
43,600	43,650	8,616	6,544	9,172	7,466	46,600	46,650	9,441	7,172	9,997	8,291	49,600	49,650	10,266	7,997	10,822	9,116
43,650	43,700	8,629	6,551	9,186	7,479	46,650	46,700	9,454	7,186	10,011	8,304	49,650	49,700	10,279	8,011	10,836	9,129
43,700	43,750	8,643	6,559	9,199	7,493	46,700	46,750	9,468	7,199	10,024	8,318	49,700	49,750	10,293	8,024	10,849	9,143
43,750	43,800	8,657	6,566	9,213	7,507	46,750	46,800	9,482	7,213	10,038	8,332	49,750	49,800	10,307	8,038	10,863	9,157
43,800	43,850	8,671	6,574	9,227	7,521	46,800	46,850	9,496	7,227	10,052	8,346	49,800	49,850	10,321	8,052	10,877	9,171
43,850	43,900	8,684	6,581	9,241	7,534	46,850	46,900	9,509	7,241	10,066	8,359	49,850	49,900	10,334	8,066	10,891	9,184
43,900	43,950	8,698	6,589	9,254	7,548	46,900	46,950	9,523	7,254	10,079	8,373	49,900	49,950	10,348	8,079	10,904	9,198

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
50,000						53,000						56,000					
50,000	50,050	10,376	8,107	10,932	9,226	53,000	53,050	11,201	8,932	11,757	10,051	56,000	56,050	12,026	9,757	12,624	10,876
50,050	50,100	10,389	8,121	10,946	9,239	53,050	53,100	11,214	8,946	11,771	10,064	56,050	56,100	12,039	9,771	12,639	10,889
50,100	50,150	10,403	8,134	10,959	9,253	53,100	53,150	11,228	8,959	11,784	10,078	56,100	56,150	12,053	9,784	12,654	10,903
50,150	50,200	10,417	8,148	10,973	9,267	53,150	53,200	11,242	8,973	11,798	10,092	56,150	56,200	12,067	9,798	12,670	10,917
50,200	50,250	10,431	8,162	10,987	9,281	53,200	53,250	11,256	8,987	11,812	10,106	56,200	56,250	12,081	9,812	12,685	10,931
50,250	50,300	10,444	8,176	11,001	9,294	53,250	53,300	11,269	9,001	11,826	10,119	56,250	56,300	12,094	9,826	12,700	10,944
50,300	50,350	10,458	8,189	11,014	9,308	53,300	53,350	11,283	9,014	11,839	10,133	56,300	56,350	12,108	9,839	12,715	10,958
50,350	50,400	10,472	8,203	11,028	9,322	53,350	53,400	11,297	9,028	11,853	10,147	56,350	56,400	12,122	9,853	12,731	10,972
50,400	50,450	10,486	8,217	11,042	9,336	53,400	53,450	11,311	9,042	11,867	10,161	56,400	56,450	12,136	9,867	12,746	10,986
50,450	50,500	10,499	8,231	11,056	9,349	53,450	53,500	11,324	9,056	11,881	10,174	56,450	56,500	12,149	9,881	12,761	10,999
50,500	50,550	10,513	8,244	11,069	9,363	53,500	53,550	11,338	9,069	11,894	10,188	56,500	56,550	12,163	9,894	12,776	11,013
50,550	50,600	10,527	8,258	11,083	9,377	53,550	53,600	11,352	9,083	11,908	10,202	56,550	56,600	12,177	9,908	12,792	11,027
50,600	50,650	10,541	8,272	11,097	9,391	53,600	53,650	11,366	9,097	11,922	10,216	56,600	56,650	12,191	9,922	12,807	11,041
50,650	50,700	10,554	8,286	11,111	9,404	53,650	53,700	11,379	9,111	11,936	10,229	56,650	56,700	12,204	9,936	12,822	11,054
50,700	50,750	10,568	8,299	11,124	9,418	53,700	53,750	11,393	9,124	11,949	10,243	56,700	56,750	12,218	9,949	12,837	11,068
50,750	50,800	10,582	8,313	11,138	9,432	53,750	53,800	11,407	9,138	11,963	10,257	56,750	56,800	12,232	9,963	12,853	11,082
50,800	50,850	10,596	8,327	11,152	9,446	53,800	53,850	11,421	9,152	11,977	10,271	56,800	56,850	12,246	9,977	12,868	11,096
50,850	50,900	10,609	8,341	11,166	9,459	53,850	53,900	11,434	9,166	11,991	10,284	56,850	56,900	12,259	9,991	12,883	11,109
50,900	50,950	10,623	8,354	11,179	9,473	53,900	53,950	11,448	9,179	12,004	10,298	56,900	56,950	12,273	10,004	12,898	11,123
50,950	51,000	10,637	8,368	11,193	9,487	53,950	54,000	11,462	9,193	12,018	10,312	56,950	57,000	12,287	10,018	12,914	11,137
51,000						54,000						57,000					
51,000	51,050	10,651	8,382	11,207	9,501	54,000	54,050	11,476	9,207	12,032	10,326	57,000	57,050	12,301	10,032	12,929	11,151
51,050	51,100	10,664	8,396	11,221	9,514	54,050	54,100	11,489	9,221	12,046	10,339	57,050	57,100	12,314	10,046	12,944	11,164
51,100	51,150	10,678	8,409	11,234	9,528	54,100	54,150	11,503	9,234	12,059	10,353	57,100	57,150	12,328	10,059	12,959	11,178
