Department of the Treasury

Internal Revenue Service

Your Federal Income Tax

For Individuals

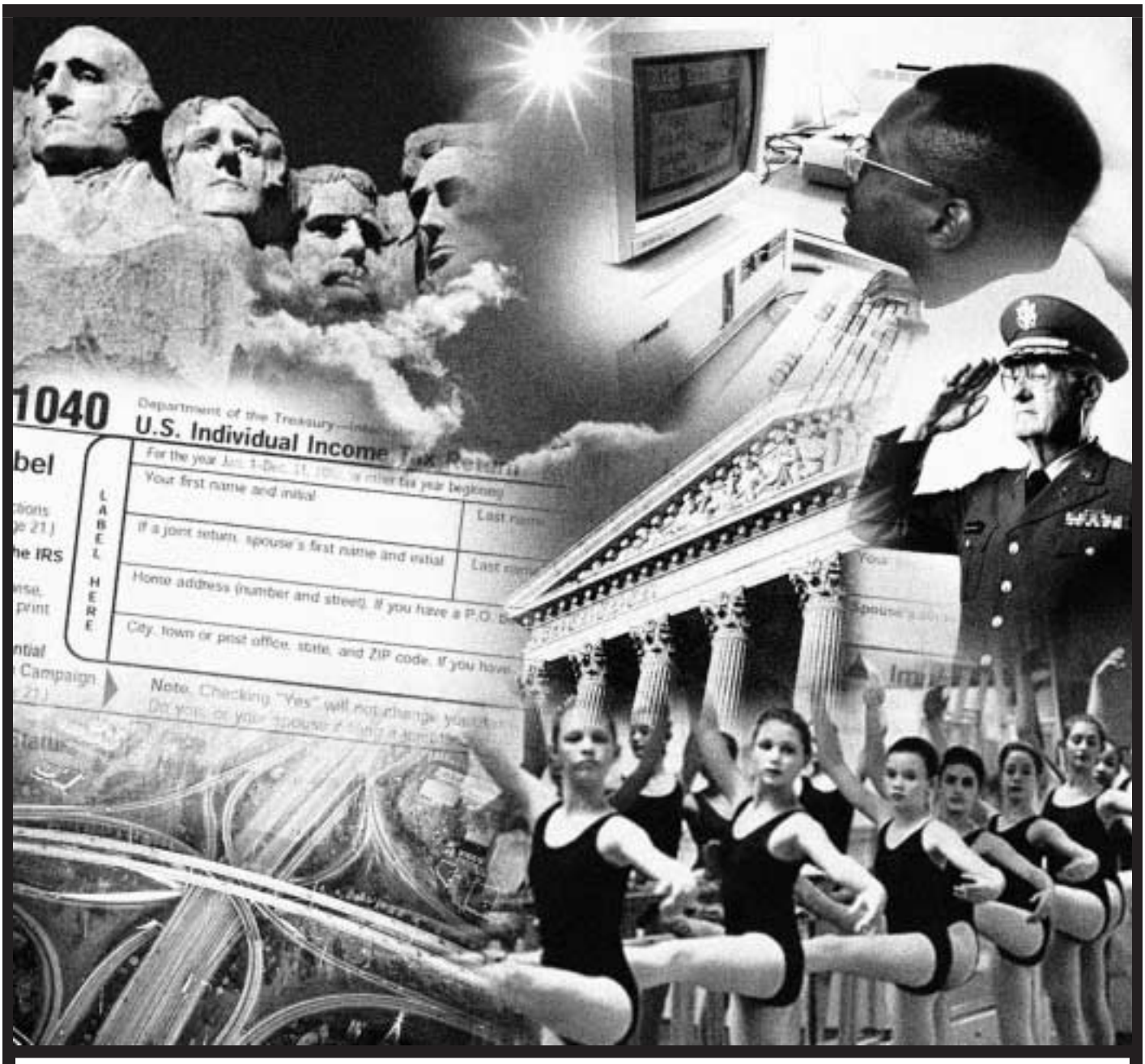
Publication 17

Catalog Number 10311G

For use in preparing

2003

Returns



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Department of the Treasury

Internal Revenue Service

Your Federal Income Tax

For Individuals

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(Inside back cover)

All material in this publication may be reprinted freely. A citation to Your Federal Income Tax (2003) *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.

Important Changes for 2003

This section summarizes important tax changes that took effect in 2003. Most of these changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 2003 Tax Changes*.

Tax rates changes. The following items highlight the changes to the tax rates. The 2003 tax tables and tax rate schedules are included near the back of this publication.

- The 10% tax rate bracket for most filing statuses is expanded.
- The 15% tax rate bracket for married taxpayers filing jointly and qualifying widow(er) is expanded.
- The 27%, 30%, 35%, and 38.6% tax rates are reduced to 25%, 28%, 33%, and 35%, respectively.

Child tax credits increased. You may be able to take credits of up to $1,000 for each qualifying child. But you must reduce your credits by any advance child tax credit payment you received in 2003. See chapter 36.

Advance child tax credit payment. You must reduce your 2003 child tax credits by any advance child tax credit payment you received in 2003. The amount of your advance payment is shown on Notice 1319. This notice was mailed to you in 2003. If you do not have this notice, you can check the amount of your advance payment on the IRS website at **www.irs.gov** or call us at **1 – 800 – 829 – 1040**.

If you received an advance payment but did not have a qualifying child for 2003, you do not have to pay back the amount you received. **Do not** enter the amount of your advance payment on your return. If you filed a joint return for 2002, but for 2003 you are not filing a joint return (or a joint return with the same spouse), you are considered to have received one-half of the advance payment.

Married filing joint standard deduction. The standard deduction for married taxpayers filing a joint return has increased. See chapter 22.

New capital gain rates. For gains after May 5, 2003, the 10% capital gain rate is reduced to 5% and the 20% capital gain rate is reduced to 15%. In addition, the 8% capital gain rate for qualified 5-year gain does not apply to gains after that date. For more information, see *Capital Gain Tax Rates* in chapter 17.

Dividends taxed at capital gain rates. After December 31, 2002, qualified dividend income is taxed at the new capital gain rates. See *Qualified Dividend Income* in Chapter 9.

Standard mileage rates. The standard mileage rate for the cost of operating your car decreased to 36 cents a mile for all business miles driven. See chapter 28.

The standard mileage rate allowed for use of your car for medical reasons decreased to 12 cents a mile. See chapter 23.

The standard mileage rate allowed for use of your car for determining moving expenses decreased to 12 cents a mile. See chapter 19.

Lifetime learning credit. The amount of qualified tuition and related expenses you may take into account in figuring your lifetime learning credit increased from $5,000 to $10,000. The credit equals 20% of these qualified expenses, with the maximum credit being $2,000. See chapter 37.

Child and dependent care credit. The following changes apply to the child and dependent care credit.

- The credit can be as much as 35% (previously 30%) of your qualified expenses.
- The maximum adjusted gross income amount that qualifies for the highest rate increased to $15,000 (previously $10,000).
- The limit on the amount of qualifying expenses increased to $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals.
- The amount of income that is treated as having been earned by a spouse who is either a full-time student or not able to care for himself or herself increased to $250 a month if there is one qualifying individual and $500 a month if there are two or more qualifying individuals. See chapter 34.

Tax benefits for adoption. Subject to the income and tax liability limits, the adoption credit and the exclusion from income of benefits under an adoption assistance program for the adoption of a child with special needs is $10,160 regardless of the amount of qualified adoption expenses. See *Adoption Credit* in chapter 39 and Publication 968, *Tax Benefits for Adoption*.

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

Traditional IRA income limits. If you have a traditional IRA and are covered by a retirement plan at work, the amount of income you can have and not be affected by the deduction phaseout increases. The amounts vary depending on filing status. See chapter 18.

Deemed IRAs. A qualified employer plan (retirement plan) can maintain a separate account or annuity under the plan (a deemed IRA) to receive voluntary employee contributions. An employee's account can be treated as a traditional IRA or a Roth IRA.

Limit on elective deferrals. The maximum amount of elective deferrals under a salary reduction agreement that could be contributed to a qualified plan increased to $12,000 ($14,000 If you were age 50 or over). However, for SIMPLE plans, the amount increased to $8,000 ($9,000 if you were age 50 or over).

Self-employed health insurance deduction. You can deduct 100% of your self-employed health insurance premiums as an adjustment to income.

Health coverage tax credit. Certain older workers can claim a credit for amounts they pay for health insurance premiums. For more information, see *Health Coverage Tax Credit* in chapter 39.

Certain amounts increased. Some tax items that are indexed for inflation increased for 2003.

Earned income credit (EIC). The maximum amount of income you can earn and still get the earned income credit increased. The amount depends on your filing status and number of children. The maximum amount of investment income you can have and still be eligible for the credit has increased to $2,600. See chapter 38.

Standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) has increased. The amount depends on your filing status. See chapter 22.

Exemption amount. You are allowed a $3,050 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 deduction. Some of your itemized deductions may be limited if your adjusted gross income is more than $139,500 ($69,750 if you are married filing separately). See chapter 31.

Social security and Medicare taxes. The maximum wages subject to social security tax (6.2%) increased to $87,000. All wages are subject to Medicare tax (1.45%).

Military Family Tax Relief Act of 2003. This legislation made the following changes. See Publication 553 for more information.

- The 5-year period that can qualify you to exclude the gain from the sale of a your main home can be suspended by certain members of the uniformed services or Foreign Service while on official extended duty.
- The tax-free treatment of the death gratuity paid to survivors of U.S. military members for deaths occurring after September 10, 2001, increased from $3,000 to $12,000.
- Amounts received as a qualifying military base realignment and closure fringe benefit are now excluded from taxable income.
- The rules for filing a return that apply to members of the armed forces in a combat zone are extended to include members of the armed forces in a designated contingency operation.
- Qualified military benefits include benefits under dependent-care assistance programs.
- The additional tax on distributions from a Coverdell education savings account or a qualified tuition plan, does not apply to a distribution made on account of attendance at a military academy.
- Reserve component members can claim an above-the-line deduction for overnight travel expenses such as transportation, lodging, and meals. See chapter 28.
- Income tax relief is granted to families of astronauts who die in the line of duty.

Important Changes for 2004

This section summarizes the important changes that take effect in 2004 that could affect your estimated tax payments for 2004. More information on these and other changes can be found in Publication 553.

Standard mileage rates. For tax years beginning in 2004, the standard mileage rate for the cost of operating your car increases to:

- 37.5 cents a mile for all business miles driven,
- 14 cents a mile for the use of your car for medical reasons, and
- 14 cents a mile for the use of your car for determining moving expenses.

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

Traditional IRA income limits. If you have a traditional IRA and are covered by a retirement plan at work, the amount of income you can have and not be affected by the deduction phaseout increases. The amounts vary depending on filing status.

Limit on elective deferrals. The maximum amount of elective deferrals under a salary reduction agreement that can be contributed to a qualified plan increases to $13,000 ($16,000 if you are age 50 or over). However, for SIMPLE plans, the amount increases to $9,000 ($10,500 if you are age 50 or over).

Tuition and fees deduction. Beginning in 2004, the amount of qualified education expenses you can take into account in figuring your tuition and fees deduction varies depending on your modified adjusted gross income. The tuition and fees deduction is explained in chapter 21.

Important Reminders

Listed below are important reminders and other items that may help you file your 2003 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 2002 and are filing a joint return for 2003 with the same spouse, enter your names and SSNs in the same order as on your 2002 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 2003. Generally, this number is the person's social security number (SSN). See chapter 1.

Reporting interest and dividends. If you have interest or dividend income of more than $1,500, you have to file Schedule 1 (Form 1040A) or Schedule B (Form 1040) with your tax return. Also, you cannot file Form 1040EZ if you have more than $1,500 of taxable interest income.

Tax relief for victims of terrorist attacks. Under the *Victims of Terrorism Tax Relief Act of 2001,* the federal income tax liability of those killed in the following attacks is forgiven for certain tax years.

- The April 19, 1995, terrorist attack on the Alfred P. Murrah Federal Building (Oklahoma City).
- The September 11, 2001 terrorist attacks.
- The terrorist attacks involving anthrax occurring after September 10, 2001, and before January 2, 2002.

The Act also exempts from federal income tax certain amounts received by survivors.

For more information, see Publication 3920, *Tax Relief for Victims of Terrorist Attacks.*

Benefits for public safety officer's survivors. 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. The provision applies to a chaplain killed in the line of duty after September 10, 2001. The chaplain must have been responding to a fire, rescue, or emergency as a member or employee of a fire or police department. See chapter 13.

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 received by 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. For more details, see chapter 13.

Advance earned income credit. If a qualifying child lives with you and you expect to qualify for the earned income credit in 2004, 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 38.

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.

Retirement planning services. If your employer has a qualified retirement plan, qualified retirement planning services provided for you (or your spouse) by your employer are not included in your income. For more information see, *Retirement Planning Services* under *Fringe Benefits* in chapter 6.

Individual retirement arrangements (IRAs). The following paragraphs highlight important reminders that relate to IRAs. See chapter 18 for details.

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.

Retirement savings contributions credit. If you contribute to an individual retirement arrangement (IRA) or to a retirement plan sponsored by your employer, you may qualify for a tax credit. See *Retirement Savings Contributions Credit* in chapter 39.

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.*

Child tax credit. You may be able to claim a tax credit for each of your qualifying children under age 17 at the end of the year. This credit can be as much as $1,000 for each qualifying child. See chapter 36.

Health insurance credit. If you are an eligible individual, you can claim a tax credit equal to 65% of the amount you pay for qualified health insurance coverage. See chapter 39.

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.

Third party designee. 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.

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. 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.

Free electronic filing. You may be able to file your 2003 taxes online for free thanks to an electronic filing agreement. See chapter 1.

Mailing your return. If you are filing a paper return, you may be mailing your return to a different address 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 the last page of this publication for a list of IRS addresses.

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 your return within 3 years from the date the return was due (including extensions) to get that refund. See chapter 1 for more information.

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.

Customer service for taxpayers expanded. The Internal Revenue Service has expanded customer service for taxpayers. Through the agency's *Everyday Tax Solutions* service, you can set up a personal appointment at the most convenient Taxpayer Assistance Center, on the most convenient business day. See *How To Get Tax Help* in the back of this publication.