51,150	51,200	10,692	8,423	11,248	9,542	54,150	54,200	11,517	9,248	12,073	10,367	57,150	57,200	12,342	10,073	12,975	11,192
51,200	51,250	10,706	8,437	11,262	9,556	54,200	54,250	11,531	9,262	12,087	10,381	57,200	57,250	12,356	10,087	12,990	11,206
51,250	51,300	10,719	8,451	11,276	9,569	54,250	54,300	11,544	9,276	12,101	10,394	57,250	57,300	12,369	10,101	13,005	11,219
51,300	51,350	10,733	8,464	11,289	9,583	54,300	54,350	11,558	9,289	12,114	10,408	57,300	57,350	12,383	10,114	13,020	11,233
51,350	51,400	10,747	8,478	11,303	9,597	54,350	54,400	11,572	9,303	12,128	10,422	57,350	57,400	12,397	10,128	13,036	11,247
51,400	51,450	10,761	8,492	11,317	9,611	54,400	54,450	11,586	9,317	12,142	10,436	57,400	57,450	12,411	10,142	13,051	11,261
51,450	51,500	10,774	8,506	11,331	9,624	54,450	54,500	11,599	9,331	12,156	10,449	57,450	57,500	12,424	10,156	13,066	11,274
51,500	51,550	10,788	8,519	11,344	9,638	54,500	54,550	11,613	9,344	12,169	10,463	57,500	57,550	12,438	10,169	13,081	11,288
51,550	51,600	10,802	8,533	11,358	9,652	54,550	54,600	11,627	9,358	12,183	10,477	57,550	57,600	12,452	10,183	13,097	11,302
51,600	51,650	10,816	8,547	11,372	9,666	54,600	54,650	11,641	9,372	12,197	10,491	57,600	57,650	12,466	10,197	13,112	11,316
51,650	51,700	10,829	8,561	11,386	9,679	54,650	54,700	11,654	9,386	12,212	10,504	57,650	57,700	12,479	10,211	13,127	11,329
51,700	51,750	10,843	8,574	11,399	9,693	54,700	54,750	11,668	9,399	12,227	10,518	57,700	57,750	12,493	10,224	13,142	11,343
51,750	51,800	10,857	8,588	11,413	9,707	54,750	54,800	11,682	9,413	12,243	10,532	57,750	57,800	12,507	10,238	13,158	11,357
51,800	51,850	10,871	8,602	11,427	9,721	54,800	54,850	11,696	9,427	12,258	10,546	57,800	57,850	12,521	10,252	13,173	11,371
51,850	51,900	10,884	8,616	11,441	9,734	54,850	54,900	11,709	9,441	12,273	10,559	57,850	57,900	12,534	10,266	13,188	11,384
51,900	51,950	10,898	8,629	11,454	9,748	54,900	54,950	11,723	9,454	12,288	10,573	57,900	57,950	12,548	10,279	13,203	11,398
51,950	52,000	10,912	8,643	11,468	9,762	54,950	55,000	11,737	9,468	12,304	10,587	57,950	58,000	12,562	10,293	13,219	11,412
52,000						55,000						58,000					
52,000	52,050	10,926	8,657	11,482	9,776	55,000	55,050	11,751	9,482	12,319	10,601	58,000	58,050	12,576	10,307	13,234	11,426
52,050	52,100	10,939	8,671	11,496	9,789	55,050	55,100	11,764	9,496	12,334	10,614	58,050	58,100	12,589	10,321	13,249	11,439
52,100	52,150	10,953	8,684	11,509	9,803	55,100	55,150	11,778	9,509	12,349	10,628	58,100	58,150	12,603	10,334	13,264	11,453
52,150	52,200	10,967	8,698	11,523	9,817	55,150	55,200	11,792	9,523	12,365	10,642	58,150	58,200	12,617	10,348	13,280	11,467
52,200	52,250	10,981	8,712	11,537	9,831	55,200	55,250	11,806	9,537	12,380	10,656	58,200	58,250	12,631	10,362	13,295	11,481
52,250	52,300	10,994	8,726	11,551	9,844	55,250	55,300	11,819	9,551	12,395	10,669	58,250	58,300	12,644	10,376	13,310	11,494
52,300	52,350	11,008	8,739	11,564	9,858	55,300	55,350	11,833	9,564	12,410	10,683	58,300	58,350	12,658	10,389	13,325	11,508
52,350	52,400	11,022	8,753	11,578	9,872	55,350	55,400	11,847	9,578	12,426	10,697	58,350	58,400	12,672	10,403	13,341	11,522
52,400	52,450	11,036	8,767	11,592	9,886	55,400	55,450	11,861	9,592	12,441	10,711	58,400	58,450	12,686	10,417	13,356	11,536
52,450	52,500	11,049	8,781	11,606	9,899	55,450	55,500	11,874	9,606	12,456	10,724	58,450	58,500	12,699	10,431	13,371	11,549
52,500	52,550	11,063	8,794	11,619	9,913	55,500	55,550	11,888	9,619	12,471	10,738	58,500	58,550	12,713	10,444	13,386	11,563
52,550	52,600	11,077	8,808	11,633	9,927	55,550	55,600	11,902	9,633	12,487	10,752	58,550	58,600	12,727	10,458	13,402	11,577
52,600	52,650	11,091	8,822	11,647	9,941	55,600	55,650	11,916	9,647	12,502	10,766	58,600	58,650	12,741	10,472	13,417	11,591
52,650																	