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 **1–800–THE–LOST (1–800–843–5678)** if you recognize a child.

Introduction

This publication covers the general rules for filing a federal income tax return. It supplements the information contained in your tax form instruction booklet. It explains the tax law to make sure you pay only the tax you owe and no more.

How this publication is arranged. This publication closely follows **Form 1040**, *U.S. Individual Income Tax Return*. It is divided into six parts which cover different sections of Form 1040. Each part is further divided into chapters which generally discuss one line of the form.

Figure 1, *Finding Form 1040 Information in Publication 17,* beginning on the next page shows you line-by-line where the items found on Form 1040 are discussed in this publication. Do not worry if you file Form 1040A or Form 1040EZ. Anything included on a line of either of these forms is also included on Form 1040.

The table of contents inside the front cover and the index in the back of the publication are also useful tools to help you find the information you need.

What is in this publication. The publication begins with the rules for filing a tax return. It explains:

1) Who must file a return,
2) Which tax form to use,
3) When the return is due,
4) How to *e-file* your return, and
5) 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 receive 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. Sample 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.

Many of the subjects discussed in this publication are discussed in greater detail in other IRS publications. References to those other publications are provided for your information.

Icons. Small graphic symbols, or **icons**, are used to draw your attention to special information. See Table 1, *Legend of Icons*, below, for an explanation of each icon used in this publication.

What is not covered in this publication. Some material that you may find helpful is not included in this publication but can be found in your tax form instruction booklet. This includes lists of:

- Where to report certain items shown on information documents, and
- Recorded tax information topics (TeleTax).

If you operate your own business or have other self-employment income, such as from babysitting or selling 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 Daycare Providers).*
- Publication 911, *Direct Sellers.*

IRS mission. Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Help from the IRS. There are many ways you can get help from the IRS. These are explained under *How To Get Tax Help* in the back of this publication.

- Tax questions. Visit **www.irs.gov** or call **1–800–829–1040.**
- Forms and publications. Visit **www.irs.gov** to download them, call **1–800– 829–3676**, or write to one of the three addresses shown on page 285.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can email us at ***taxforms@irs.gov**. Please put "Publications Comment" on the subject line.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and
Publications Branch
SE:W:CAR:MP:T:I
1111 Constitution Ave. NW
Washington, DC 20224

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.

Table 1. **Legend of Icons**

Icon	Explanation
CAUTION	Items that may cause you particular problems, or an alert about pending legislation that may be enacted after this publication goes to print.
	An Internet site or an email address.
	An address you may need.
RECORDS	Items you should keep in your personal records.
	Items you may need to figure or a worksheet you may need to complete.
	An important phone number.
TIP	Helpful information you may need.

Figure 1—Finding Form 1040 Information in Publication 17

Questions about what to put on a line? Help is on the page number in the circle.

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2003 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20 OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial (18) | Last name | **Your social security number** (15)

If a joint return, spouse's first name and initial | Last name | **Spouse's social security number**

FOR REFERENCE ONLY—DO NOT FILE

Home address (number and street). If you have a P.O. box, see page 19. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.

Important! You **must** enter your SSN(s) above.

Presidential Election Campaign (See page 19.) **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? (16) ▶ ☐ Yes ☐ No ☐ Yes ☐ No (You / Spouse)

Filing Status Check only one box. (23)

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 20.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child. (See page 20.)

Exemptions (28)

6a ☐ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:** (28)

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 21)
			☐
			☐
			☐
			☐
			☐

If more than five dependents, see page 21.

No. of boxes checked on 6a and 6b ____
No. of children on 6c who:
- **lived with you** ____
- **did not live with you due to divorce or separation (see page 21)** ____

Dependents on 6c not entered above ____
Add numbers on lines above ▶ ☐

d Total number of exemptions claimed

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	(50)
8a	**Taxable** interest. Attach Schedule B if required		8a	(60)
b	**Tax-exempt** interest. **Do not** include on line 8a	8b (60)		
9a	Ordinary dividends. Attach Schedule B if required		9a	(68)
b	Qualified dividends (see page 23)	9b (69)		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		10	(95)
11	Alimony received		11	(143)
12	Business income or (loss). Attach Schedule C or C-EZ		12	(8)
13a	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13a	(117)
b	If box on 13a is checked, enter post-May 5 capital gain distributions	13b (117)		
14	Other gains or (losses). Attach Form 4797		14	(107)
15a	IRA distributions	15a (125)	b Taxable amount (see page 25)	15b
16a	Pensions and annuities	16a (83)	b Taxable amount (see page 25)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	(73)
18	Farm income or (loss). Attach Schedule F		18	(8)
19	Unemployment compensation		19	(96)
20a	Social security benefits	20a	b Taxable amount (see page 27)	20b (89)
21	Other income. List type and amount (see page 27)		21	(93)
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	

Adjusted Gross Income

23	Educator expenses (see page 29)	23 (146)		
24	IRA deduction (see page 29)	24 (125)		
25	Student loan interest deduction (see page 31)	25 (146)		
26	Tuition and fees deduction (see page 32)	26 (148)		
27	Moving expenses. Attach Form 3903	27 (138)		
28	One-half of self-employment tax. Attach Schedule SE	28 (124)		
29	Self-employed health insurance deduction (see page 33)	29 (124)		
30	Self-employed SEP, SIMPLE, and qualified plans	30 (124)		
31	Penalty on early withdrawal of savings	31 (67)		
32a	Alimony paid b Recipient's SSN ▶	32a (143)		
33	Add lines 23 through 32a		33	
34	Subtract line 33 from line 22. This is your **adjusted gross income** ▶		34	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 77. Cat. No. 11320B Form **1040** (2003)

Figure 1—Finding Form 1040 Information in Publication 17, continued

Questions about what to put on a line? Help is on the page number in the circle.

Form 1040 (2003) Page **2**

Tax and Credits

Standard Deduction for—

- People who checked any box on line 36a or 36b **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $4,750

Married filing jointly or Qualifying widow(er), $9,500

Head of household, $7,000

35	Amount from line 34 (adjusted gross income)		35	
36a	Check if: ☐ **You** were born before January 2, 1939, ☐ Blind. ☐ **Spouse** was born before January 2, 1939, ☐ Blind. **Total boxes checked** ▶ 36a			
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 36b ☐			
37	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		37	150
38	Subtract line 37 from line 35		38	
39	If line 35 is $104,625 or less, multiply $3,050 by the total number of exemptions claimed on line 6d. If line 35 is over $104,625, see the worksheet on page 35		39	
40	**Taxable income.** Subtract line 39 from line 38. If line 39 is more than line 38, enter -0-		40	
41	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972		41	217
42	**Alternative minimum tax** (see page 38). Attach Form 6251		42	218
43	Add lines 41 and 42 ▶		43	
44	Foreign tax credit. Attach Form 1116 if required	44 268		
45	Credit for child and dependent care expenses. Attach Form 2441	45 227		
46	Credit for the elderly or the disabled. Attach Schedule R	46 237		
47	Education credits. Attach Form 8863	47 248		
48	Retirement savings contributions credit. Attach Form 8880	48 268		
49	Child tax credit (see page 40)	49 244		
50	Adoption credit. Attach Form 8839	50 267		
51	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	51 268		
52	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify _____	52 269		
53	Add lines 44 through 52. These are your **total credits**		53	
54	Subtract line 53 from line 43. If line 53 is more than line 43, enter -0- ▶		54	

Other Taxes

55	Self-employment tax. Attach Schedule SE	55	9
56	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	56	59
57	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	57	133
58	Advance earned income credit payments from Form(s) W-2	58	262
59	Household employment taxes. Attach Schedule H	59	233
60	Add lines 54 through 59. This is your **total tax** ▶	60	217

Payments

If you have a qualifying child, attach Schedule EIC.

61	Federal income tax withheld from Forms W-2 and 1099	61 42		
62	2003 estimated tax payments and amount applied from 2002 return	62	42	
63	**Earned income credit (EIC)**	63 254		
64	Excess social security and tier 1 RRTA tax withheld (see page 56)	64	269	
65	Additional child tax credit. Attach Form 8812	65 245		
66	Amount paid with request for extension to file (see page 56)	66	13	
67	Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	67 70		
68	Add lines 61 through 67. These are your **total payments** ▶		68	

Refund

Direct deposit? See page 56 and fill in 70b, 70c, and 70d.

69	If line 68 is more than line 60, subtract line 60 from line 68. This is the amount you **overpaid**		69	
70a	Amount of line 69 you want **refunded to you** ▶		70a	16
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
▶ d	Account number			
71	Amount of line 69 you want **applied to your 2004 estimated tax** ▶	71	47	

Amount You Owe

72	**Amount you owe.** Subtract line 68 from line 60. For details on how to pay, see page 57 ▶		72	17
73	Estimated tax penalty (see page 58)	73	49	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 58)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ 16 Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 20. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
16			( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶ 16	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** (2003)

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.

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 *Where Do I File*, later in this chapter.

Important Reminders

Alternative filing methods. Rather than filing a return on paper, you may be able to file electronically using IRS *e-file*. Create your own personal identification number (PIN) and file a completely paperless tax return. 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, 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**, *Application for IRS Individual Taxpayer Identification Number*, with the IRS. For more information, see *Social Security Number*, later.

Table 1–1. **2003 Filing Requirements for Most Taxpayers**

To use this table, first find your marital status at the end of 2003. Then, read across the line that shows your filing status and age at the end of 2003. 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 2003. (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	$ 7,800 $ 8,950
	Head of household	under 65 65 or older	$10,050 $11,200
Married, with a child in your home, living apart from your spouse during the last 6 months of 2003	Head of household	under 65 65 or older	$10,050 $11,200
Married, living with your spouse at the end of 2003 (or on the date your spouse died)	Married, joint return	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)	$15,600 $16,550 $17,500
	Married, separate return	any age	$ 3,050
Married, not living with your spouse at end of 2003 (or on the date your spouse died)	Married, joint or separate return	any age	$ 3,050
Widowed before 2003 and not remarried in 2003	Single	under 65 65 or older	$ 7,800 $ 8,950
	Head of household	under 65 65 or older	$10,050 $11,200
	Qualifying widow(er) with dependent child	under 65 65 or older	$12,550 $13,500

*If your 65th birthday is on January 1, 2004, you are considered to be age 65 at the end of 2003.

Table 1–2. **2003 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 $3,050 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 $4,750.
- Your gross income was more than the larger of:
  - $750, or
  - Your earned income (up to $4,500) **plus** $250.

❑ **Yes.** You must file a return if **any** of the following apply.
- Your unearned income was more than $1,900 ($3,050 if 65 or older **and** blind).
- Your earned income was more then $5,900 ($7,050 if 65 or older **and** blind).
- Your gross income was more than $1,150 ($2,300 if 65 or older **and** blind) **plus** the larger of:
  - $750, or
  - Your earned income (up to $4,500) **plus** $250.

Married 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 $4,750.
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than the larger of:
  - $750, or
  - Your earned income (up to $4,500) **plus** $250.

❑ **Yes.** You must file a return if **any** of the following apply.
- Your unearned income was more than $1,700 ($2,650 if 65 or older **and** blind).
- Your earned income was more than $5,700 ($6,650 if 65 or older **and** blind).
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than $950 ($1,900 if 65 or older **and** blind) **plus** the larger of:
  - $750, or
  - Your earned income (up to $4,500) **plus** $250.

Third party designee. You can allow the IRS to discuss your 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. For more information, see *Third Party Designee*, later.

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 and residents living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
2) Dependents.
3) Children 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.

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

CAUTION *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.)

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 *Part Two* of this publication.

Community income. 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*, line 1 of Schedule C–EZ (Form 1040), *Net Profit From Business*, and line 11 of Schedule F (Form 1040), *Profit or Loss From Farming*. See *Self-Employed Persons*, later, for more information about your filing requirements.

CAUTION *If you do not report all of your self-employment income, your social security benefits may 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 is on January 1, 2004, you are considered 65 for 2003.

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 and Residents Living Outside the United States

If you are a U.S. citizen or resident 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*. For more information, 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*.

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.

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, then 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 (your signature), parent 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.

Children Under Age 14

If a child's only income is interest and dividends (including Alaska Permanent Fund dividends) and certain other conditions are met, a parent can elect to include the child's income on the parent's return. If this election is made, the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends* in chapter 33.

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, such as certain part-time work 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*.

Employees of 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 is not required to withhold social security and Medicare taxes from your wages, 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.

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 are 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 federal income tax withheld from your pay.
2) You qualify for the earned income credit. See chapter 38 for more information.
3) You qualify for the additional child tax credit. See chapter 36 for more information.
4) You qualify for the health coverage tax credit. See chapter 39 for more information.

Table 1–3. **Other Situations When You Must File a 2003 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. This amount should be shown in box 12 of your Form W-2.
   - Alternative minimum tax. (See chapter 32.)
   - 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)*.)
   - Tax on a Coverdell ESA or qualified tuition program. (See Publication 970, *Tax Benefits for Education*.)
   - 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 39.)
   - Recapture of an education credit. (See chapter 37.)
   - Recapture of the Indian employment credit. (See the instructions for Form 8845, *Indian Employment Credit*.)
   - Recapture of the new markets credit. (See Form 8874, *New Markets 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 38.)
3. You had net earnings from self-employment of at least $400. (See *Self-Employed Persons* earlier 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.)

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 2003, your filing status must be married filing jointly.
2) You (and your spouse if married filing a joint return) were under age 65 and not blind at the end of 2003. If you were born on January 1, 1939, you are considered to be age 65 at the end of 2003.
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, and taxable interest of $1,500 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.
9) You do not owe any household employment taxes on wages you paid to a household employee.

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 use only 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, and unemployment compensation.
2) Your taxable income is less than $50,000.
3) Your adjustments to income are for only the following items.
   a) Educator expenses.
   b) IRA deduction.
   c) Student loan interest deduction.
   d) Tuition and fees 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 32.)
   c) Advance earned income credit (EIC) payments, if you received any. (See chapter 38.)
   d) Recapture of an education credit. (See chapter 37.)
   e) Form 8615, *Tax for Children Under Age 14 With Investment Income of More Than $1,500*.
   f) *Qualified Dividends and Capital Gain Tax Worksheet*.
6) You claim only the following tax credits.
   a) The credit for child and dependent care expenses. (See chapter 34.)
   b) The credit for the elderly or the disabled. (See chapter 35.)
   c) The child tax credit. (See chapter 36.)
   d) The additional child tax credit. (See chapter 36.)
   e) The education credits. (See chapter 37.)
   f) The retirement savings contributions credit. (See chapter 39.)
   g) The earned income credit. (See chapter 38.)
   h) The adoption credit. (See chapter 39.)

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.

CAUTION *If you receive a capital gain distribution that includes qualified 5-year gain, unrecaptured section 1250 gain, section 1202 gain, or collectibles (28%) 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, 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 had income that cannot be reported on Form 1040EZ or Form 1040A.
4) You claim any adjustments to gross income other than the adjustments listed earlier under *Form 1040A*.
5) Your Form W–2, box 12, shows uncollected employee tax (social security and Medicare tax) on tips (see chapter 7) or group-term life insurance (see chapter 6).
6) You received $20 or more in tips in any one month and did not report all of them to your employer. (See chapter 7.)
7) You claim any credits other than the credits listed earlier under *Form 1040A*.
8) You have to file other forms with your return to report certain exclusions, taxes, or transactions.

Does My Return Have To Be on Paper?

You may be able to file a paperless return using IRS *e-file* (electronic filing). It's so easy, 53 million taxpayers preferred *e-file* over filing a paper tax return last year.

This section explains how to *e-file*:

- Using an Authorized IRS *e-file* Provider,
- 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, 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.

Electronic signatures. Create your own personal identification number (PIN) and use a tax professional or file your own paperless return electronically. If you are married filing jointly, you and your spouse will each need to create a PIN and enter these PINs as your electronic signatures.

A PIN is any combination of five numbers you choose, except five zeros. If you use a PIN, there is nothing to sign and nothing to mail—not even your Forms W–2.

To verify your identity, you will be asked to enter your adjusted gross income (AGI) from your **originally** filed 2002 income tax return, if applicable. Do not use your AGI from an amended return (Form 1040X). AGI is the amount shown on your 2002 Form 1040, line 35; Form 1040A, line 21; Form 1040EZ, line 4; and on the TeleFile Tax Record, line I. If you do not have your 2002 income tax return, call the IRS at **1–800–829–1040** to get a free transcript of your account. You will also be asked to enter your date of birth (DOB). Make sure your DOB is accurate and matches the information on record with the Social Security Administration by checking your annual Social Security Statement.

CAUTION *You* **cannot** *sign your return electronically if you are a first-time filer under age 16 at the end of 2003,* **or** *if you are* ***filing Form 3115, 5713, 8283*** *(if completing Section B),* ***8332****, or* ***8609****.*

For more details on the Self-Select PIN method, visit **www.irs.gov/efile** and click on "IRS *e-file* for Individual Taxpayers."

Forms 8453 and 8453–OL. Your return is not complete without your signature. If you are not eligible or choose not to sign your return electronically, you must complete, sign, and file Form 8453, *U.S. Individual Income Tax Declaration for an IRS* e-file *Return*, or Form 8453–OL, *U.S. Individual Income Tax Declaration for an IRS* e-file *Online Return*, whichever applies.

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/efile**.

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. If you choose Direct 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 3 weeks after your electronically-filed return was accepted by IRS, see *Past-Due Refund* later.

Balance due. If you owe tax, you must pay it by April 15, 2004, to avoid late-payment penalties and interest. You can make your payment electronically by credit card or by scheduling an electronic funds withdrawal from your checking or savings account.

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

Using an Authorized IRS *e-file* Provider

Many tax professionals electronically file tax returns for their clients. As a taxpayer, you have two options.

Table 1–4. **Benefits of IRS *e-file***

Free File Options!	• At least 60 percent of taxpayers—or 78 million—are eligible to use free commercial online tax preparation software to *e-file*.
	• Visit **www.irs.gov/efile** to see if you qualify and to access these free services offered by the tax software industry (not the IRS).
Fast! Easy! Convenient!	• Get your refund in half the time as paper filers do, even faster and safer with Direct Deposit—in as few as 10 days.
	• Sign electronically and file a completely paperless return.
	• Receive an electronic proof of receipt within 48 hours that the IRS received your return.
	• If you owe, you can *e-file* and authorize an electronic funds withdrawal or pay by credit card. If you *e-file* before April 15, 2004, you can schedule an electronic funds withdrawal from your checking or savings account as late as April 15, 2004.
	• Prepare and file your federal and state returns together and save time.
Accurate! Secure!	• IRS computers quickly and automatically check for errors or other missing information.
	• The error rate for *e-filed* returns is less than 1 percent.
	• The chance of being audited does not differ whether you *e-file* or file a paper tax return.
	• Your bank account information is safeguarded along with other tax return information. The IRS does not have access to credit card numbers.

1) You can prepare your return, take it to an Authorized IRS *e-file* Provider, and have the provider transmit it electronically to the IRS.

2) You can have a tax professional prepare your return and transmit it for you electronically.

You may personally enter your self-selected PIN or complete **Form 8879**, *IRS* e-file *Signature Authorization*, to authorize the provider to enter your self-selected PIN on your return.

Note. Tax professionals may charge a fee for IRS *e-file*. Fees may vary depending on the professional and the specific services rendered.

Using Your Personal Computer

You can file your tax return in a fast, easy, convenient way using your personal computer. A computer with a modem or Internet access and tax preparation software are all you need. You can *e-file* from the comfort of your home 24 hours a day, 7 days a week. Best of all, you may qualify for Free File.

If you do not qualify for the Free File options, visit our Partners Page for partners that offer other free or low-cost filing options.

IRS approved tax preparation software is available for online use on the Internet, for download from the Internet, and in retail stores.

For information on Free File, Partners Page, and tax preparation software, visit our website at **www.irs.gov/efile**.

Using a Telephone (TeleFile)

For millions of eligible taxpayers, TeleFile is the easiest way to file. TeleFile allows you to file your simple federal tax return using a touch-tone telephone. Only taxpayers who met the qualifications for Form 1040EZ in the prior year are eligible to receive the TeleFile tax package for the current year. A TeleFile tax package is automatically mailed to you if you are eligible. TeleFile is completely paperless—there are no forms to mail in. Just follow the instructions in the TeleFile tax package. TeleFile is filed directly with the IRS, usually in 10 minutes, and it's FREE.

Parents: If your children receive a TeleFile tax package, please encourage them to use TeleFile.

Through Employers and Financial Institutions

Some businesses offer free *e-file* to their employees, members, or customers. Others offer it for a fee. Ask your employer or financial institution if they offer IRS *e-file* as an employee, member, or customer benefit.

Free Help With Your Return

Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 or older with their tax returns. Some locations offer free electronic filing and all volunteers will let you know about the credits and deductions you may be entitled to claim. To find a site near you, call **1–800–829–1040**. Or to find the nearest AARP TaxAide site, visit AARP's website at **www.aarp.org/taxaide** or call **1–888–227–7669**.

When Do I Have To File?

April 15, 2004, is the due date for filing your 2003 income tax return if you use the calendar year. For a quick view of due dates for filing a return with or without an extension of time to file (discussed later), see *Table 1–5*.

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, has enough postage, and is postmarked by the due date. 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, FedEx 2Day, FedEx International Priority, and FedEx International First.
- 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 due (including extensions) to get that refund.

Nonresident alien. If you are a nonresident alien and earn wages subject to U.S. income tax withholding, your 2003 U.S. income tax return (Form 1040NR or Form 1040NR–EZ) is due by:

- April 15, 2004, 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 15, 2004, if you use a calendar year, or

Table 1–5. **When To File Your 2003 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, 2004	June 15, 2004
Automatic extension Form 4868 filed, or credit card payment made	August 16, 2004	August 16, 2004
2nd extension Form 2688 filed after getting automatic extension	October 15, 2004	October 15, 2004

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

Get Publication 519 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 2003 return, this will be April 15, 2004. 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 for those who were:

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

Automatic Extension

If you cannot file your 2003 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, 2004, you will have until August 16, 2004, to file.

CAUTION *If you do not pay the tax due by the regular due date (generally, April 15), you will owe interest. You may also be charged penalties, discussed later.*

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 ways you can use *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 February 2 through April 15, 2004. You will need to provide certain information from your tax return for 2002. If you wish to make a payment by electronic funds withdrawal, see *Electronic payment options*, 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 2002. If you wish to make a payment by electronic funds withdrawal, see *Electronic payment options*, 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 *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 SSN, daytime phone number, and "2003 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 66, Form 1040. If you file Form 1040EZ or Form 1040A, include that payment in your total payments on line 9 of Form 1040EZ or line 43 of Form 1040A. Also print "Form 4868" and the amount paid in the space to the left of line 9 or line 43.

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*. 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.

CAUTION *You should ask for the extension early so that, if it is not approved, you still will be able to file on time.*

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 2002. If you file electronically, do not mail the Form 2688.

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 will be null and void. You will have to pay the failure-to-file penalty (discussed later under *Civil Penalties*).

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. If you are in the United States, an extension of more than 6 months will not be approved.

Individuals Outside the United States

You are allowed an automatic 2-month extension (until June 15, 2004, if you use the calendar year) to file your 2003 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 regular due date (generally, April 15), interest will be charged from that date until the date the tax is paid.

If you served in a combat zone or qualified hazardous duty area, you may be eligible for a longer extension of time to file. 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. Write "Taxpayer Abroad" across the top of Form 4868.

This additional 2-month extension of time to file is ***not*** a further extension of time to pay. You can use a credit card to pay your estimate of tax due. See *How To Pay*, later in this chapter.

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. For more information, see *Further extensions* under *When To File and Pay* in Publication 54 .

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 merchant marines serving aboard vessels under the operational control of the Department of Defense, 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 January 17, 1991.
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.
4) Afghanistan, effective September 19, 2001.

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.

The above rules on the extension for filing your return also apply when you are deployed outside the United States (away from your permanent duty station) while participating in a designated contingency operation.

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, based on what you filed last year, the IRS will mail you Form 1040, Form 1040A, or Form 1040EZ with related instructions, or a TeleFile package. Before you fill in the form, look at the form instructions to see if you need, or would benefit from filing, a different form this year. Also see if you need any 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 or print them from the Internet. See *How To Get Tax Help* in the back of this publication.

Substitute tax forms. You cannot use your own version of a tax form unless it meets the requirements explained in Publication 1167, *General Rules and Specifications for Substitute Forms and Schedules*.

Table 1–6. **Six Steps for Preparing Your Return**

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.

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 to prepare your return. See *Form W–2* under *Credit for Withholding and Estimated Tax* in chapter 5.

If you do not receive Form W–2 by February 2, 2004, contact your employer. If you still do not get the form by February 16, the IRS can help you by requesting the form from your employer. When you request IRS help, be prepared to provide the following information.

- Your name, address (including zip code), and phone number.
- Your SSN.
- Your dates of employment.
- Your employer's name, address (including zip code), and phone number.

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 February 2, 2004, contact the payer. If you still do not get the form by February 16, 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 choose your accounting period (tax year) 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. Generally, you deduct all expenses in the year you actually pay them. This is the method most individual taxpayers use.

Constructive receipt. Generally, 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, 2003, is taxable income to you in 2003 if you could have withdrawn it in 2003 (even if the

amount is not entered in your passbook or withdrawn until 2004).

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 may include rent 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. 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 will help 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 2003 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 (Form 1040 or 1040A).

No social security number. File **Form SS–5**, *Application for a Social Security Card*, 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 (ITIN)*, 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 or on the Internet at **www.ssa.gov**. 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**, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*, 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 an 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.

CAUTION *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. If you have a tax liability of at least $3, 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 and have a tax liability of at least $6, 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 Forms W–2: 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.

TIP *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 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. 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 2003 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,
   c) Call the IRS to ask for copies of notices or transcripts related to your return, and
   d) Respond to certain IRS notices about math errors, offsets (see *Refunds*, later), and return preparation.

The authorization will automatically end no later than the due date (without any extensions) for filing your 2004 tax return. This is April 15, 2005, for most people.

See your form instructions for more information.

TIP *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.

CAUTION *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.*

TIP *If you* e-file *your return, you can use an electronic signature to sign your return. See* Does My Return Have To Be on Paper, *earlier.*

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 phone 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 (your signature), parent 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.

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, 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 (2004) estimated tax. You cannot have your overpayment applied to your 2004 estimated tax if you file Form 1040EZ.

If you choose to have a 2003 overpayment applied to your 2004 estimated tax, you cannot change your mind and have any of it refunded to you after the due date (without extensions) of your 2003 return.

Follow the form instructions to complete the entries to claim your refund and/or to apply your overpayment to your 2004 estimated tax.

If your refund for 2003 is large, you may want to decrease the amount of income tax withheld from your pay in 2004. 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 32.

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 2003 is large, you may want to increase the amount of income tax withheld from your pay or make estimated tax payments for 2004. 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 electronically.

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

Check or money order. If you pay by check or money order, make it out to the "United States Treasury." Show your correct name, address, SSN, daytime phone number, and the tax year and form number on the front of your check or money order. If you are filing a joint return, enter the SSN shown first on your tax return.

For example, if you file Form 1040 for 2003 and you owe additional tax, show your name, address, SSN, daytime phone number, and "2003 Form 1040" on the front of your check or money order. If you file an amended return (Form 1040X) for 2002 and you owe tax, show your name, address, SSN, daytime phone number, and "2002 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.

Electronic payment options. Electronic payment options are convenient, safe and secure methods for paying individual income taxes. There's no check to write, money order to buy, or voucher to mail.

Credit card. You can use your American Express®, Discover®, MasterCard®, or Visa® 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

Link2Gov Corporation

To make a payment, call	1–888–PAY–1040℠
or	1–888–729–1040
For Customer Service	1–888–658–5465
Web Address	**www.PAY1040.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**

You can *e-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. You can also pay by credit card using the telephone or the Internet.

Electronic funds withdrawal. You can *e-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, 2004).

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.

Electronic Federal Tax Payment System (EFTPS). EFTPS offers another way to pay your federal taxes. Best of all, it's free and available to business and individual taxpayers. In fact, it's recommended for estimated tax payments (Form 1040–ES) and installment agreement payments. For details on how to enroll, visit **www.EFTPS.gov** or call EFTPS Customer Service at **1–800–555–4477** or **1–800–945–8400**.