2001 Tax Table—Continued **Caution.** Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
59,000						62,000						65,000					
59,000	59,050	12,851	10,582	13,539	11,701	62,000	62,050	13,676	11,407	14,454	12,526	65,000	65,050	14,501	12,232	15,369	13,351
59,050	59,100	12,864	10,596	13,554	11,714	62,050	62,100	13,689	11,421	14,469	12,539	65,050	65,100	14,514	12,246	15,384	13,364
59,100	59,150	12,878	10,609	13,569	11,728	62,100	62,150	13,703	11,434	14,484	12,553	65,100	65,150	14,528	12,259	15,399	13,378
59,150	59,200	12,892	10,623	13,585	11,742	62,150	62,200	13,717	11,448	14,500	12,567	65,150	65,200	14,542	12,273	15,415	13,392
59,200	59,250	12,906	10,637	13,600	11,756	62,200	62,250	13,731	11,462	14,515	12,581	65,200	65,250	14,556	12,287	15,430	13,406
59,250	59,300	12,919	10,651	13,615	11,769	62,250	62,300	13,744	11,476	14,530	12,594	65,250	65,300	14,569	12,301	15,445	13,419
59,300	59,350	12,933	10,664	13,630	11,783	62,300	62,350	13,758	11,489	14,545	12,608	65,300	65,350	14,583	12,314	15,460	13,433
59,350	59,400	12,947	10,678	13,646	11,797	62,350	62,400	13,772	11,503	14,561	12,622	65,350	65,400	14,597	12,328	15,476	13,447
59,400	59,450	12,961	10,692	13,661	11,811	62,400	62,450	13,786	11,517	14,576	12,636	65,400	65,450	14,611	12,342	15,491	13,461
59,450	59,500	12,974	10,706	13,676	11,824	62,450	62,500	13,799	11,531	14,591	12,649	65,450	65,500	14,624	12,356	15,506	13,474
59,500	59,550	12,988	10,719	13,691	11,838	62,500	62,550	13,813	11,544	14,606	12,663	65,500	65,550	14,638	12,369	15,521	13,488
59,550	59,600	13,002	10,733	13,707	11,852	62,550	62,600	13,827	11,558	14,622	12,677	65,550	65,600	14,653	12,383	15,537	13,502
59,600	59,650	13,016	10,747	13,722	11,866	62,600	62,650	13,841	11,572	14,637	12,691	65,600	65,650	14,668	12,397	15,552	13,516
59,650	59,700	13,029	10,761	13,737	11,879	62,650	62,700	13,854	11,586	14,652	12,704	65,650	65,700	14,683	12,411	15,567	13,529
59,700	59,750	13,043	10,774	13,752	11,893	62,700	62,750	13,868	11,599	14,667	12,718	65,700	65,750	14,698	12,424	15,582	13,543
59,750	59,800	13,057	10,788	13,768	11,907	62,750	62,800	13,882	11,613	14,683	12,732	65,750	65,800	14,714	12,438	15,598	13,557
59,800	59,850	13,071	10,802	13,783	11,921	62,800	62,850	13,896	11,627	14,698	12,746	65,800	65,850	14,729	12,452	15,613	13,571
59,850	59,900	13,084	10,816	13,798	11,934	62,850	62,900	13,909	11,641	14,713	12,759	65,850	65,900	14,744	12,466	15,628	13,584
59,900	59,950	13,098	10,829	13,813	11,948	62,900	62,950	13,923	11,654	14,728	12,773	65,900	65,950	14,759	12,479	15,643	13,598
59,950	60,000	13,112	10,843	13,829	11,962	62,950	63,000	13,937	11,668	14,744	12,787	65,950	66,000	14,775	12,493	15,659	13,612
60,000						63,000						66,000					
60,000	60,050	13,126	10,857	13,844	11,976	63,000	63,050	13,951	11,682	14,759	12,801	66,000	66,050	14,790	12,507	15,674	13,626
60,050	60,100	13,139	10,871	13,859	11,989	63,050	63,100	13,964	11,696	14,774	12,814	66,050	66,100	14,805	12,521	15,689	13,639
60,100	60,150	13,153	10,884	13,874	12,003	63,100	63,150	13,978	11,709	14,789	12,828	66,100	66,150	14,820	12,534	15,704	13,653
60,150	60,200	13,167	10,898	13,890	12,017	63,150	63,200	13,992	11,723	14,805	12,842	66,150	66,200	14,836	12,548	15,720	13,667
60,200	60,250	13,181	10,912	13,905	12,031	63,200	63,250	14,006	11,737	14,820	12,856	66,200	66,250	14,851	12,562	15,735	13,681
60,250	60,300	13,194	10,926	13,920	12,044	63,250	63,300	14,019	11,751	14,835	12,869	66,250	66,300	14,866	12,576	15,750	13,694
60,300	60,350	13,208	10,939	13,935	12,058	63,300	63,350	14,033	11,764	14,850	12,883	66,300	66,350	14,881	12,589	15,765	13,708
60,350	60,400	13,222	10,953	13,951	12,072	63,350	63,400	14,047	11,778	14,866	12,897	66,350	66,400	14,897	12,603	15,781	13,722
60,400	60,450	13,236	10,967	13,966	12,086	63,400	63,450	14,061	11,792	14,881	12,911	66,400	66,450	14,912	12,617	15,796	13,736
60,450	60,500	13,249	10,981	13,981	12,099	63,450	63,500	14,074	11,806	14,896	12,924	66,450	66,500	14,927	12,631	15,811	13,749
60,500	60,550	13,263	10,994	13,996	12,113	63,500	63,550	14,088	11,819	14,911	12,938	66,500	66,550	14,942	12,644	15,826	13,763
60,550	60,600	13,277	11,008	14,012	12,127	63,550	63,600	14,102	11,833	14,927	12,952	66,550	66,600	14,958	12,658	15,842	13,777
60,600	60,650	13,291	11,022	14,027	12,141	63,600	63,650	14,116	11,847	14,942	12,966	66,600	66,650	14,973	12,672	15,857	13,791
60,650	60,700	13,304	11,036	14,042	12,154	63,650	63,700	14,129	11,861	14,957	12,979	66,650	66,700	14,988	12,686	15,872	13,804
60,700	60,750	13,318	11,049	14,057	12,168	63,700	63,750	14,143	11,874	14,972	12,993	66,700	66,750	15,003	12,699	15,887	13,818
60,750	60,800	13,332	11,063	14,073	12,182	63,750	63,800	14,157	11,888	14,988	13,007	66,750	66,800	15,019	12,713	15,903	13,832
60,800	60,850	13,346	11,077	14,088	12,196	63,800	63,850	14,171	11,902	15,003	13,021	66,800	66,850	15,034	12,727	15,918	13,846
60,850	60,900	13,359	11,091	14,103	12,209	63,850	63,900	14,184	11,916	15,018	13,034	66,850	66,900	15,049	12,741	15,933	13,859
60,900	60,950	13,373	11,104	14,118	12,223	63,900	63,950	14,198	11,929	15,033	13,048	66,900	66,950	15,064	12,754	15,948	13,873
60,950	61,000	13,387	11,118	14,134	12,237	63,950	64,000	14,212	11,943	15,049	13,062	66,950	67,000	15,080	12,768	15,964	13,887
61,000						64,000						67,000					
61,000	61,050	13,401	11,132	14,149	12,251	64,000	64,050	14,226	11,957	15,064	13,076	67,000	67,050	15,095	12,782	15,979	13,901
61,050	61,100	13,414	11,146	14,164	12,264	64,050	64,100	14,239	11,971	15,079	13,089	67,050	67,100	15,110	12,796	15,994	13,914
61,100	61,150	13,428	11,159	14,179	12,278	64,100	64,150	14,253	11,984	15,094	13,103	67,100	67,150	15,125	12,809	16,009	13,928
61,150	61,200	13,442	11,173	14,195	12,292	64,150	64,200	14,267	11,998	15,110	13,117	67,150	67,200	15,141	12,823	16,025	13,942
61,200	61,250	13,456	11,187	14,210	12,306	64,200	64,250	14,281	12,012	15,125	13,131	67,200	67,250	15,156	12,837	16,040	13,956
61,250	61,300	13,469	11,201	14,225	12,319	64,250	64,300	14,294	12,026	15,140	13,144	67,250	67,300	15,171	12,851	16,055	13,969
61,300	61,350	13,483	11,214	14,240	12,333	64,300	64,350	14,308	12,039	15,155	13,158	67,300	67,350	15,186	12,864	16,070	13,983
61,350	61,400	13,497	11,228	14,256	12,347	64,350	64,400	14,322	12,053	15,171	13,172	67,350	67,400	15,202	12,878	16,086	13,997
61,400	61,450	13,511	11,242	14,271	12,361	64,400	64,450	14,336	12,067	15,186	13,186	67,400	67,450	15,217	12,892	16,101	14,011
61,450	61,500	13,524	11,256	14,286	12,374	64,450	64,500	14,349	12,081	15,201	13,199	67,450	67,500	15,232	12,906	16,116	14,024
61,500	61,550	13,538	11,269	14,301	12,388	64,500	64,550	14,363	12,094	15,216	13,213	67,500	67,550	15,247	12,919	16,131	14,038
61,550	61,600	13,552	11,283	14,317	12,402	64,550	64,600	14,377	12,108	15,232	13,227	67,550	67,600	15,263	12,933	16,147	14,052
61,600	61,650	13,566	11,297	14,332	12,416	64,600	64,650	14,391	12,122	15,247	13,241	67,600	67,650	15,278	12,947	16,162	14,066
61,650	61,700	13,579	11,311	14,347	12,429	64,650	64,700	14,404	12,136	15,262	13,254	67,650	67,700	15,293	12,961	16,177	14,079
61,700	61,750	13,593	11,324	14,362	12,443	64,700	64,750	14,418	12,149	15,277	13,268	67,700	67,750	15,308	12,974	16,192	14,093
61,750	61,800	13,607	11,338	14,378	12,457	64,750	64,800	14,432	12,163	15,293	13,282	67,750	67,800	15,324	12,988	16,208	14,107