Estimated tax payments. Do not include any 2004 estimated tax payment in the payment for your 2003 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 32.*

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, 2004, 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.

In addition to paying by check or money order, you can use a credit card or EFTPS to make installment agreement payments. See *Credit card* and *Electronic Federal Tax Payment System (EFTPS)*, under *How To Pay*, earlier.

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."

Send your check to:

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

Or, enclose your separate check in the envelope with your income tax return. 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 back 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 you are not eligible or choose not to sign your return using your self-selected PIN, use your label on Form 8453 or 8453–OL. (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 or 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 address shown at the end of this publication for the area where you now live.

What Happens After I File?

After you send your return to the 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 your benefits in case there is a question about your work record or earnings in a particular year. Review the information shown on your annual (for workers over age 25) *Social Security Statement*.

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 of Tax Return*. There is a charge for a copy of a return, which you must pay with Form 4506. It may take up to 60 days to process your request.

Transcript. You can use **Form 4506–T**, *Request for Transcript of Tax Return*, 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. A transcript usually contains the information that a third party (such as a mortgage company) requires.

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 the IRS for your tax account information. You should have your name and address, SSN 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

You can check on the status of your 2003 refund if it has been at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Be sure to have a copy of your 2003 tax return available because you will need to know the filing status, the first SSN shown on the return, and the ***exact*** whole-dollar amount of the refund. To check on your refund, do one of the following.

- Go to **www.irs.gov**, and click on ***Where's My Refund***.
- Call **1–800–829–4477** for automated refund information and follow the recorded instructions.
- Call **1–800–829–1954** during the hours shown in your form instructions.

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. Send the notification to the Internal Revenue Service Center serving your old address. 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 SSN (and the name and SSN 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 a 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 installment 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). Do not use the addresses listed at the end of this publication.

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 your return within 3 years from the date the return was due (including extensions) to get that refund. Generally, your return must be postmarked no later than 3 years from the date the return was due (including extensions). For information on postmarks, see *Filing on time*, under *When Do I Have To File*, earlier.

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, including estimated tax payments, made before the due date (without regard to extensions) of the original return are considered paid on the due date. For example, income tax withheld during the year is considered paid on the due date of the return, April 15 for most taxpayers.

Example 1. You made estimated tax payments of $500 and got an automatic extension of time to August 15, 2001, to file your 2000 income tax return. When you filed your return on that date, you paid an additional $200 tax. On August 16, 2004 (next business day after August 15, 2004), 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 27, 2001, 2½ months after the extension period ended. You paid an additional $200 on that date. On October 27, 2004, 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 3. You filed your 2000 tax return on April 16, 2001. You paid taxes of $500. On November 1, 2002, after an examination of your 2000 return, you had to pay an additional tax of $200. On May 13, 2004, 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 for claiming a refund are suspended for the period in which you are financially disabled. For a joint income tax return, only one spouse has to be financially disabled for the time period to be suspended. 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.

- Bad debt. (See *Nonbusiness Bad Debts* in chapter 15.)
- 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*.)
- Claim based on an agreement with the IRS extending the period for assessment of tax.
- 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.

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. If your spouse owes these debts, see *Offset against debts*, earlier, for the correct refund procedures to follow.

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 SSN or individual taxpayer identification number. If you provide fraudulent information on your return, you may have to pay a civil fraud penalty.

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

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

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

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

Paying tax late. You will have to pay a ***failure-to-pay*** penalty of ½ of 1% (.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 you underpay your tax because:

1) You show ***negligence*** or ***disregard*** of the 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.

This exception will not apply to an item that is attributable to a tax shelter. In addition, it will not apply if you fail to keep adequate books and records, or substantiate items properly.

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 may be reduced to the extent the understatement is due to:

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

If an item on your return is attributable to a tax shelter, there is no reduction for an adequate disclosure. However, there is a reduction for a position with substantial authority, but only if you reasonably believed that your tax treatment was more likely than not the proper treatment.

Substantial authority. Whether there is or was substantial authority for the tax treatment of an item depends on the facts and circumstances. Some of the items that may be considered are 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 2002–66 (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 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 helps you determine which filing status to use. There are five filing statuses:

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

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

You must determine your filing status before you can determine your filing requirements (chapter 1), standard deduction (chapter 22), and correct tax (chapter 32). 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, 2003, and did not remarry in 2003. 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. You can file a joint return even if one of you had no income or deductions.

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.

TIP *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 12 months ending the date election of this relief is filed.
3) ***Equitable relief,*** which applies to all joint filers who do not qualify for innocent spouse relief or separation of liability.

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, Yugoslavia, or Afghanistan), 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, or who are in missing status as a result of 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 filing status may benefit you if you want to be responsible only for your own tax or if it results in less tax than filing a joint return.

If you and your spouse do not agree to file a joint return, you may have to use this filing status.

You may be able to choose ***head of household*** filing status if you live apart from your spouse, meet certain tests, and are ***considered unmarried*** (defined later, under *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.

TIP *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 filing status 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 for the reasons listed under* Special Rules, *later.*

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

If you choose married filing separately as your filing status, the following special rules apply. Because of these special rules, you will usually pay more tax on a separate return than if you used another filing status that you qualify for.

1) Your tax rate generally will be higher than on a joint return.
2) Your exemption amount for figuring the alternative minimum tax will be half that allowed a joint return filer.
3) You cannot take the credit for child and dependent care expenses in most cases, 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). For more information about these expenses, the credit, and the exclusion, see chapter 34.
4) You cannot take the earned income credit.
5) You cannot take the exclusion or credit for adoption expenses in most cases.
6) You cannot take the education credits (the Hope credit and the lifetime learning credit), the deduction for student loan interest, or the tuition and fees deduction.
7) You cannot exclude any interest income from qualified U.S. savings bonds that you used for higher education expenses.
8) If you lived with your spouse at any time during the tax year:
   a) You cannot claim the credit for the elderly or the disabled.
   b) You will have to include in income more (up to 85%) of your social security benefits or equivalent railroad retirement benefits you received, and
   c) You cannot roll over amounts from a traditional IRA into a Roth IRA.
9) The following deductions and credits are reduced at income levels that are half those for a joint return:

a) The child tax credit,

b) The retirement savings contributions credit,

c) Itemized deductions, and

d) The deduction for personal exemptions.

10) Your capital loss deduction limit is $1,500 (instead of $3,000 if you filed a joint return).

11) If your spouse itemizes deductions, you cannot claim the standard deduction. If you can claim the standard deduction, it is half the amount allowed on 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 chapter 18.

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.

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.

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. Also, see *Table 2–1,* later.

TIP *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 tax year if you meet ***all*** of the following tests.

1) You file a ***separate return***, defined earlier under *Joint Return After Separate Returns*.

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*, under *Qualifying Person*, 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*, under *Qualifying Person*, later, for rules applying to a child's birth, death, or temporary absence during the year.)

5) You must be able 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.

CAUTION *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 chapter 38 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 on the next page.

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.

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.

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

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 and 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, and you can claim an exemption for him or her[2]	a qualifying person.
	he or she is married, and you cannot claim an exemption for him or her	**NOT** a qualifying person.[5]
foster child[6]	the child lived with you all year, and you can claim an exemption for him or her[2]	a qualifying person.
	the child lived with you all year, and you cannot claim an exemption for him or her	**NOT** a qualifying person.

[1]A person cannot qualify more than one taxpayer to use the head of household filing status for the year.
[2]If 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* in chapter 3.
[3]You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father. You are related by blood to a nephew or niece if he or she is the child of your brother or sister.
[4]This child is a qualifying person even if you cannot claim an exemption for the child.
[5]This 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 Child of Divorced or Separated Parents* in chapter 3.
[6]The term "foster child" is defined under *Exemptions for Dependents* in chapter 3.

$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 2003, you can use married filing jointly as your filing status for 2003 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 2002, and you have not remarried, you may be able to use this filing status for 2003 and 2004.

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. 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 2003 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 2003.
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.*

CAUTION *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 2001. John has not remarried. During 2002 and 2003, he continued to keep up a home for himself and his child (for whom he can claim an exemption). For 2001 he was entitled to file a joint return for himself and his deceased wife. For 2002 and 2003 he can file as qualifying widower with a dependent child. After 2003 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 $3,000 in 2002 to $3,050 in 2003.

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 2003, the phaseout begins at $104,625 for married persons filing separately, $139,500 for unmarried individuals, $174,400 for heads of household, and $209,250 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.

Deduction. Exemptions reduce your taxable income. Generally, you can deduct $3,050 for each exemption you claim in 2003. But, you may lose the benefit of part or all of your exemption if your adjusted gross income is above a certain amount. See *Phaseout of Exemptions*, later.

How you claim an exemption. 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 26 (Form 1040A) or line 39 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by $3,050. If your adjusted gross income is more than $104,625, 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 each is worth the same amount ($3,050 for 2003), 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.

CAUTION *If you are entitled to claim an exemption for a dependent, that dependent cannot claim his or her own personal exemption.*

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 36.

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. The child also must be a member of your household, but does not have to be a member of your household for the entire year.

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

Authorized placement agency. An authorized placement agency includes any person or court authorized by state law to place children for legal adoption.

Foster child. A foster child must live with you as a member of your household for the entire year to qualify as your dependent. For this test, a foster child is one who is in your care that you care for as your own child. It does not matter how the child became a member of the household.

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

You cannot claim an exemption for a dependent unless that person is 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. However, there is an exception for certain adopted children, as explained next.

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.

Adopted child. 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 $3,000 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, even though they file a joint return.

Gross Income Test

Generally, you cannot take an exemption for a dependent if that person had gross income of $3,050 or more for 2003. 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 about scholarships, 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 $4,000. 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 $4,000. 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.

How to determine if test is met. 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. She put $300 in a savings account.

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.

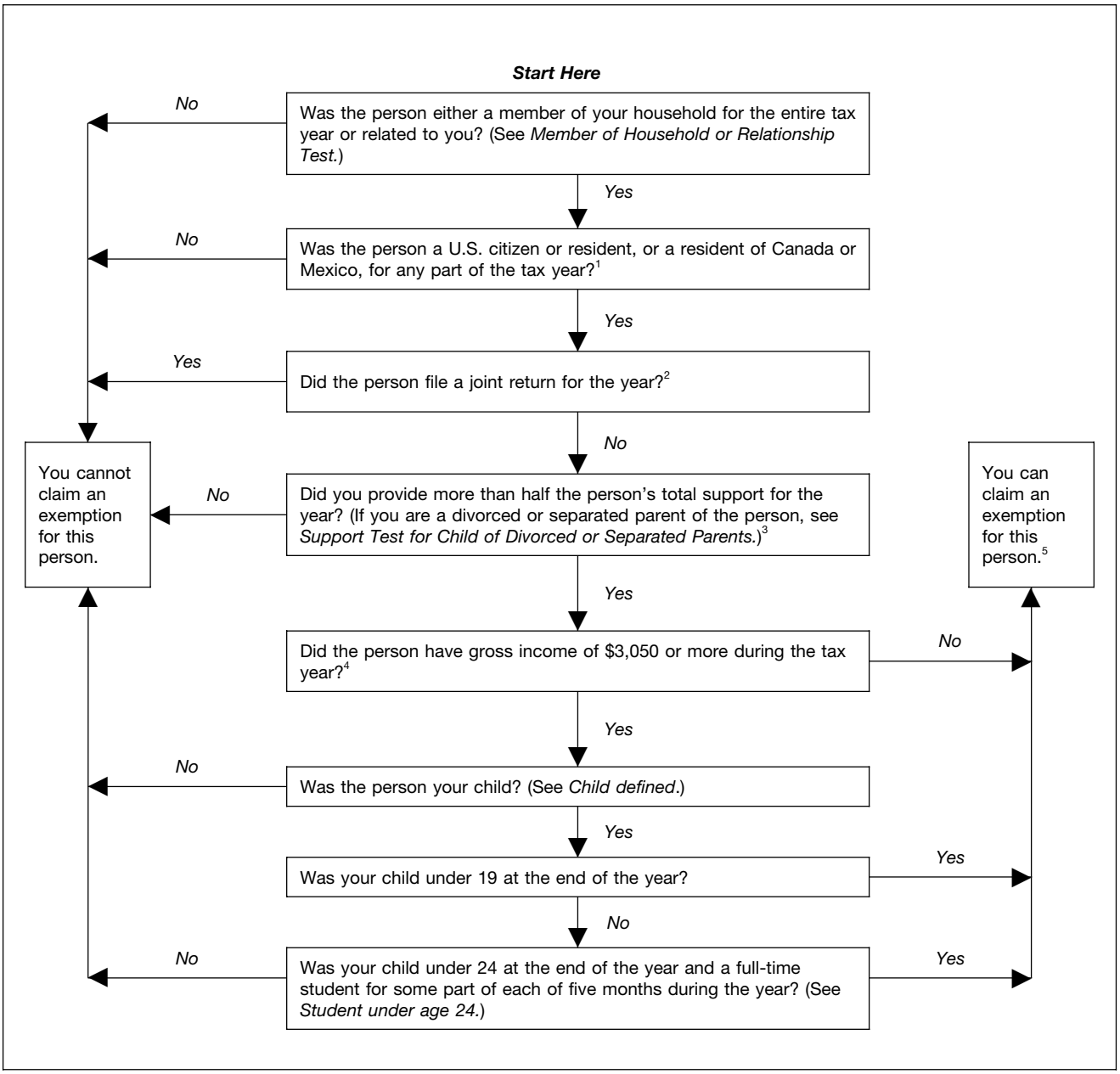
Support provided by the state (food stamps, housing, etc.). Benefits provided by the state to a needy person generally are considered support provided by the state. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that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

Table 3–1. **Worksheet for Determining Support** *Keep for Your Records*

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 *Multiple Support Agreement* in this chapter.	

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



[1]If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.
[2]If 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.
[3]Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement.*
[4]Gross income for this purpose does not include income received by a permanently disabled individual at a sheltered workshop. See *Disabled dependents.*
[5]If your adjusted gross income is more than $104,625, see *Phaseout of Exemptions.*

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 chapter 26. 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 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, transportation, and recreation. Your total food expense for the household is $6,000. Your heat and utility bills amount to $1,200. Your mother has hospital and medical expenses of $600, which you pay during the year. Figure your parents' total support as follows:

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

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. If you provide a person with lodging, you are considered to provide support equal to the fair rental value of the room, apartment, house, or other shelter in which the person lives. Fair rental value includes a reasonable allowance for the use of furniture and appliances and for heat and other utilities that are provided.

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 instead of actual expenses, such as rent, 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 the 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.

Child care expenses. If you pay someone to provide child care or disabled dependent care, you can include these payments in the amount you provided for the support of your child or disabled dependent, even if you claim a credit for the payments. For information on the credit, see chapter 34.

Other support items. Other items may be considered as support depending on the facts in each case.

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 statement agreeing not to claim the exemption for that year. The person who claims the exemption must keep these signed statements for his or her records. A multiple support declaration identifying each of the others who agreed not to claim the exemption must be attached to the return of the person claiming 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 statement agreeing not to take an exemption

for your mother. The one who claims the exemption must attach a Form 2120 or similar declaration to his or her return and must keep for his or her records the signed statement from the one agreeing not to take the exemption. Because neither brother provides more than 10% of the support, neither can take the exemption. Your brothers do not have to sign a 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 if the other signs a statement agreeing not to. The one who takes the exemption must attach a Form 2120 or a similar declaration to his return and must keep for his records the signed statement from the one agreeing not to take 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 2003. For the first 8 months of the year, you had custody of your child under your 1995 divorce decree (the most recent decree at the time). On August 31, 2003, 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) The custodial parent signed a decree or agreement executed after 1984 that states he or she will not claim the exemption for the child and that the noncustodial parent can claim an exemption for the child without regard to any condition, such as payment of support, and the noncustodial parent attaches to his or her return the documentation described later under *Divorce decree or separation agreement made after 1984*, 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.

Written declaration. The custodial parent may use either **Form 8332** or a similar statement (containing the same information required by the form) 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 made after 1984. If your divorce decree or separation agreement was executed after 1984, the noncustodial parent does not have to attach Form 8332 if both of the following requirements are met.

1) The decree or agreement is signed by the custodial parent and states all of the following.
   a) The custodial parent will not claim the child as a dependent for the year.
   b) The noncustodial parent can claim the child as a dependent ***without regard to any condition,*** such as payment of support.
   c) The years for which the noncustodial parent, rather than the custodial parent, can claim the child as a dependent.
2) The noncustodial parent attaches a copy of the following pages of the decree or agreement to his or her tax return.
   a) The cover page (write the other parent's social security number on this page).
   b) The pages that contain the information shown in item (1).
   c) The signature page with the other parent's signature and the date of the agreement.

CAUTION *If these requirements are not met, the noncustodial parent must attach to his or her return Form 8332 or a similar statement from the custodial parent releasing the exemption.*

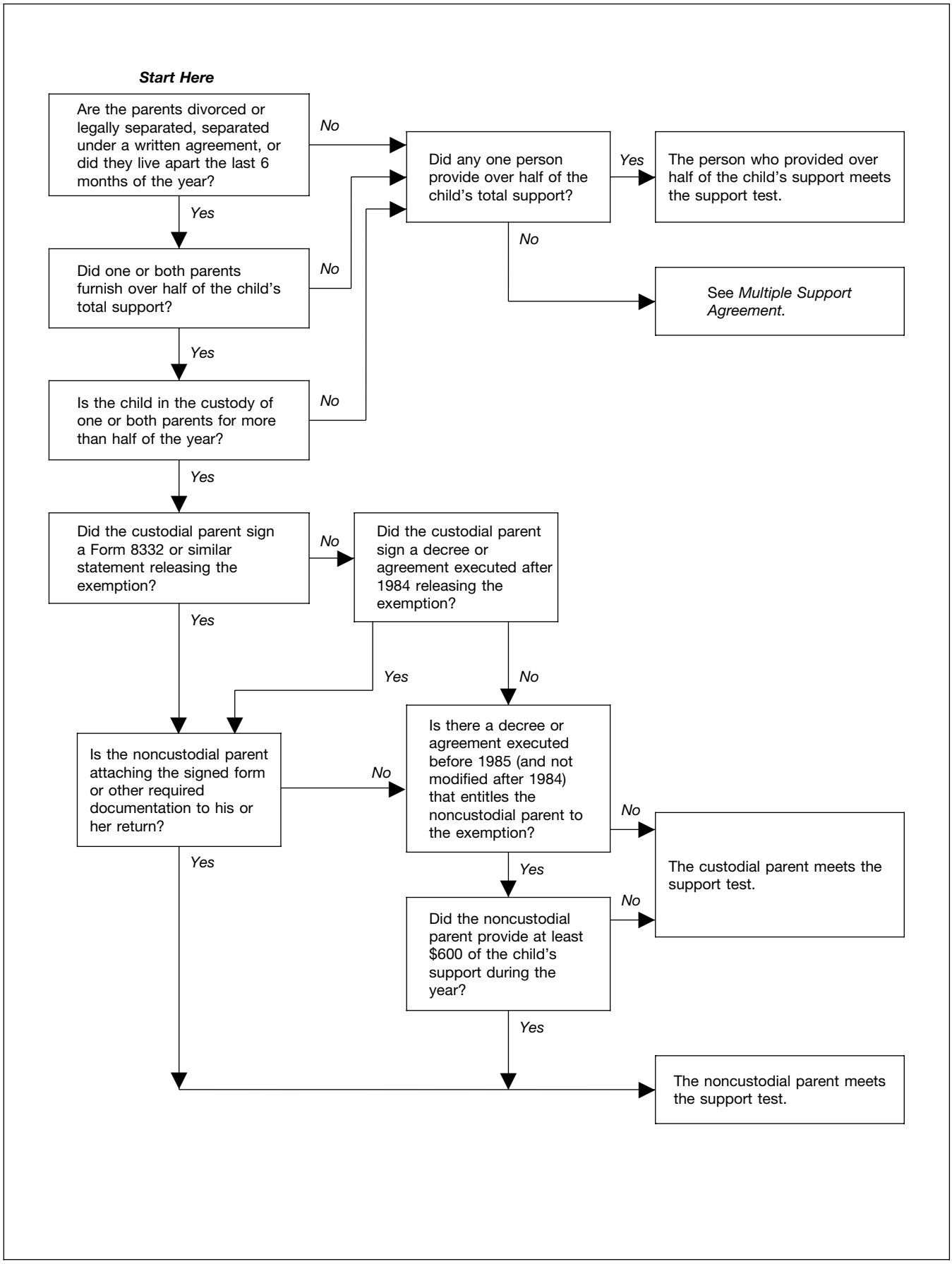
Child support. All child support payments actually received from the noncustodial parent are considered used for the support of the child.

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 your support for this year, but your payment of the amount owed from

Figure 3–B. **Support Test for Children of Divorced or Separated Parents**



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.

Phaseout of Exemptions

The amount you can claim as a deduction for exemptions is phased out once your adjusted gross income (AGI) goes above a certain level for your filing status. These levels are as follows:

Filing Status	AGI Level Which Reduces Exemption Amount
Married filing separately	$ 104,625
Single	139,500
Head of household	174,400
Married filing jointly	209,250
Qualifying widow(er)	209,250

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 above 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.

CAUTION *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 numbers 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 2003. If your child was born and died in 2003, 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 Reminders

Estate tax return. Generally, if the decedent died during 2003, an estate tax return (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.

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,* later.)
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. If you are appointed to act in any fiduciary capacity for another, you must file a written notice with the IRS stating this. Form 56 can be used for this purpose. The instructions and other requirements are given on the back of the form.

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 38 and 39 for additional information on refundable credits and see chapter 36 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 *Decedent* 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, 2003, before filing her 2002 tax return. Her personal representative must file her 2002 return by April 15, 2003. Her final tax return is due April 15, 2004.

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, of 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 2003. 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.

Third party designee. You can check the *Yes* box in the Third Party Designee area of the return to authorize the IRS to discuss the return with a friend, family member, or any other person you choose. This allows the IRS to call the person you identified as the designee to answer any questions that may arise during the processing of the return. It also allows the 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.

If the personal representative is filing a claim for refund on Form 1040X, *Amended U.S. Individual Income Tax Return,* or Form 843, *Claim for Refund and Request for Abatement,* and the court certificate has already been filed with the IRS, attach Form 1310 and write "Certificate Previously Filed" at the bottom of the form.

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 occurred. 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 return is filed timely if filed by 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 can be electronically filed.

Joint return. Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if no personal representative has been appointed before the due date for filing the 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 filing the return for that year. The income of the decedent that was includible 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 joint return with the decedent cannot be filed for the year of death 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.

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. If the decedent qualified for this relief while alive, the personal representative can pursue an existing request, or file a request, for relief from joint liability. For information on requesting this relief, see *Filing a Joint Return* in chapter 2.

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 reporting 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 properly 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.

DECEASED JOHN S. STONE FEBRUARY 28, 2003

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2003

IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2003, or other tax year beginning , 2003, ending , 20

OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

CAR-RT SORT**CR01
LP S29 30 IRS
JOHN S & JANE M STONE
1772 OAK ST 103
SHERIDAN WY 82801

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 (See page 19.) **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 ☐ Yes ☐ No (You / Spouse)

Filing Status

1 ☐ Single

2 ☐ Married filing jointly (even if only one had income)

4 ☐ Head of household (with qualifying person). (See page 20.) If the qualifying person is a child but not your dependent, enter

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see page 58)? ☐ **Yes.** Complete the following. ☑ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here Joint return? See page 20. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Jane M. Stone	4/1/04	Engineer	( )
Spouse's signature. If a joint return, **both** must sign. Filing as surviving spouse	Date	Spouse's occupation	

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** (2003)

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. 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.*

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. If a beneficiary acquires the interest, see the discussion under *Income in Respect of the Decedent,* later.

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 a learning disability) requires additional time to complete his or her education.

For more information on Coverdell ESAs, see Publication 970, *Tax Benefits for Education.*

Archer MSA

The treatment of an Archer MSA or 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.

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 22.

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.

CAUTION *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 *Decedent* in chapter 23.

Unrecovered investment in pension. If the decedent was receiving a pension or annuity (with an annuity starting date after 1986) 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 (see Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*). 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 34 through 39.

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 36.

Income in Respect of the Decedent

All 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.

CAUTION *If the decedent is a specified terrorist victim (see Publication 3920,* Tax Relief for Victims of Terrorist Attacks*), any income received after the date of death and before the end of the decedent's tax year (determined without regard to death) is excluded from the recipient's gross income. This exclusion does not apply to certain income.*

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.

TIP *If you have to include income in respect of the decedent in your gross income and an estate tax return was filed for the decedent, you may be able to claim a deduction for the estate tax paid on that income. For more information, see Publication 559.*

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 an 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:

- The amount you receive for the right, or
- 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 have been a capital gain to the decedent, it will be a capital gain 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, the distribution is not currently taxed. A surviving spouse can also roll over tax free the taxable part of the distribution into a qualified plan, section 403(b) annuity, or section 457 plan.

Example. 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.

For more information on inherited IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs)*.

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.

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). 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 education expenses of the decedent that are paid by the beneficiary within 1 year after the decedent's date of death.

Archer MSA. 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 include 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.

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.

5.

Tax Withholding and Estimated Tax

Important Changes for 2004

Tax law changes for 2004. When you figure how much income tax you want withheld from your pay and when you figure your estimated tax, consider tax law changes effective in 2004. See *Important Changes for 2004* in the front of this publication, or get Publication 553, *Highlights of 2003 Tax Changes.*

Important Reminder

Estimated tax safe harbor for higher income taxpayers. If your adjusted gross income was more than $150,000 ($75,000 if you are married filing a separate return), you will have to deposit the smaller of 90% of your expected tax for 2004 or ***110%*** of the tax shown on your 2003 return to avoid an estimated tax penalty.

Payment of estimated tax by electronic funds withdrawal. You may be able to pay your estimated tax by authorizing an automatic withdrawal from your checking or savings account. For more information, see *Payment by Electronic Funds Withdrawal* in chapter 2 of Publication 505.

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 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 the following.

- ***Credit for withholding and estimated tax.*** When you file your 2003 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 2003.
- ***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 2003 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 section discusses income tax 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, such as social security.

This section explains in detail the rules for withholding tax from each of these types of income.

This section 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.

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.

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 pay estimated tax, 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.

You can ask your employer to withhold income tax from noncash wages and other wages not subject to withholding. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to pay estimated tax, as discussed later under *Estimated Tax.*

Determining Amount of Tax Withheld Using Form W–4

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.

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 later, 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.

If the event changes your withholding status or the number of allowances you are claiming, 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 2005. If events in 2004 will decrease the number of your withholding allowances for 2005, you ***must*** give your employer a new Form W–4 by December 1, 2004. If the event occurs in December 2004, submit a new Form W–4 within 10 days.

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 Publication 919 under *Getting the Right Amount of Tax Withheld.* If too much or too little tax is being withheld, you should give your employer a new Form W–4 to change your withholding.

Note. You cannot give your employer a payment to cover withholding for past pay periods or a payment for estimated tax.

Completing Form W–4 and Worksheets

Form W–4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

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 using separate worksheets based on your own individual income, adjustments, deductions, exemptions, and credits.

Alternative method of figuring withholding allowances. You do not have to use the Form W–4 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.

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. Use this worksheet if you plan to itemize your deductions or claim adjustments to your income and you want to reduce your withholding.

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.

Cumulative wage method. If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

Publication 919

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 pay estimated tax, 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 2004 only if ***both*** the following situations apply.

1) For **2003** you had a right to a refund of all federal income tax withheld because you had no tax liability.
2) For **2004** 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 worksheet if you will itemize deductions, claim exemptions for dependents, or claim tax credits on your 2004 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 2004, but you expect to owe income tax for 2005, you must file a new Form W–4 by December 1, 2004.

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, vacation allowances, certain sick pay, and expense allowances under certain plans. 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.

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 correctly, but claims seven when the proper number is six, will not be charged a W–4 penalty.

Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income.*

How employer figures amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways.

1) By withholding at the regular rate on the sum of your pay plus your reported tips.
2) By withholding at the regular rate on your pay plus a percentage of your reported tips.

Not enough pay to cover taxes. If your regular pay is not enough for your employer to withhold all the tax (including income tax, 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. See *Giving your employer money for taxes* in chapter 7.