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
68,000						71,000						74,000					
68,000	68,050	15,400	13,057	16,284	14,176	71,000	71,050	16,315	13,882	17,199	15,001	74,000	74,050	17,230	14,707	18,114	15,826
68,050	68,100	15,415	13,071	16,299	14,189	71,050	71,100	16,330	13,896	17,214	15,014	74,050	74,100	17,245	14,721	18,129	15,839
68,100	68,150	15,430	13,084	16,314	14,203	71,100	71,150	16,345	13,909	17,229	15,028	74,100	74,150	17,260	14,734	18,144	15,853
68,150	68,200	15,446	13,098	16,330	14,217	71,150	71,200	16,361	13,923	17,245	15,042	74,150	74,200	17,276	14,748	18,160	15,867
68,200	68,250	15,461	13,112	16,345	14,231	71,200	71,250	16,376	13,937	17,260	15,056	74,200	74,250	17,291	14,762	18,175	15,881
68,250	68,300	15,476	13,126	16,360	14,244	71,250	71,300	16,391	13,951	17,275	15,069	74,250	74,300	17,306	14,776	18,190	15,894
68,300	68,350	15,491	13,139	16,375	14,258	71,300	71,350	16,406	13,964	17,290	15,083	74,300	74,350	17,321	14,789	18,205	15,908
68,350	68,400	15,507	13,153	16,391	14,272	71,350	71,400	16,422	13,978	17,306	15,097	74,350	74,400	17,337	14,803	18,221	15,922
68,400	68,450	15,522	13,167	16,406	14,286	71,400	71,450	16,437	13,992	17,321	15,111	74,400	74,450	17,352	14,817	18,236	15,936
68,450	68,500	15,537	13,181	16,421	14,299	71,450	71,500	16,452	14,006	17,336	15,124	74,450	74,500	17,367	14,831	18,251	15,949
68,500	68,550	15,552	13,194	16,436	14,313	71,500	71,550	16,467	14,019	17,351	15,138	74,500	74,550	17,382	14,844	18,266	15,963
68,550	68,600	15,568	13,208	16,452	14,327	71,550	71,600	16,483	14,033	17,367	15,152	74,550	74,600	17,398	14,858	18,282	15,977
68,600	68,650	15,583	13,222	16,467	14,341	71,600	71,650	16,498	14,047	17,382	15,166	74,600	74,650	17,413	14,872	18,297	15,991
68,650	68,700	15,598	13,236	16,482	14,354	71,650	71,700	16,513	14,061	17,397	15,179	74,650	74,700	17,428	14,886	18,312	16,004
68,700	68,750	15,613	13,249	16,497	14,368	71,700	71,750	16,528	14,074	17,412	15,193	74,700	74,750	17,443	14,899	18,327	16,018
68,750	68,800	15,629	13,263	16,513	14,382	71,750	71,800	16,544	14,088	17,428	15,207	74,750	74,800	17,459	14,913	18,343	16,032
68,800	68,850	15,644	13,277	16,528	14,396	71,800	71,850	16,559	14,102	17,443	15,221	74,800	74,850	17,474	14,927	18,358	16,046
68,850	68,900	15,659	13,291	16,543	14,409	71,850	71,900	16,574	14,116	17,458	15,234	74,850	74,900	17,489	14,941	18,373	16,059
68,900	68,950	15,674	13,304	16,558	14,423	71,900	71,950	16,589	14,129	17,473	15,248	74,900	74,950	17,504	14,954	18,388	16,073
68,950	69,000	15,690	13,318	16,574	14,437	71,950	72,000	16,605	14,143	17,489	15,262	74,950	75,000	17,520	14,968	18,404	16,087
69,000						72,000						75,000					
69,000	69,050	15,705	13,332	16,589	14,451	72,000	72,050	16,620	14,157	17,504	15,276	75,000	75,050	17,535	14,982	18,419	16,101
69,050	69,100	15,720	13,346	16,604	14,464	72,050	72,100	16,635	14,171	17,519	15,289	75,050	75,100	17,550	14,996	18,434	16,114
69,100	69,150	15,735	13,359	16,619	14,478	72,100	72,150	16,650	14,184	17,534	15,303	75,100	75,150	17,565	15,009	18,449	16,128
69,150	69,200	15,751	13,373	16,635	14,492	72,150	72,200	16,666	14,198	17,550	15,317	75,150	75,200	17,581	15,023	18,465	16,142
69,200	69,250	15,766	13,387	16,650	14,506	72,200	72,250	16,681	14,212	17,565	15,331	75,200	75,250	17,596	15,037	18,480	16,156
69,250	69,300	15,781	13,401	16,665	14,519	72,250	72,300	16,696	14,226	17,580	15,344	75,250	75,300	17,611	15,051	18,495	16,169
69,300	69,350	15,796	13,414	16,680	14,533	72,300	72,350	16,711	14,239	17,595	15,358	75,300	75,350	17,626	15,064	18,510	16,183
69,350	69,400	15,812	13,428	16,696	14,547	72,350	72,400	16,727	14,253	17,611	15,372	75,350	75,400	17,642	15,078	18,526	16,197
69,400	69,450	15,827	13,442	16,711	14,561	72,400	72,450	16,742	14,267	17,626	15,386	75,400	75,450	17,657	15,092	18,541	16,211
69,450	69,500	15,842	13,456	16,726	14,574	72,450	72,500	16,757	14,281	17,641	15,399	75,450	75,500	17,672	15,106	18,556	16,224
69,500	69,550	15,857	13,469	16,741	14,588	72,500	72,550	16,772	14,294	17,656	15,413	75,500	75,550	17,687	15,119	18,571	16,238
69,550	69,600	15,873	13,483	16,757	14,602	72,550	72,600	16,788	14,308	17,672	15,427	75,550	75,600	17,703	15,133	18,587	16,252
69,600	69,650	15,888	13,497	16,772	14,616	72,600	72,650	16,803	14,322	17,687	15,441	75,600	75,650	17,718	15,147	18,602	16,266
69,650	69,700	15,903	13,511	16,787	14,629	72,650	72,700	16,818	14,336	17,702	15,454	75,650	75,700	17,733	15,161	18,617	16,279
69,700	69,750	15,918	13,524	16,802	14,643	72,700	72,750	16,833	14,349	17,717	15,468	75,700	75,750	17,748	15,174	18,632	16,293
69,750	69,800	15,934	13,538	16,818	14,657	72,750	72,800	16,849	14,363	17,733	15,482	75,750	75,800	17,764	15,188	18,648	16,307
69,800	69,850	15,949	13,552	16,833	14,671	72,800	72,850	16,864	14,377	17,748	15,496	75,800	75,850	17,779	15,202	18,663	16,321
69,850	69,900	15,964	13,566	16,848	14,684	72,850	72,900	16,879	14,391	17,763	15,509	75,850	75,900	17,794	15,216	18,678	16,334
69,900	69,950	15,979	13,579	16,863	14,698	72,900	72,950	16,894	14,404	17,778	15,523	75,900	75,950	17,809	15,229	18,693	16,348
69,950	70,000	15,995	13,593	16,879	14,712	72,950	73,000	16,910	14,418	17,794	15,537	75,950	76,000	17,825	15,243	18,709	16,362
70,000						73,000						76,000					
70,000	70,050	16,010	13,607	16,894	14,726	73,000	73,050	16,925	14,432	17,809	15,551	76,000	76,050	17,840	15,257	18,724	16,376
70,050	70,100	16,025	13,621	16,909	14,739	73,050	73,100	16,940	14,446	17,824	15,564	76,050	76,100	17,855	15,271	18,739	16,389
70,100	70,150	16,040	13,634	16,924	14,753	73,100	73,150	16,955	14,459	17,839	15,578	76,100	76,150	17,870	15,284	18,754	16,403
70,150	70,200	16,056	13,648	16,940	14,767	73,150	73,200	16,971	14,473	17,855	15,592	76,150	76,200	17,886	15,298	18,770	16,417
70,200	70,250	16,071	13,662	16,955	14,781	73,200	73,250	16,986	14,487	17,870	15,606	76,200	76,250	17,901	15,312	18,785	16,431
70,250	70,300	16,086	13,676	16,970	14,794	73,250	73,300	17,001	14,501	17,885	15,619	76,250	76,300	17,916	15,326	18,800	16,444
70,300	70,350	16,101	13,689	16,985	14,808	73,300	73,350	17,016	14,514	17,900	15,633	76,300	76,350	17,931	15,339	18,815	16,458
70,350	70,400	16,117	13,703	17,001	14,822	73,350	73,400	17,032	14,528	17,916	15,647	76,350	76,400	17,947	15,353	18,831	16,472
70,400	70,450	16,132	13,717	17,016	14,836	73,400	73,450	17,047	14,542	17,931	15,661	76,400	76,450	17,962	15,367	18,846	16,486
70,450	70,500	16,147	13,731	17,031	14,849	73,450	73,500	17,062	14,556	17,946	15,674	76,450	76,500	17,977	15,381	18,861	16,499
70,500	70,550	16,162	13,744	17,046	14,863	73,500	73,550	17,077	14,569	17,961	15,688	76,500	76,550	17,992	15,394	18,876	16,513
70,550	70,600	16,178	13,758	17,062	14,877	73,550	73,600	17,093	14,583	17,977	15,702	76,550	76,600	18,008	15,408	18,892	16,527
70,600	70,650	16,193	13,772	17,077	14,891	73,600	73,650	17,108	14,597	17,992	15,716	76,600	76,650	18,023	15,422	18,907	16,541
70,650	70,700	16,208	13,786	17,092	14,904	73,650	73,700	17,123	14,611	18,007	15,729	76,650	76,700	18,038	15,436	18,922	16,554
70,700	70,750	16,223	13,799	17,107	14,918	73,700	73,750	17,138	14,624	18,022	15,743	76,700	76,750	18,053	15,449	18,937	16,568
70,750	70,800	16,239	13,813	17,123	14,932	73,750	73,800	17,154	14,638	18,038	15,757	76,750	76,800	18,069	15,463	18,953	16,582
70,800	70,850	16,254	13,827	17,138	14,946	73,800	73,850	17,169	14,652	18,05							