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 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 an employer-provided car, truck, or other highway motor vehicle. 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 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. 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 at a flat rate.

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 pay estimated tax. See *Estimated Tax,* later.

If you do not pay enough tax through withholding or estimated tax payments, you may have to pay 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 61 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** (or a similar form provided by the payer) and give it to the payer.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to pay estimated tax. 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.

If you do not choose to have income tax withheld, you may have to pay estimated tax. 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. Backup withholding can apply to most kinds of payments that are reported on Form 1099.

The payer must withhold at a flat 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 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 1 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 estimated tax payments, you may have to pay 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.

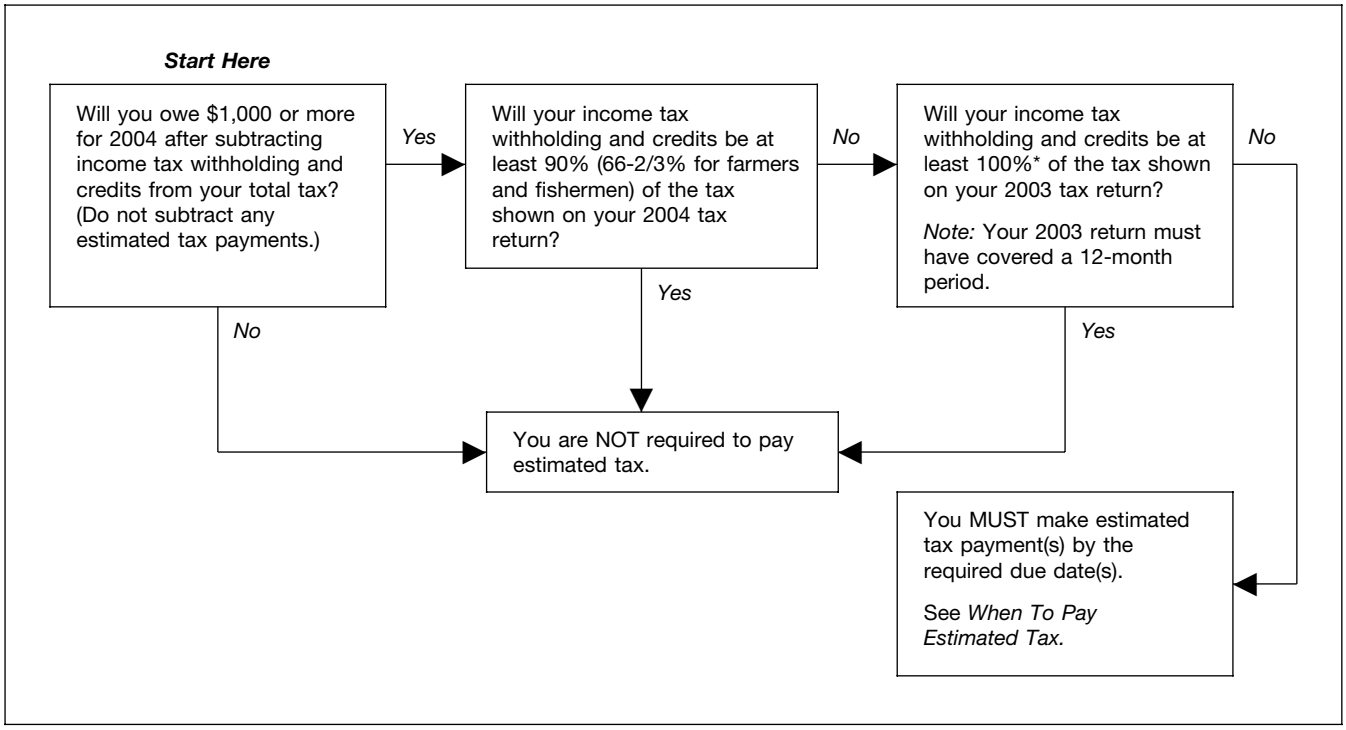
Who Does Not Have To Pay Estimated Tax

If you receive salaries or wages, you can avoid having to pay estimated tax by asking your employer to take more tax out of your earnings. To do this, give a new Form W–4 to your employer. See chapter 1.

Estimated tax not required. You do not have to pay estimated tax for 2004 if you meet all three of the following conditions.

1) You had no tax liability for 2003.
2) You were a U.S. citizen or resident for the whole year.
3) Your 2003 tax year covered a 12-month period.

Figure 5–A. **Do You Have To Pay Estimated Tax?**



* 110% if less than two-thirds of your gross income for 2003 and 2004 is from farming or fishing and your 2003 adjusted gross income was more than $150,000 ($75,000 if your filing status for 2004 is married filing a separate return).

You had no tax liability for 2003 if your total tax was zero or you did not have to file an income tax return.

Who Must Pay Estimated Tax?

If you had a tax liability for 2003, you may have to pay estimated tax for 2004.

General rule. You must pay estimated tax for 2004 if both of the following apply.

1) You expect to owe at least $1,000 in tax for 2004 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 2004 tax return, or
- 100% of the tax shown on your 2003 tax return. Your 2003 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 pay estimated tax. 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.*

Married taxpayers. To figure whether you must pay estimated tax, 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 2004.

2003 separate returns and 2004 joint return. If you plan to file a joint return with your spouse for 2004, but you filed separate returns for 2003, your 2003 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.

2003 joint return and 2004 separate returns. If you plan to file a separate return for 2004, but you filed a joint return for 2003, your 2003 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 2003 using the same filing status as for 2004. 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 2003 showing taxable income of $48,500 and a tax of $6,579. Of the $48,500 taxable income, $40,100 was Joe's and the rest was Heather's. For 2004, they plan to file married filing separately. Joe figures his share of the tax on the 2003 joint return as follows.

Tax on $40,100 based on a separate return	$ 6,841
Tax on $8,400 based on a separate return	914
Total	$ 7,755
Joe's percentage of total ($6,841 ÷ $7,755)	88%
Joe's share of tax on joint return ($6,579 × 88%)	$ 5,790

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 2004 estimated tax, it may be helpful to use your income, deductions, and credits for 2003 as a starting point. Use your 2003 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 2004, there are several changes in the law. Some of these changes are discussed in Publication 553, *High-*

lights of 2003 Tax Changes, or visit the IRS website 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 2004, 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	Apr. 15
April 1 through May 31	June 15
June 1 through Aug. 31	Sept. 15
Sept. 1 through Dec. 31	Jan. 15 next year**

*If your tax year does not begin on January 1, see the Form 1040–ES instructions.
**See *January payment,* later.

Saturday, Sunday, holiday rule. If the due date for 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, January 15, 2005, will be on time if you make it by Tuesday, January 18, 2005. January 17 is a legal holiday.

January payment. If you file your 2004 Form 1040 or Form 1040A by January 31, 2005, and pay the rest of the tax you owe, you do not need to make the payment due on January 18, 2005.

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 do not have income subject to estimated tax until a later payment period, you can 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 Sept. 15 Jan. 15 next year*
After Mar. 31 and before June 1	June 15	Sept. 15 Jan. 15 next year*
After May 31 and before Sept. 1	Sept. 15	Jan. 15 next year*
After Aug. 31	Jan. 15 next year*	(None)

*See *January payment,* and *Saturday, Sunday, holiday rule* under *When To Pay Estimated Tax,* earlier.

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 chapter 2 of 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.

Underpayment 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. See chapter 4 of Publication 505 for more information.

Change in estimated tax. After you make an 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.

Estimated Tax Payments Not Required

You do not have to pay estimated tax if your withholding in each payment period is at least as much as:

- One-fourth of your required annual payment, or
- Your required annualized income installment for that period.

You also do not have to pay estimated tax 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 2003 return to your 2004 estimated tax.
2) **By sending in your payment** with a payment-voucher from **Form 1040–ES.**
3) **By using the Electronic Federal Tax Payment System (EFTPS).** For EFTPS information, call **1–800–945–8400** or **1–800–555–4477.**
4) **By electronic funds withdrawal** if you are filing Form 1040 or Form 1040A electronically.
5) **By credit card** using a pay-by-phone system or the Internet.

Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 2003 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 2004. On line 71 of Form 1040, or line 46 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 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 2003 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 Form 1040–ES. 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.

CAUTION ***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 Electronic Funds Withdrawal or Credit Card

If you want to make estimated payments by electronic funds withdrawal 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 2003 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 2003. 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 $87,000 during 2003, 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 39.

Withholding

If you had income tax withheld during 2003, you should be sent a statement by February 2, 2004, 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 send you a Form W–2 for 2003 by February 2, 2004. You should receive a separate Form W–2 from each employer you worked for.

If you stopped working before the end of the year, your employer could have given you your Form W–2 at any time after you stopped working. However, your employer must send it to you by February 2, 2004.

If you ask for the form, your employer must send 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 on time, you should ask your employer for it. If you do not receive it by February 17, 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 61 if you file Form 1040,
- Line 39 if you file Form 1040A, or
- Line 7 if you file Form 1040EZ.

Form W–2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

Form W–2G

If you had gambling winnings in 2003, the payer may have withheld 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 61 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 be sent these forms by February 2, 2004. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,*
- Form 1099–DIV, *Dividends and Distributions,*
- Form 1099–G, *Certain Government Payments,*
- Form 1099–INT, *Interest Income,*
- Form 1099–MISC, *Miscellaneous Income,*
- Form 1099–OID, *Original Issue Discount,*
- Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,*
- Form SSA–1099, *Social Security Benefit Statement,* and
- Form RRB–1099, *Payments by the Railroad Retirement Board.*

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 61 of Form 1040 or line 39 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 2003, include the amount withheld, as shown on your Form 1099, in the total on line 61 of Form 1040, or line 39 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.*

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 2003 on line 62 of Form 1040 or line 40 of Form 1040A. Include any overpayment from 2002 that you had credited to your 2003 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,
- The IRS address to which you sent the payments,
- 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 2003 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 2003.

Divorced Taxpayers

If you made joint estimated tax payments for 2003, 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 2003.

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 2003, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 62, Form 1040, or line 40, 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 2003 if any of the following situations applies.

- The total of your withholding and estimated tax payments was at least as much as your 2002 tax (or 110% of your 2002 tax if your adjusted gross income was more than $150,000 — $75,000 if your 2003 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 2003 tax, and you paid all required estimated tax payments on time.
- Your total 2003 tax minus your withholding is less than $1,000.
- You did not have a tax liability for 2002.
- 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 attach it to your return if you think 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 compensation received for services as an employee, such as wages, salaries, and fringe benefits. The topics include:

- Bonuses and awards,
- Special rules for certain employees, and
- Sickness and injury benefits.

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 various types of employee compensation including fringe benefits, retirement plan contributions, stock options, and restricted property.

Form W–2. 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 childcare, 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 childcare providers apply to you.

Miscellaneous Compensation

This section discusses different types of employee compensation.

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 a nonnegotiable 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.

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.

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 your 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 generally 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*. File the form with 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 your 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.* File the form with 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 benefits such as discounts at company cafeterias, cab fares home when working overtime, and company picnics are 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, do not 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 applies to undergraduate and graduate-level courses. For more information, see Publication 970, *Tax Benefits for 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.

TIP *Certain employer-provided transportation can be excluded from gross income. See the discussion on* Transportation, *later.*

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 reduced by any amount you pay toward the purchase of the insurance.

For exceptions to this rule, see *Entire cost excluded,* and *Entire cost taxed,* later.

If your employer provided more than $50,000 of coverage, 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 to 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 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.

Former employer. If your former employer provides more than $50,000 of group-term life insurance coverage during the year, the amount included in your income is reported as wages in box 1 of Form W–2. Also, it is shown separately in box 12 with code C. Box 12 also will show the amount of uncollected social security and Medicare taxes on the excess coverage, with codes M and N. You must pay these taxes with your income tax return. Include them in your total tax on line 60, Form 1040, and enter "UT" and the amount of the taxes on the dotted line next to line 60.

Two or more employers. Your exclusion for employer-provided group-term life insurance coverage cannot exceed the cost of $50,000 of coverage, whether the insurance is provided by a single employer or multiple employers. If two or more employers provide insurance coverage that totals more than $50,000, the amounts reported as wages on your Forms W–2 will not be correct. You must figure how much to include in your income. Reduce the amount you figure by any amount reported with code C in box 12 of your Forms W–2, add the result to the wages reported in box 1, and report the total on your return.

Figuring the taxable cost. Use the following worksheet to figure the amount to include in your income.

Worksheet 6–1. **Figuring the Cost of Group-Term Life Insurance To Include in Income**

1. Enter the total amount of your insurance coverage from your employers	**1.**	_____
2. Limit on exclusion for employer-provided group-term life insurance coverage	**2.**	***50,000***
3. Subtract line 2 from line 1	**3.**	_____
4. Divide line 3 by $1,000. Figure to the nearest tenth	**4.**	_____
5. Go to *Table 6–1.* Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group	**5.**	_____
6. Multiply line 4 by line 5	**6.**	_____
7. Enter the number of full months of coverage at this cost.	**7.**	_____
8. Multiply line 6 by line 7	**8.**	_____
9. Enter the premiums you paid per month **9.** _____		
10. Enter the number of months you paid the premiums **10.** _____		
11. Multiply line 9 by line 10.	**11.**	_____
12. Subtract line 11 from line 8. **Include this amount in your income as wages**	**12.**	_____

Table 6–1. **Cost of $1,000 of Group-Term Life Insurance 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.

Worksheet 6–1. **Figuring the Cost of Group-Term Life Insurance to Include in Income—Illustrated**

1. Enter the total amount of your insurance coverage from your employers	**1.**	*80,000*
2. Limit on exclusion for employer-provided group-term life insurance coverage	**2.**	***50,000***
3. Subtract line 2 from line 1	**3.**	*30,000*
4. Divide line 3 by $1,000. Figure to the nearest tenth	**4.**	*30.0*
5. Go to *Table 6–1.* Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group	**5.**	*.23*
6. Multiply line 4 by line 5	**6.**	*6.90*
7. Enter the number of full months of coverage at this cost.	**7.**	*12*
8. Multiply line 6 by line 7	**8.**	*82.80*
9. Enter the premiums you paid per month **9.** *4.15*		
10. Enter the number of months you paid the premiums **10.** *12*		
11. Multiply line 9 by line 10.	**11.**	*49.80*
12. Subtract line 11 from line 8. **Include this amount in your income as wages**	**12.**	*33.00*

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.

Retirement Planning Services

If your employer has a qualified retirement plan, qualified retirement planning services provided to you (and your spouse) by your employer are not included in your income. Qualified services include retirement planning advice, information about your employer's retirement plan, and information about how the plan may fit into your overall individual retirement income plan. You cannot exclude the value of any tax preparation, accounting, legal, or brokerage services provided by your employer.

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 $100 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than $190 a month, regardless of its value.

If the benefits have a value that is more than these limits, the excess must be included in your income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- For transporting employees between their homes and work place, and
- 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, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualified parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work by mass transit, in a commuter highway vehicle, or by carpool. It does not include parking at or near the employee's home.

Retirement Plan Contributions

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,* earlier, under *Fringe Benefits.*

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 not transferable or is subject to a substantial risk of forfeiture (meaning you have a good chance of losing it) at the time of the contribution, you do not have to include the value of your interest in your income until it is transferable or is no longer subject to a substantial risk of forfeiture.

Elective deferrals. If you are covered by certain kinds of retirement plans, you can choose to have part of your compensation contributed by your employer to a retirement fund, rather than have it paid to you. The amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan. It is not included in wages subject to income tax at the time contributed. However, it is included in wages subject to social security and Medicare taxes.

Elective deferrals include elective contributions to the following retirement plans.

1) Cash or deferred arrangements (section 401(k) plans).
2) The Thrift Savings Plan for federal employees.
3) Salary reduction simplified employee pension plans (SARSEP).
4) Savings incentive match plans for employees (SIMPLE plans).
5) Tax-sheltered annuity plans (403(b) plans).
6) Section 501(c)(18)(D) plans.
7) Section 457 plans.

Overall limit on deferrals. For 2003, you generally should not have deferred more than a total of $12,000 of contributions to the plans listed in (1) through (6) above. You should not have deferred more than the lesser of your includible compensation or $12,000 of contributions to the plan listed in (7) above (section 457 plan). If you set aside more than the limit, the excess generally 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.

TIP *You may be allowed an additional elective deferral if you are age 50 or older.*

Your employer or plan administrator should apply the proper annual limit when figuring your plan contributions. However, you are responsible for monitoring the total you defer to ensure that the deferrals are not more than the overall limit.

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 when you receive the option, when you exercise the option (use it to buy or sell the stock or other property), or when you sell or otherwise dispose of the option. However, if your option is a statutory stock option, you 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 do not include the value of the property in your income until it has substantially vested. (You can choose to include the value of the property in your income in the year it is transferred to you.) For details, see *Restricted Property* in Publication 525.

Dividends you receive on restricted stock are treated as compensation and not as dividend income. 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.

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, and 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 for housing 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 designated housing allowance provided to you as part of your pay. However, the exclusion cannot be more than the reasonable pay for your service. The home or allowance must be provided as compensation for your services as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance 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.*

Pension. A pension or retirement pay for a member of the clergy is usually treated 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 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.

Employees of international organizations or foreign governments. Your compensation for official services to an international organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal income tax if all of the following are true.

1) You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).
2) Your work is like the work done by employees of the United States in foreign countries.
3) The foreign government gives an equal exemption to employees of the United States in its 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.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.

- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- 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.

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.
- 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.
- Leave allowances.
- 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. See chapter 26.

Sickness and Injury Benefits

This section discusses sickness and injury benefits including disability pensions, long-term care insurance contracts, workers' compensation, and other benefits.

Disability Pensions

Generally, if you retire on disability, you must report your pension or annuity as income.

TIP *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 35.*

For information on disability payments from a governmental program provided as a substitute for unemployment compensation, see chapter 13.

Disability income. 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.

TIP *Do not report as income any amounts paid to reimburse you for medical expenses you incurred after the plan was established.*

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.

Service-connected disability. 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. However, if the pension qualifies for the exclusion for a service-connected disability (discussed earlier), 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.

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.

Terrorist attack or military action. Do not include in your income disability payments you receive for injuries resulting directly from a terroristic or military action.

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 an insurance contract that only provides coverage for ***qualified long-term care services***. The contract must:

- Be guaranteed renewable,
- Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,
- 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
- Generally 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:

- Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance and personal care services, and
- Required by a ***chronically ill individual*** and provided pursuant to a plan of care as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified by a licensed health care practitioner within the previous 12 months as one of the following.

- 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.
- An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Limit on exclusion. You can generally exclude from gross income up to $220 a day for 2003. 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 an occupational sickness or injury.

CAUTION *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 Pensions,* 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.

CAUTION *If part of the payments you receive under FECA 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 a discussion of the taxability of these benefits, see* Social security and equivalent railroad retirement benefits *under* Other Income, *in Publication 525.*

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 used 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 disfig-

urement. 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, it 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. For information on how long to keep records, see Publication 552, *Recordkeeping for Individuals*.

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.

CAUTION *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 the tips for that month to that 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 May 2004 by June 10, 2004.

Example 2. You must report your tips received in June 2004 by July 12, 2004. July 10th is on a Saturday, and the 12th 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.

CAUTION **Uncollected taxes.** *You must report on your tax return any social security and Medicare taxes or railroad retirement tax that remained uncollected at the end of 2003. 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 2003 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 (or Cumulative Bulletin 2001–1).

Your employer can provide you with a copy of the agreement. If you want to learn more about these agreements, contact the local IRS 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 2003, including both cash tips and noncash tips, on your tax return. Any tips you reported to your employer for 2003 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.

CAUTION *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.*

CAUTION *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 2003) 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 56, Form 1040, and attach Form 4137 to your return.

CAUTION *If you are subject to the Railroad Retirement Tax Act, you cannot use Form 4137 to pay railroad retirement tax on unreported tips. To get railroad retirement credit, you must report tips to your employer.*

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 2003, 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 61, and write "UT" and the total of the uncollected taxes on the dotted line next to line 60.

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 2003 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 at the end of 2003. A child born on January 1, 1990, is considered to be age 14 at the end of 2003.
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 2003.

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 33.

Beneficiary of an estate or trust. Interest 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 2004, the percentage is 28%.

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 into 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 32 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 2003, 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 2003 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 2003. 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 noncash 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 4-week, 13-week, or 26-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:

Treasury Direct
Attn: Customer Information
P.O. Box 9150
Minneapolis, MN 55480–9150

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.

Treasury inflation-indexed securities. These securities pay interest twice a year at a fixed rate, based on a principal amount that is adjusted to take into account inflation and deflation. For the tax treatment of these securities, see *Inflation-Indexed Debt Instruments* under *Original Issue discount (OID),* in Publication 550.

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 2003, 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 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 and exclude $20 from your income for the year. You must include the $20 in your income for the year you can withdraw it.

Bonds traded flat. If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, the transaction is described as trading a bond flat. The defaulted or unpaid 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 of your bond. 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. In general, 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:

For series EE and I:
Bureau of the Public Debt
Accrual Services Division
P.O. Box 1328
Parkersburg, WV 26106–1328

For series HH/H:
Bureau of the Public Debt
Current Income Services Division
HH/H Assistance Branch
P.O. Box 2186
Parkersburg, WV 26106–2186

Or, on the Internet, visit:
www.savingsbonds.gov

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.*

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.*

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. 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. 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 all accrued interest is payable to you at maturity.

Reporting options for cash method taxpayers. 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 1963 and 1973 matured in 2003. If you have used method 1, you generally must report the interest on these bonds on your 2003 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.

TIP *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 as follows:"***Change in Method of Accounting Under Section 6.01 of the Appendix of Rev. Proc. 2002–9 (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:

Table 8–1. **Who Pays the Tax on U.S. Savings Bond Interest**

IF ...	THEN the interest must be reported 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 report one-half of the interest.

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 for the year of change (excluding extensions) to file the statement with an amended return. At the top of the statement, write "*Filed pursuant to section 301.9100–2.*" To get this extension, you must have filed your original return for the year of change by the due date (including extensions).

By the date you file the original statement with your return, you must also send a copy to the address below.

Internal Revenue Service
Attention: CC:IT&A (Automatic Rulings Branch)
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:IT&A (Automatic Rulings Branch),
1111 Constitution Avenue, NW
Room 4516
Washington, DC 20224

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. The former co-owner does not have to include in gross income at the time of reissue 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 differ-

ence 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 EE 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, see *How To Report Interest Income,* later. Publication 550 includes examples showing how to report these amounts.

TIP *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.*

You do not qualify for this exclusion if your filing status is married filing separately.

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.

CAUTION *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 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 or certificate granting 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 tuition program, or
   c) Certain employer-provided educational assistance benefits.

Effect of other education benefits. Do not include in your qualified expenses any expenses used to:

1) Figure an education credit on Form 8863,
2) Figure the nontaxable amount of a distribution from a Coverdell ESA, or
3) Figure the nontaxable amount of a distribution from a qualified state tuition program.

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 2003, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in April 1995. They received proceeds of $7,256, representing principal of $5,000 and interest of $2,256. In 2003, 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 a Coverdell ESA. They can exclude $1,244 ($2,256 × ($4,000 ÷ $7,256)) of interest in 2003. 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:

- $58,500 to $73,500 for taxpayers filing single or head of household, and
- $87,750 to $117,750 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 21 of Form 1040A or line 35 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,

6) Deduction for tuition and fees, and

7) 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 items 6 and 7), add the amount of the exclusion or deduction (except any deduction for tuition and fees or 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 royalties and other investment 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 from a nonqualified plan, not as interest income. See chapter 11 for information on pension and annuity income from nonqualified plans.

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 that pays interest at maturity, 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 a bond used to finance government operations is not taxable if the bond is issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions.

Bonds issued after 1982 by an Indian tribal government are treated as issued by a state. Interest on these bonds is generally tax exempt if the bonds are part of an issue of which substantially all of the proceeds are used in the exercise of any essential government function.

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, is taxable.

Generally, interest on private activity bonds 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, 2001, 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, 2003. In 2003, 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 2003 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: 2001, $80; 2002, $249.60; and 2003, $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 $1,500. 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 $1,500.
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 2003.
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 2003 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 $1,500.
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 2003.
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 7, on Form 1040A, line 39, or on Form 1040, line 61 (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 Change

Dividends taxed at new tax rate. After December 31, 2002, qualified dividends are taxed at the new capital gain rates. The maximum tax rate for qualified dividends is 15% (generally 5% for people whose other income is taxed at the 10% or 15% rate). See *Qualified Dividends.*

Important Reminder

Reporting dividends on your return. Ordinary dividend income that exceeds a certain amount must be reported on a separate schedule. If you file Form 1040A, you must attach Schedule 1 to your return if your ordinary dividend income is more than $1,500; if you file Form 1040, you must attach Schedule B to your return if your ordinary dividend income is more than $1,500.

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 2003 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 at the end of 2003. A child born on January 1, 1990, is considered to be age 14 at the end of 2003.
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) At least one of the child's parents was alive at the end of 2003.

If all of these statements are true, **Form 8615,** *Tax for Children Under Age 14 With 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 33.

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 2004, this percentage is 28%.

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 re-

ceived 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 1a of the Form 1099–DIV you receive.

Qualified Dividends

Qualified dividends are the ordinary dividends received in tax years beginning after 2002 that are subject to the same 5% or 15% maximum tax rate that applies to net capital gain. They should be shown in box 1b of Form 1099–DIV you receive.

Qualified dividends are subject to the 15% rate if the regular tax rate that would apply is 25% or higher. If the regular tax rate that would apply is lower than 25%, qualified dividends are subject to the 5% rate.

To qualify for the 5% or 15% maximum rate, all of the following requirements must be met.

1) The dividends must have been paid by a U.S. corporation or a qualified foreign corporation. (See *Qualified foreign corporation* later.)
2) The dividends are not of the type listed later under *Dividends that are not qualified dividends.*
3) You meet the holding period (discussed next).

Holding period. You must have held the stock for more than 60 days during the 120-day period that begins 60 days before the ex-dividend date. The ***ex-dividend*** date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days you held the stock, include the day you disposed the stock, but not the day you acquired it. See the examples later.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 180-day period that begins 90 days before the ex-dividend date ***if*** the dividends are attributable to periods totaling more than 366 days. If the preferred dividends are attributable to periods totaling less than 367 days, the holding period in the previous paragraph applies.

Example 1. You bought 5,000 shares of XYZ Corp. common stock on July 1, 2003. XYZ Corp. paid a cash dividend of 10 cents per share. The ex-dividend date was July 9, 2003. Your Form 1099–DIV from XYZ Corp. shows $500 in box 1a (ordinary dividends) and in box 1b (qualified dividends). However, you sold the 5,000 shares on August 4, 2003. You held your shares of XYZ Corp. for only 34 days of the 120–day period (from July 2, 2003, through August 4, 2003). The 120–day period began on May 10, 2003 (60 days before the ex-dividend date), and ended on September 6, 2003. You have no qualified dividends from XYZ Corp. because you did not hold the XYZ stock for more than 60 days.

Example 2. Assume the same facts as in Example 1 except that you bought the stock on July 8, 2003 (the day before the ex-dividend date), and you sold the stock on September 9, 2003. You held the stock for 63 days (from July 9, 2003, through September 9, 2003). However, you have no qualified dividends from XYZ Corp. because you held the stock for only 60 days of the 120–day period (from July 9, 2003, through September 6, 2003).

Example 3. You bought 10,000 shares of ABC Mutual Fund common stock on July 1, 2003. ABC Mutual Fund paid a cash dividend of 10 cents a share. The ex-dividend date was July 9, 2003. The ABC Mutual Fund advises you that the portion of the dividend eligible to be treated as qualified dividends equals 2 cents per share. Your Form 1099–DIV from ABC Mutual Fund shows total ordinary dividends of $1,000 and qualified dividends of $200. However, you sold the 10,000 shares on August 4, 2003. You have no qualified dividends from ABC Mutual Fund because you held the ABC Mutual Fund stock for less than 61 days.

Holding period reduced where risk of loss is diminished. When determining whether you met the minimum holding period discussed earlier, you cannot count any day during which you meet any of the following conditions.

1) You had an option to sell, were under a contractual obligation to sell, or had made (and not closed) a short sale of substantially identical stock or securities.
2) You were grantor (writer) of an option to buy substantially identical stock or securities.
3) Your risk of loss is diminished by holding one or more other positions in substantially similar or related property.