2001 Tax Table—Continued **Caution.** Dependents, see *Tax Computation Worksheet for Certain Dependents* in your tax form package.

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
77,000						80,000						83,000					
77,000	77,050	18,145	15,532	19,029	16,651	80,000	80,050	19,060	16,357	19,944	17,476	83,000	83,050	19,975	17,182	20,859	18,301
77,050	77,100	18,160	15,546	19,044	16,664	80,050	80,100	19,075	16,371	19,959	17,489	83,050	83,100	19,990	17,196	20,874	18,314
77,100	77,150	18,175	15,559	19,059	16,678	80,100	80,150	19,090	16,384	19,974	17,503	83,100	83,150	20,005	17,209	20,889	18,328
77,150	77,200	18,191	15,573	19,075	16,692	80,150	80,200	19,106	16,398	19,990	17,517	83,150	83,200	20,021	17,223	20,905	18,342
77,200	77,250	18,206	15,587	19,090	16,706	80,200	80,250	19,121	16,412	20,005	17,531	83,200	83,250	20,036	17,237	20,920	18,356
77,250	77,300	18,221	15,601	19,105	16,719	80,250	80,300	19,136	16,426	20,020	17,544	83,250	83,300	20,051	17,251	20,936	18,369
77,300	77,350	18,236	15,614	19,120	16,733	80,300	80,350	19,151	16,439	20,035	17,558	83,300	83,350	20,066	17,264	20,954	18,383
77,350	77,400	18,252	15,628	19,136	16,747	80,350	80,400	19,167	16,453	20,051	17,572	83,350	83,400	20,082	17,278	20,972	18,397
77,400	77,450	18,267	15,642	19,151	16,761	80,400	80,450	19,182	16,467	20,066	17,586	83,400	83,450	20,097	17,292	20,990	18,411
77,450	77,500	18,282	15,656	19,166	16,774	80,450	80,500	19,197	16,481	20,081	17,599	83,450	83,500	20,112	17,306	21,007	18,424
77,500	77,550	18,297	15,669	19,181	16,788	80,500	80,550	19,212	16,494	20,096	17,613	83,500	83,550	20,127	17,319	21,025	18,438
77,550	77,600	18,313	15,683	19,197	16,802	80,550	80,600	19,228	16,508	20,112	17,627	83,550	83,600	20,143	17,333	21,043	18,452
77,600	77,650	18,328	15,697	19,212	16,816	80,600	80,650	19,243	16,522	20,127	17,641	83,600	83,650	20,158	17,347	21,061	18,466
77,650	77,700	18,343	15,711	19,227	16,829	80,650	80,700	19,258	16,536	20,142	17,654	83,650	83,700	20,173	17,361	21,078	18,479
77,700	77,750	18,358	15,724	19,242	16,843	80,700	80,750	19,273	16,549	20,157	17,668	83,700	83,750	20,188	17,374	21,096	18,493
77,750	77,800	18,374	15,738	19,258	16,857	80,750	80,800	19,289	16,563	20,173	17,682	83,750	83,800	20,204	17,388	21,114	18,507
77,800	77,850	18,389	15,752	19,273	16,871	80,800	80,850	19,304	16,577	20,188	17,696	83,800	83,850	20,219	17,402	21,132	18,521
77,850	77,900	18,404	15,766	19,288	16,884	80,850	80,900	19,319	16,591	20,203	17,709	83,850	83,900	20,234	17,416	21,149	18,534
77,900	77,950	18,419	15,779	19,303	16,898	80,900	80,950	19,334	16,604	20,218	17,723	83,900	83,950	20,249	17,429	21,167	18,548
77,950	78,000	18,435	15,793	19,319	16,912	80,950	81,000	19,350	16,618	20,234	17,737	83,950	84,000	20,265	17,443	21,185	18,562
78,000						81,000						84,000					
78,000	78,050	18,450	15,807	19,334	16,926	81,000	81,050	19,365	16,632	20,249	17,751	84,000	84,050	20,280	17,457	21,203	18,576
78,050	78,100	18,465	15,821	19,349	16,939	81,050	81,100	19,380	16,646	20,264	17,764	84,050	84,100	20,295	17,471	21,220	18,589
78,100	78,150	18,480	15,834	19,364	16,953	81,100	81,150	19,395	16,659	20,279	17,778	84,100	84,150	20,310	17,484	21,238	18,603
78,150	78,200	18,496	15,848	19,380	16,967	81,150	81,200	19,411	16,673	20,295	17,792	84,150	84,200	20,326	17,498	21,256	18,617
78,200	78,250	18,511	15,862	19,395	16,981	81,200	81,250	19,426	16,687	20,310	17,806	84,200	84,250	20,341	17,512	21,274	18,631
78,250	78,300	18,526	15,876	19,410	16,994	81,250	81,300	19,441	16,701	20,325	17,819	84,250	84,300	20,356	17,526	21,291	18,644
78,300	78,350	18,541	15,889	19,425	17,008	81,300	81,350	19,456	16,714	20,340	17,833	84,300	84,350	20,371	17,539	21,309	18,658
78,350	78,400	18,557	15,903	19,441	17,022	81,350	81,400	19,472	16,728	20,356	17,847	84,350	84,400	20,387	17,553	21,327	18,672
78,400	78,450	18,572	15,917	19,456	17,036	81,400	81,450	19,487	16,742	20,371	17,861	84,400	84,450	20,402	17,567	21,345	18,686
78,450	78,500	18,587	15,931	19,471	17,049	81,450	81,500	19,502	16,756	20,386	17,874	84,450	84,500	20,417	17,581	21,362	18,699
78,500	78,550	18,602	15,944	19,486	17,063	81,500	81,550	19,517	16,769	20,401	17,888	84,500	84,550	20,432	17,594	21,380	18,713
78,550	78,600	18,618	15,958	19,502	17,077	81,550	81,600	19,533	16,783	20,417	17,902	84,550	84,600	20,448	17,608	21,398	18,727
78,600	78,650	18,633	15,972	19,517	17,091	81,600	81,650	19,548	16,797	20,432	17,916	84,600	84,650	20,463	17,622	21,416	18,741
78,650	78,700	18,648	15,986	19,532	17,104	81,650	81,700	19,563	16,811	20,447	17,929	84,650	84,700	20,478	17,636	21,433	18,754
78,700	78,750	18,663	15,999	19,547	17,118	81,700	81,750	19,578	16,824	20,462	17,943	84,700	84,750	20,493	17,649	21,451	18,768
78,750	78,800	18,679	16,013	19,563	17,132	81,750	81,800	19,594	16,838	20,478	17,957	84,750	84,800	20,509	17,663	21,469	18,782
78,800	78,850	18,694	16,027	19,578	17,146	81,800	81,850	19,609	16,852	20,493	17,971	84,800	84,850	20,524	17,677	21,487	18,796
78,850	78,900	18,709	16,041	19,593	17,159	81,850	81,900	19,624	16,866	20,508	17,984	84,850	84,900	20,539	17,691	21,504	18,809
78,900	78,950	18,724	16,054	19,608	17,173	81,900	81,950	19,639	16,879	20,523	17,998	84,900	84,950	20,554	17,704	21,522	18,823
78,950	79,000	18,740	16,068	19,624	17,187	81,950	82,000	19,655	16,893	20,539	18,012	84,950	85,000	20,570	17,718	21,540	18,837
79,000						82,000						85,000					
79,000	79,050	18,755	16,082	19,639	17,201	82,000	82,050	19,670	16,907	20,554	18,026	85,000	85,050	20,585	17,732	21,558	18,851
79,050	79,100	18,770	16,096	19,654	17,214	82,050	82,100	19,685	16,921	20,569	18,039	85,050	85,100	20,600	17,746	21,575	18,864
79,100	79,150	18,785	16,109	19,669	17,228	82,100	82,150	19,700	16,934	20,584	18,053	85,100	85,150	20,615	17,759	21,593	18,878
79,150	79,200	18,801	16,123	19,685	17,242	82,150	82,200	19,716	16,948	20,600	18,067	85,150	85,200	20,631	17,773	21,611	18,892
79,200	79,250	18,816	16,137	19,700	17,256	82,200	82,250	19,731	16,962	20,615	18,081	85,200	85,250	20,646	17,787	21,629	18,906
79,250	79,300	18,831	16,151	19,715	17,269	82,250	82,300	19,746	16,976	20,630	18,094	85,250	85,300	20,661	17,801	21,646	18,919
79,300	79,350	18,846	16,164	19,730	17,283	82,300	82,350	19,761	16,989	20,645	18,108	85,300	85,350	20,676	17,814	21,664	18,933
79,350	79,400	18,862	16,178	19,746	17,297	82,350	82,400	19,777	17,003	20,661	18,122	85,350	85,400	20,692	17,828	21,682	18,947
79,400	79,450	18,877	16,192	19,761	17,311	82,400	82,450	19,792	17,017	20,676	18,136	85,400	85,450	20,707	17,842	21,700	18,961
79,450	79,500	18,892	16,206	19,776	17,324	82,450	82,500	19,807	17,031	20,691	18,149	85,450	85,500	20,722	17,856	21,717	18,974
79,500	79,550	18,907	16,219	19,791	17,338	82,500	82,550	19,822	17,044	20,706	18,163	85,500	85,550	20,737	17,869	21,735	18,988
79,550	79,600	18,923	16,233	19,807	17,352	82,550	82,600	19,838	17,058	20,722	18,177	85,550	85,600	20,753	17,883	21,753	19,002
79,600	79,650	18,938	16,247	19,822	17,366	82,600	82,650	1									

Caution. Dependents, see Tax Computation Worksheet for Certain Dependents in your tax form package. **2001 Tax Table—Continued**

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
86,000						89,000						92,000					
86,000	86,050	20,890	18,007	21,913	19,126	89,000	89,050	21,805	18,832	22,978	19,951	92,000	92,050	22,720	19,657	24,043	20,776
86,050	86,100	20,905	18,021	21,930	19,139	89,050	89,100	21,820	18,846	22,995	19,964	92,050	92,100	22,735	19,671	24,060	20,789
86,100	86,150	20,920	18,034	21,948	19,153	89,100	89,150	21,835	18,859	23,013	19,978	92,100	92,150	22,750	19,684	24,078	20,803
86,150	86,200	20,936	18,048	21,966	19,167	89,150	89,200	21,851	18,873	23,031	19,992	92,150	92,200	22,766	19,698	24,096	20,817
86,200	86,250	20,951	18,062	21,984	19,181	89,200	89,250	21,866	18,887	23,049	20,006	92,200	92,250	22,781	19,712	24,114	20,831
86,250	86,300	20,966	18,076	22,001	19,194	89,250	89,300	21,881	18,901	23,066	20,019	92,250	92,300	22,796	19,726	24,131	20,844
86,300	86,350	20,981	18,089	22,019	19,208	89,300	89,350	21,896	18,914	23,084	20,033	92,300	92,350	22,811	19,739	24,149	20,858
86,350	86,400	20,997	18,103	22,037	19,222	89,350	89,400	21,912	18,928	23,102	20,047	92,350	92,400	22,827	19,753	24,167	20,872
86,400	86,450	21,012	18,117	22,055	19,236	89,400	89,450	21,927	18,942	23,120	20,061	92,400	92,450	22,842	19,767	24,185	20,886
86,450	86,500	21,027	18,131	22,072	19,249	89,450	89,500	21,942	18,956	23,137	20,074	92,450	92,500	22,857	19,781	24,202	20,899
86,500	86,550	21,042	18,144	22,090	19,263	89,500	89,550	21,957	18,969	23,155	20,088	92,500	92,550	22,872	19,794	24,220	20,913
86,550	86,600	21,058	18,158	22,108	19,277	89,550	89,600	21,973	18,983	23,173	20,102	92,550	92,600	22,888	19,808	24,238	20,927
86,600	86,650	21,073	18,172	22,126	19,291	89,600	89,650	21,988	18,997	23,191	20,116	92,600	92,650	22,903	19,822	24,256	20,941
86,650	86,700	21,088	18,186	22,143	19,304	89,650	89,700	22,003	19,011	23,208	20,129	92,650	92,700	22,918	19,836	24,273	20,954
86,700	86,750	21,103	18,199	22,161	19,318	89,700	89,750	22,018	19,024	23,226	20,143	92,700	92,750	22,933	19,849	24,291	20,968
86,750	86,800	21,119	18,213	22,179	19,332	89,750	89,800	22,034	19,038	23,244	20,157	92,750	92,800	22,949	19,863	24,309	20,982
86,800	86,850	21,134	18,227	22,197	19,346	89,800	89,850	22,049	19,052	23,262	20,171	92,800	92,850	22,964	19,877	24,327	20,996
86,850	86,900	21,149	18,241	22,214	19,359	89,850	89,900	22,064	19,066	23,279	20,184	92,850	92,900	22,979	19,891	24,344	21,009
86,900	86,950	21,164	18,254	22,232	19,373	89,900	89,950	22,079	19,079	23,297	20,198	92,900	92,950	22,994	19,904	24,362	21,023
86,950	87,000	21,180	18,268	22,250	19,387	89,950	90,000	22,095	19,093	23,315	20,212	92,950	93,000	23,010	19,918	24,380	21,037
87,000						90,000						93,000					
87,000	87,050	21,195	18,282	22,268	19,401	90,000	90,050	22,110	19,107	23,333	20,226	93,000	93,050	23,025	19,932	24,398	21,051
87,050	87,100	21,210	18,296	22,285	19,414	90,050	90,100	22,125	19,121	23,350	20,239	93,050	93,100	23,040	19,946	24,415	21,064
87,100	87,150	21,225	18,309	22,303	19,428	90,100	90,150	22,140	19,134	23,368	20,253	93,100	93,150	23,055	19,959	24,433	21,078
87,150	87,200	21,241	18,323	22,321	19,442	90,150	90,200	22,156	19,148	23,386	20,267	93,150	93,200	23,071	19,973	24,451	21,092
87,200	87,250	21,256	18,337	22,339	19,456	90,200	90,250	22,171	19,162	23,404	20,281	93,200	93,250	23,086	19,987	24,469	21,106
87,250	87,300	21,271	18,351	22,356	19,469	90,250	90,300	22,186	19,176	23,421	20,294	93,250	93,300	23,101	20,001	24,486	21,119
87,300	87,350	21,286	18,364	22,374	19,483	90,300	90,350	22,201	19,189	23,439	20,308	93,300	93,350	23,116	20,014	24,504	21,133
87,350	87,400	21,302	18,378	22,392	19,497	90,350	90,400	22,217	19,203	23,457	20,322	93,350	93,400	23,132	20,028	24,522	21,147
87,400	87,450	21,317	18,392	22,410	19,511	90,400	90,450	22,232	19,217	23,475	20,336	93,400	93,450	23,147	20,042	24,540	21,161
87,450	87,500	21,332	18,406	22,427	19,524	90,450	90,500	22,247	19,231	23,492	20,349	93,450	93,500	23,162	20,056	24,557	21,174
87,500	87,550	21,347	18,419	22,445	19,538	90,500	90,550	22,262	19,244	23,510	20,363	93,500	93,550	23,177	20,069	24,575	21,188
87,550	87,600	21,363	18,433	22,463	19,552	90,550	90,600	22,278	19,258	23,528	20,377	93,550	93,600	23,193	20,083	24,593	21,202
87,600	87,650	21,378	18,447	22,481	19,566	90,600	90,650	22,293	19,272	23,546	20,391	93,600	93,650	23,208	20,097	24,611	21,216
87,650	87,700	21,393	18,461	22,498	19,579	90,650	90,700	22,308	19,286	23,563	20,404	93,650	93,700	23,223	20,111	24,628	21,230
87,700	87,750	21,408	18,474	22,516	19,593	90,700	90,750	22,323	19,299	23,581	20,418	93,700	93,750	23,238	20,124	24,646	21,245
87,750	87,800	21,424	18,488	22,534	19,607	90,750	90,800	22,339	19,313	23,599	20,432	93,750	93,800	23,254	20,138	24,664	21,261
87,800	87,850	21,439	18,502	22,552	19,621	90,800	90,850	22,354	19,327	23,617	20,446	93,800	93,850	23,269	20,152	24,682	21,276
87,850	87,900	21,454	18,516	22,569	19,634	90,850	90,900	22,369	19,341	23,634	20,459	93,850	93,900	23,284	20,166	24,699	21,291
87,900	87,950	21,469	18,529	22,587	19,648	90,900	90,950	22,384	19,354	23,652	20,473	93,900	93,950	23,299	20,179	24,717	21,306
87,950	88,000	21,485	18,543	22,605	19,662	90,950	91,000	22,400	19,368	23,670	20,487	93,950	94,000	23,315	20,193	24,735	21,322
88,000						91,000						94,000					
88,000	88,050	21,500	18,557	22,623	19,676	91,000	91,050	22,415	19,382	23,688	20,501	94,000	94,050	23,330	20,207	24,753	21,337
88,050	88,100	21,515	18,571	22,640	19,689	91,050	91,100	22,430	19,396	23,705	20,514	94,050	94,100	23,345	20,221	24,770	21,352
88,100	88,150	21,530	18,584	22,658	19,703	91,100	91,150	22,445	19,409	23,723	20,528	94,100	94,150	23,360	20,234	24,788	21,367
88,150	88,200	21,546	18,598	22,676	19,717	91,150	91,200	22,461	19,423	23,741	20,542	94,150	94,200	23,376	20,248	24,806	21,383
88,200	88,250	21,561	18,612	22,694	19,731	91,200	91,250	22,476	19,437	23,759	20,556	94,200	94,250	23,391	20,262	24,824	21,398
88,250	88,300	21,576	18,626	22,711	19,744	91,250	91,300	22,491	19,451	23,776	20,569	94,250	94,300	23,406	20,276	24,841	21,413
88,300	88,350	21,591	18,639	22,729	19,758	91,300	91,350	22,506	19,464	23,794	20,583	94,300	94,350	23,421	20,289	24,859	21,428
88,350	88,400	21,607	18,653	22,747	19,772	91,350	91,400	22,522	19,478	23,812	20,597	94,350	94,400	23,437	20,303	24,877	21,444
88,400	88,450	21,622	18,667	22,765	19,786	91,400	91,450	22,537	19,492	23,830	20,611	94,400	94,450	23,452	20,317	24,895	21,459
88,450	88,500	21,637	18,681	22,782	19,799	91,450	91,500	22,552	19,506	23,847	20,624	94,450	94,500	23,467	20,331	24,912	21,474
88,500	88,550	21,652	18,694	22,800	19,813	91,500	91,550	22,567	19,519	23,865	20,638	94,500	94,550	23,482	20,344	24,930	21,489
88,550	88,600	21,668	18,708	22,818	19,827	91,550	91,600	22,583	19,533	23,883	20,652	94,550	94,600	23,498	20,358	24,948	21,505
88,600	88,650	21,683	18,722	22,836	19,841	91,600	91,650	22,598	19,547	23,901	20,666	94,600	94,650	23,513	20,372	24,966	21,520
88,650	88,700	21,698	18,736	22,853	19,854	91,650	91,700	22,613	19,561	23,918	20,679	94,650	94,700	23,528	20,386	24,983	21,535
88,700	88,750	21,713	18,749	22,871	19,868	91,700	91,750	22,628	19,574	23,936	20,693	94,700	94,750	23,543	20,399	25,001	21,550
88,750	88,800	21,729	18,763	22,889	19,882	91,750	91,800	22,644	19,588	23,954	20,707	94,750	94,800	23,559	20,413	25,019	21,566
88,																	

2001 Tax Table—Continued

If line 39 (taxable income) is—		And you are—				If line 39 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—			
95,000						98,000					
95,000	95,050	23,635	20,482	25,108	21,642	98,000	98,050	24,550	21,307	26,173	22,557
95,050	95,100	23,650	20,496	25,125	21,657	98,050	98,100	24,565	21,321	26,190	22,572
95,100	95,150	23,665	20,509	25,143	21,672	98,100	98,150	24,580	21,334	26,208	22,587
95,150	95,200	23,681	20,523	25,161	21,688	98,150	98,200	24,596	21,348	26,226	22,603
95,200	95,250	23,696	20,537	25,179	21,703	98,200	98,250	24,611	21,362	26,244	22,618
95,250	95,300	23,711	20,551	25,196	21,718	98,250	98,300	24,626	21,376	26,261	22,633
95,300	95,350	23,726	20,564	25,214	21,733	98,300	98,350	24,641	21,389	26,279	22,648
95,350	95,400	23,742	20,578	25,232	21,749	98,350	98,400	24,657	21,403	26,297	22,664
95,400	95,450	23,757	20,592	25,250	21,764	98,400	98,450	24,672	21,417	26,315	22,679
95,450	95,500	23,772	20,606	25,267	21,779	98,450	98,500	24,687	21,431	26,332	22,694
95,500	95,550	23,787	20,619	25,285	21,794	98,500	98,550	24,702	21,444	26,350	22,709
95,550	95,600	23,803	20,633	25,303	21,810	98,550	98,600	24,718	21,458	26,368	22,725
95,600	95,650	23,818	20,647	25,321	21,825	98,600	98,650	24,733	21,472	26,386	22,740
95,650	95,700	23,833	20,661	25,338	21,840	98,650	98,700	24,748	21,486	26,403	22,755
95,700	95,750	23,848	20,674	25,356	21,855	98,700	98,750	24,763	21,499	26,421	22,770
95,750	95,800	23,864	20,688	25,374	21,871	98,750	98,800	24,779	21,513	26,439	22,786
95,800	95,850	23,879	20,702	25,392	21,886	98,800	98,850	24,794	21,527	26,457	22,801
95,850	95,900	23,894	20,716	25,409	21,901	98,850	98,900	24,809	21,541	26,474	22,816
95,900	95,950	23,909	20,729	25,427	21,916	98,900	98,950	24,824	21,554	26,492	22,831
95,950	96,000	23,925	20,743	25,445	21,932	98,950	99,000	24,840	21,568	26,510	22,847
96,000						99,000					
96,000	96,050	23,940	20,757	25,463	21,947	99,000	99,050	24,855	21,582	26,528	22,862
96,050	96,100	23,955	20,771	25,480	21,962	99,050	99,100	24,870	21,596	26,545	22,877
96,100	96,150	23,970	20,784	25,498	21,977	99,100	99,150	24,885	21,609	26,563	22,892
96,150	96,200	23,986	20,798	25,516	21,993	99,150	99,200	24,901	21,623	26,581	22,908
96,200	96,250	24,001	20,812	25,534	22,008	99,200	99,250	24,916	21,637	26,599	22,923
96,250	96,300	24,016	20,826	25,551	22,023	99,250	99,300	24,931	21,651	26,616	22,938
96,300	96,350	24,031	20,839	25,569	22,038	99,300	99,350	24,946	21,664	26,634	22,953
96,350	96,400	24,047	20,853	25,587	22,054	99,350	99,400	24,962	21,678	26,652	22,969
96,400	96,450	24,062	20,867	25,605	22,069	99,400	99,450	24,977	21,692	26,670	22,984
96,450	96,500	24,077	20,881	25,622	22,084	99,450	99,500	24,992	21,706	26,687	22,999
96,500	96,550	24,092	20,894	25,640	22,099	99,500	99,550	25,007	21,719	26,705	23,014
96,550	96,600	24,108	20,908	25,658	22,115	99,550	99,600	25,023	21,733	26,723	23,030
96,600	96,650	24,123	20,922	25,676	22,130	99,600	99,650	25,038	21,747	26,741	23,045
96,650	96,700	24,138	20,936	25,693	22,145	99,650	99,700	25,053	21,761	26,758	23,060
96,700	96,750	24,153	20,949	25,711	22,160	99,700	99,750	25,068	21,774	26,776	23,075
96,750	96,800	24,169	20,963	25,729	22,176	99,750	99,800	25,084	21,788	26,794	23,091
96,800	96,850	24,184	20,977	25,747	22,191	99,800	99,850	25,099	21,802	26,812	23,106
96,850	96,900	24,199	20,991	25,764	22,206	99,850	99,900	25,114	21,816	26,829	23,121
96,900	96,950	24,214	21,004	25,782	22,221	99,900	99,950	25,129	21,829	26,847	23,136
96,950	97,000	24,230	21,018	25,800	22,237	99,950	100,000	25,145	21,843	26,865	23,152
97,000						<p>Caution.</p> <ul style="list-style-type: none"> • Dependents, see <i>Tax Computation Worksheet for Certain Dependents</i> in your tax form package • \$100,000 or over — use the Tax Rate Schedules 					
97,000	97,050	24,245	21,032	25,818	22,252						
97,050	97,100	24,260	21,046	25,835	22,267						
97,100	97,150	24,275	21,059	25,853	22,282						
97,150	97,200	24,291	21,073	25,871	22,298						
97,200	97,250	24,306	21,087	25,889	22,313						
97,250	97,300	24,321	21,101	25,906	22,328						
97,300	97,350	24,336	21,114	25,924	22,343						
97,350	97,400	24,352	21,128	25,942	22,359						
97,400	97,450	24,367	21,142	25,960	22,374						
97,450	97,500	24,382	21,156	25,977	22,389						
97,500	97,550	24,397	21,169	25,995	22,404						
97,550	97,600	24,413	21,183	26,013	22,420						
97,600	97,650	24,428	21,197	26,031	22,435						
97,650	97,700	24,443	21,211	26,048	22,450						
97,700	97,750	24,458	21,224	26,066	22,465						
97,750	97,800	24,474	21,238	26,084	22,481						
97,800	97,850	24,489	21,252	26,102	22,496						
97,850	97,900	24,504	21,266	26,119	22,511						
97,900	97,950	24,519	21,279	26,137	22,526						
97,950	98,000	24,535	21,293	26,155	22,542						

* This column must also be used by a qualifying widow(er).

2001 Tax Rate Schedules



Use **only** if your taxable income (Form 1040, line 39) is \$100,000 or more. If less, use the **Tax Table**. Even though you cannot use the Tax Rate Schedules below if your taxable income is less than \$100,000, all levels of taxable income are shown so taxpayers can see the tax rate that applies to each level.

Schedule X—Use if your filing status is **Single**

If the amount on Form 1040, line 39, is: Over—	But not over—	Enter on Form 1040, line 40	of the amount over—
\$0	\$27,050	..... 15%	\$0
27,050	65,550	\$4,057.50 + 27.5%	27,050
65,550	136,750	14,645.00 + 30.5%	65,550
136,750	297,350	36,361.00 + 35.5%	136,750
297,350	.....	93,374.00 + 39.1%	297,350



Dependents,
see *Tax
Computation
Worksheet
for Certain
Dependents*
in your tax
form
package.

Schedule Y-1—Use if your filing status is **Married filing jointly** or **Qualifying widow(er)**

If the amount on Form 1040, line 39, is: Over—	But not over—	Enter on Form 1040, line 40	of the amount over—
\$0	\$45,200	..... 15%	\$0
45,200	109,250	\$6,780.00 + 27.5%	45,200
109,250	166,500	24,393.75 + 30.5%	109,250
166,500	297,350	41,855.00 + 35.5%	166,500
297,350	.....	88,306.75 + 39.1%	297,350

Schedule Y-2—Use if your filing status is **Married filing separately**

If the amount on Form 1040, line 39, is: Over—	But not over—	Enter on Form 1040, line 40	of the amount over—
\$0	\$22,600	..... 15%	\$0
22,600	54,625	\$3,390.00 + 27.5%	22,600
54,625	83,250	12,196.88 + 30.5%	54,625
83,250	148,675	20,927.50 + 35.5%	83,250
148,675	.....	44,153.38 + 39.1%	148,675

Schedule Z—Use if your filing status is **Head of household**

If the amount on Form 1040, line 39, is: Over—	But not over—	Enter on Form 1040, line 40	of the amount over—
\$0	\$36,250	..... 15%	\$0
36,250	93,650	\$5,437.50 + 27.5%	36,250
93,650	151,650	21,222.50 + 30.5%	93,650
151,650	297,350	38,912.50 + 35.5%	151,650
297,350	.....	90,636.00 + 39.1%	297,350

Your Rights as a Taxpayer

The first part of this section explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes.

Declaration of Taxpayer Rights

Protection of your rights. IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

Privacy and confidentiality. The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

Professional and courteous service. If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to the IRS director for your area or the center where you filed your return.

Representation. You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

Payment of only the correct amount of tax. You are responsible for paying only the correct amount of tax due under the law—no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

Help with unresolved tax problems. See *How To Get Tax Help*.

Appeals and judicial review. If you disagree with us about the amount of your tax liability or certain collection actions, you have

the right to ask the Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties and interest. The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

Examinations, Appeals, Collections, and Refunds

Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

By mail. We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. You can respond by mail or you can request a personal interview with an examiner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes.

Please do not hesitate to write to us about anything you do not understand.

By interview. If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

Repeat examinations. If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

Appeals

If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through the appeals system, and you gave us the information necessary to resolve the case.

Collections

Publication 594, *The IRS Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Your collection appeal rights are explained in detail in Publication 1660, *Collection Appeal Rights*.

Innocent spouse relief. Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return. However, if you qualify for innocent spouse relief, you may not have to pay the tax, interest, and penalties related to your spouse (or former spouse). For information on innocent spouse relief and two other ways to get relief, see Publication 971, *Innocent Spouse Relief*, and Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*.

Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, has more information on refunds.

If you were due a refund but you did not file a return, you must file within 3 years from the date the return was originally due to get that refund.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer.

With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then

save the form for recordkeeping.

- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at ftp.irs.gov.



TaxFax Service.

Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone.

Many services are available by phone.

- **Ordering forms, instructions, and publications.** Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- **Asking tax questions.** Call the IRS with your tax questions at **1-800-829-1040**.
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- **TeleTax topics.** Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistant and does not keep a record of

any taxpayer's name or tax identification number.

- We sometimes record telephone calls to evaluate IRS assistants objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



Walk-in.

You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



Mail.

You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:** Western Area Distribution Center
Rancho Cordova, CA
95743-0001
- **Central part of U.S.:** Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:** Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.

- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at www.irs.gov. The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676** or visiting the IRS web site at www.irs.gov.

Written tax questions. You can send your written tax questions to your IRS office. You should get an answer in about 30 days. If you do not have the address, you can get it by calling **1-800-829-1040**. Do not send tax questions with your return.

Braille tax materials. Braille tax materials are available for review from Regional Libraries for the Visually Impaired in conjunction with the National Library Service for the Blind and Physically Handicapped. To locate your nearest library, write to:

National Library Service for
the Blind and Physically
Handicapped
Library of Congress
1291 Taylor St., NW
Washington, DC 20542

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

Assistance with your return. IRS offices can help you prepare your return. An assistant will explain a Form 1040EZ, 1040A, or 1040 with Schedules A and B to you and other taxpayers in a group setting. You may also be able to file your return electronically by computer free of charge at some IRS offices. To find the IRS office nearest you, look in the phone book under "United States Government, Internal Revenue Service" or call **1-800-829-1040**.

At all IRS offices you can also get help with questions about IRS notices or bills.

Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Free help from volunteers is available in most communities. After completing IRS training, these volunteers help prepare basic tax returns for taxpayers with special needs, including

low-income people, persons with disabilities, the elderly, and non-English-speaking people. At some of these offices, you can file your tax return electronically. See *IRS e-file* in chapter 1 for information on electronic filing.

Call the IRS for the location of the volunteer assistance site near you. Or, for the location of an American Association of Retired Persons (AARP) Tax-Aide site in your community, call

1-877-227-7844 or visit their Internet Web Site at www.aarp.org/taxaide.



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Order Blank for Forms and Publications

The most frequently ordered forms and publications are listed on the order blank below. We will mail you two copies of each form and one copy of each publication you order. To help reduce waste, please order only the items you need to prepare your return.



For faster ways of getting the items you need, such as by computer or fax, see the front cover.

How To Use the Order Blank

Circle the items you need on the order blank below. Use the blank spaces to order items not listed. If you need more space, attach a separate sheet of paper.

Print or type your name and address accurately in the space provided below. An accurate address is necessary to ensure delivery of your order. Cut the order blank on the dotted line. Enclose the order blank in your own envelope and send it to the IRS address shown on this page that applies to you. You should receive your order within 10 days after we receive your request.



Where To Mail Your Order Blank for Free Forms and Publications

IF you live in the . . .	THEN mail to . . .	AT this address . . .
Western United States	Western Area Distribution Center	Rancho Cordova, CA 95743-0001
Central United States	Central Area Distribution Center	P.O. Box 8903 Bloomington, IL 61702-8903
Eastern United States or a foreign country	Eastern Area Distribution Center	P.O. Box 85074 Richmond, VA 23261-5074

Detach at this line

Order Blank

Fill in your name and address.

Name _____

Number and street _____ Apt./Suite/Room _____

City _____ State _____ ZIP code _____

Foreign country _____ International postal code _____

Daytime telephone number (optional)
(_____) _____

Some items may be picked up at many IRS offices, post offices, and libraries. You may also download all these items from the Internet at www.irs.gov or place an electronic order for them.

Circle the forms and publications you need. The instructions for any form you order will be included.

1040	Schedule F (1040)	Schedule 3 (1040A)	2441	8812	Pub. 463	Pub. 527	Pub. 910
Schedules A&B (1040)	Schedule H (1040)	1040EZ	3903	8822	Pub. 501	Pub. 529	Pub. 926
Schedule C (1040)	Schedule J (1040)	1040-ES (2000)	4562	8829	Pub. 502	Pub. 535	Pub. 929
Schedule C-EZ (1040)	Schedule R (1040)	1040-V	4868	8863	Pub. 505	Pub. 550	Pub. 936
Schedule D (1040)	Schedule SE (1040)	1040X	5329	9465	Pub. 508	Pub. 554	Pub. 970
Schedule D-1 (1040)	1040A	2106	8283	Pub. 1	Pub. 521	Pub. 575	Pub. 972
Schedule E (1040)	Schedule 1 (1040A)	2106-EZ	8582	Pub. 17	Pub. 523	Pub. 590	
Schedule EIC (1040A or 1040)	Schedule 2 (1040A)	2210	8606	Pub. 334	Pub. 525	Pub. 596	