For information about how to apply condition (3), see Regulations section 1.246–5.

Qualified foreign corporation. A foreign corporation is a qualified foreign corporation if it meets any of the following conditions.

1) The corporation is incorporated in a U.S. possession.
2) The corporation is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines is satisfactory for this purpose and that includes an exchange of information program. For a list of those treaties, see *Table 9–1.*
3) The corporation does not meet (1) or (2) above, but the stock for which the dividend is paid is readily tradable on an established securities market in the United States. See *Readily tradable stock,* later.

Exception. A corporation is ***not*** a qualified foreign corporation if it is a foreign personal holding company, foreign investment company, or a passive foreign investment company during its tax year in which the dividends are paid or during its previous tax year.

Readily tradable stock. Common or ordinary stock, or an American depositary receipt in respect of that stock, is considered to satisfy requirement (3) if it is listed on one of the following securities markets: the New York Stock Exchange, the NASDAQ Stock Market, the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the Philadelphia Stock Exchange, or the Pacific Exchange.

Dividends that are not qualified dividends. The following dividends are ***not*** qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099–DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. (Report these amounts as interest income.)
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities which are held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.

Table 9–1. **Income Tax Treaties**

Income tax treaties that the United States has with the following countries satisfy requirement (2) under *Qualified foreign corporation.*		
Australia	Ireland	Romania
Austria	Israel	Russian Federation
Belgium	Italy	Slovak Republic
Canada	Jamaica	Slovenia
China	Japan	South Africa
Cyprus	Kazakhstan	Spain
Czech Republic	Korea	Sweden
Denmark	Latvia	Switzerland
Egypt	Lithuania	Thailand
Estonia	Luxembourg	Trinidad and Tobago
Finland	Mexico	Tunisia
France	Morocco	Turkey
Germany	Netherlands	Ukraine
Greece	New Zealand	United Kingdom
Hungary	Norway	Venezuela
Iceland	Pakistan	
India	Philippines	
Indonesia	Poland	
	Portugal	

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 shown in box 1a of Form 2439 as long-term capital gains in column (f) on line 11 of Schedule D (Form 1040). If there is an amount shown in box 1b of Form 2439, report that amount in column (g) on line 11 of Schedule D. 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 67, 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 1991 for $100. In 1994, 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 2003. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2003. 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, 1995, for $100. The corporation declared a common stock dividend of 5% on June 30, 2003. 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	$210.00
Basis (cost) of old stock after the stock dividend (($200 ÷ $210) × $100)	$95.24
Basis (cost) of stock dividend (($10 ÷ $210) × $100)	+ 4.76
Total	$100.00
Cash received	$10.00
Basis (cost) of stock dividend	– 4.76
Gain	$5.24

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 32 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. 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 9a of Form 1040 or Form 1040A. Report qualified dividends on line 9b of that form.

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 1a of Form 1099–DIV) are more than $1,500, or
2) You received, as a nominee, ordinary 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 9a, 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 1a of Form 1099–DIV) are more than $1,500, or
2) You received, as a nominee, ordinary dividends that actually belong to someone else.

If your ordinary dividends are more than $1,500, 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 9a, Form 1040.

Qualified dividends. Report qualified dividends (box 1b of Form 1099–DIV) on line 9b of Form 1040 or Form 1040A. Do not include any of the following on line 9b.

- Qualified dividends you received as a nominee. See *Nominees* under *How to Report Dividend Income* in chapter 1 of Publication 550.
- Dividends on stock for which you did not meet the holding period. See *Holding period* earlier under *Qualified Dividends*.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.

If you have qualified dividends, you must figure your tax by completing either Schedule D (Form 1040) or the *Qualified Dividends and Capital Gain Tax Worksheet* in the Form 1040 or 1040A instructions. If you have to file Schedule D (Form 1040), enter qualified dividends on line 23 of that schedule or line 2 of the *Schedule D Tax Worksheet*. If you do not have to file Schedule D (Form 1040), enter qualified dividends on line 2 of the *Qualified Dividends and Capital Gain Tax Worksheet*. To find out whether you have to file Schedule D, see the Form 1040 instructions.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your qualified dividends that are eligible for the 5% or 15% tax rate. Reduce it by the amount of qualified dividends you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on lines 4–6 of the *Qualified Dividends and Capital Gain Tax Worksheet* in the Form 1040 instructions, lines 24–26 of Schedule D, or lines 4–6 of the *Schedule D Tax Worksheet*. For more information about the limit on investment interest, see *Interest Expenses* in chapter 25.

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

Important Change

Special depreciation allowance increased. For qualified property you placed in service after May 5, 2003, you can claim a special depreciation allowance that is an additional depreciation deduction equal to 50% of the property's depreciable basis. However, you can still choose to claim an allowance at the 30% rate for property that qualifies for the 50% rate.

Qualified property includes property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of ***20 years or less***. See *Special Depreciation Allowance* under *Depreciation* later, for more information.

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 2003, the standard mileage rate for all business miles is 36 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 2003 Schedule E, you can deduct fees paid in 2003 to prepare Part I of your 2002 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 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.

Treat the property as being placed in service on the conversion date for depreciation.

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 2003, 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 brother 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 ordinarily 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,* later.

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 or 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 any rental income in your 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. However, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Worksheet 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. Even if you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted. If you did not deduct the correct amount of depreciation for property in any year, you may be able to make a correction for that year by filing Form 1040X *Amended U.S Individual Income Tax Return*. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation. 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

Worksheet 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.

the IRS. In some instances, you can receive automatic consent. For more information, see chapter 1 of Publication 946.

Land. You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

Depreciation Methods

There are three ways to figure depreciation. The depreciation method you use depends on the type of property and when the property was placed in service. For property used in rental activities you use one of the following.

- 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.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

CAUTION *This chapter discusses MACRS only. If you need more information about depreciating property placed in service before 1987, see Publication 534.*

If you placed property in service before 2003, 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. See chapter 2 of Publication 946.

No deduction greater than basis. The total of all your yearly depreciation deductions cannot

Table 10–1. **MACRS Recovery Periods for Property Used in Rental Activities**

Type of Property	MACRS Recovery Period: General Depreciation System	MACRS Recovery Period: 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
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	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.	

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 are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation for the apartment even though it is owned by the corporation. Your depreciation deduction is your share of the corporation's depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

Special Depreciation Allowance

You can claim a special depreciation allowance (in addition to your regular MACRS depreciation deduction) for qualified property you placed in service in 2003. For qualified property placed in service before May 6, 2003, the allowance is a depreciation deduction equal to ***30%*** of the property's depreciable basis. For qualified property placed in service after May 5, 2003, it is a depreciation deduction equal to ***50%*** of the property's depreciable basis, or you can choose to figure the deduction at the old 30% rate. The special depreciation allowance is figured before you calculate your regular MACRS deduction.

CAUTION *You should claim the special depreciation allowance for all qualified property. However, you can elect not to claim the allowance. If you make this election for any property, it applies to all property in the same property class placed in service during the year. See* How Can You Elect Not To Claim an Allowance? *in Publication 946 for more information.*

Qualified property. To qualify for the special depreciation allowance, your property must meet the following requirements.

1) It must be ***new*** property that is depreciated under MACRS with a recovery period of ***20 years or less***.
2) It must meet the following tests.
   a) Acquisition date test.
   b) Placed-in-service date test.
   c) Original use test.

Acquisition date test. Generally, you must have acquired the property after September 10, 2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance).

Placed-in-service date test. Generally, the property must be placed in service for use in your trade or business or for the production of income after September 10, 2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance), and before January 1, 2005.

Original use test. The original use of the property must have begun with you after September 10, 2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance). "Original use" means the first use to which the property is put, whether or not by you.

Example. Dave bought and placed in service a new refrigerator ($700) for one of his residential rental properties in June of 2003. Dave notes that the refrigerator has a 5-year recovery period (see *Table 10–1.*). Dave's refrigerator is qualifying property and he claims the special depreciation allowance using the 50% rate.

Dave determines the total depreciable basis of the property to be $700. Next, he multiplies this amount by 50% to figure his special depreciation allowance deduction of $350 ($700 × 50%). This leaves an adjusted basis of $350 ($700 – $350), which he will use to figure his MACRS deduction.

For more information, see *Special Depreciation Allowance* in Publication 946.

MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS.

MACRS consists of two systems that determine how you depreciate your property—the ***General Depreciation System (GDS)*** and the ***Alternative Depreciation System (ADS).*** GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

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 2003.

Excluded property. You cannot use MACRS for certain personal property placed in service in your rental property in 2003 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. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

Table 10–2. **Optional MACRS Tables**

Table 10–2–A. MACRS 5-Year property

	Half-year convention	Mid-quarter convention			
Year		**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 10–2–B. MACRS 7-Year property

	Half-year convention	Mid-quarter convention			
Year		**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 10–2–C. MACRS 15-Year property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Forth 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 10–2–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
Mar.	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
Jun.	1.970	3.636	3.636	3.636	3.636	3.636
Jul.	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.	0.4555	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

- 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 10–1.*

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 original 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 2003. 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.

Depreciable 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

Under MACRS, conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

Mid-month convention. A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property you placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40%

of the total basis of all such property you place in service during the tax year.

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half-year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

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. He elects not to claim the special depreciation allowance, discussed earlier. 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). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

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 10–2,* 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 10–2* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in Tables 10–2–A, 10–2–B, and 10–2–C make the change from declining balance to straight line in the year that straight line will yield an equal or 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.

CAUTION *Figure any special depreciation allowance on qualified property before using* Table 10–2–A, 10–2–B*, or* 10–2–C*, or the 5-, 7-, or 15-year property 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 10–2–A, 10–2–B, and 10–2–C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use *Table 10–2–A* for 5-year property, *Table 10–2–B* for 7-year property, and *Table 10–2–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 June. Your basis in the stove is $600 and your basis in the refrigerator is $1,000. After figuring the special depreciation allowance 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 10–2–A*, you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is $60 ($300 × .20) for the stove and $100 ($500 × .20) for the refrigerator.

For year 2, you find your depreciation percentage is 32%. That year's depreciation deduction will be $96 ($300 × .32) for the stove and $160 ($500 × .32) for the refrigerator.

Example 2. Assume the same facts as in *Example 1,* except you buy the refrigerator in October instead of June. 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 ($1,000) is more than 40% of the total basis of all property placed in service during the year ($1,600 × .40 = $640).

Because you placed the refrigerator in service in October, you use the fourth quarter column of *Table 10–2–A* and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator (after figuring the special depreciation allowance) is $25 ($500 × .05).

Because you placed the stove in service in June, you use the second quarter column of *Table 10–2–A* and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove (after figuring the special depreciation allowance) is $75 ($300 × .25).

Table 10–2–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 $160,000. Using *Table 10–2–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 $5,091 ($160,000 × .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 10–1 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 and nonresidential real property. For all other property, use the half-year or mid-quarter convention.

Election. For property placed in service during 2003, you choose to use ADS by entering the depreciation on line 20, Part III 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 and nonresidential real 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, all 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 tax 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, for 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.

How To Report Rental Income and Expenses

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040). 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 complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 2003,
- 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 $150,000. 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 $725. He uses the MACRS method with a 5-year recovery period. The refrigerator qualifies for the special depreciation allowance which he figures first.

Justin uses the percentage for January in *Table 10–2–D* to figure his depreciation deduction for the townhouse. He uses the percentage under "Half-year convention" in *Table 10–2–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:		
Townhouse ($150,000 × 3.485%)	5,228	
Refrigerator–special allowance ($725 × 50%)	363	
Refrigerator ($725 – $363 special allowance × 20%)	72	
Total depreciation		5,663
Net rental income for townhouse		$790

11.

Retirement Plans, Pensions, and Annuities

Important Reminders

Rollovers to and from qualified retirement plans. For rollover purposes, tax-sheltered annuity plans (403(b) plans) and eligible state or local government section 457 deferred compensation plans are qualified retirement plans. See *Rollovers.*

Hardship distribution. A hardship distribution from any retirement plan is not an eligible rollover distribution. See *Rollovers.*

Rollover by surviving spouse. You may be able to roll over a distribution you receive as the surviving spouse of a deceased employee into a qualified retirement plan or a traditional IRA. See *Rollovers.*

Eligible rollover distribution. You may be able to roll over the nontaxable part of a retirement plan distribution to another qualified retirement plan or a traditional IRA. See *Rollovers.*

Section 457 plan early distributions. The tax on early distributions may apply to certain distributions made from an eligible state or local government section 457 deferred compensation plan. See *Tax on Early Distributions.*

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 (including commercial annuities). 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 IRA 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 is paid under a qualified plan and 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 may have to figure the taxable part of each separately. You may have to 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 35.

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.*

Section 457 deferred compensation plans. If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

This chapter covers the tax treatment of benefits under eligible section 457 plans, but it does not cover the treatment of deferrals. For information on deferrals under section 457 plans, see *Retirement Plan Contributions* under *Employee Compensation* in Publication 525.

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 obligations 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. For more information about foreign employment contributions, see Publication 575.

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.

Annuity starting before November 19, 1996. If your annuity starting date is after July 1, 1986, and before November 19, 1996, you had to use the General Rule for either circumstance described above. You also had to use it for any fixed-period annuity. If you did not have to use the General Rule, you could have chosen to use it. If your annuity starting date is before July 2, 1986, you had to use the General Rule unless you could use the Three-Year Rule.

If you had to use the General Rule (or chose to use it), you must continue to use it each year that you recover your cost.

Who cannot use the General Rule. You cannot use the General Rule if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions apply to you. See *Who must use the Simplified Method,* earlier.

More information. For complete information on using the General Rule, including the actuarial tables you need, see Publication 939.

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.

Exclusion limit. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years.

Exclusion limited to cost. If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a recovery of the cost cannot exceed your total cost. 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.

Exclusion not limited to cost. If your annuity starting date is before 1987, you can continue to take your monthly exclusion for as long as you receive your annuity. If you chose a joint and survivor annuity, your survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your cost.

How to use it. Complete the *Simplified Method Worksheet* to figure your taxable annuity for 2003. 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 Smith, age 65, began receiving retirement benefits in 2003, under a joint and survivor annuity. Bill's annuity starting date is January 1, 2003. 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 Worksheet 11–A.

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

Worksheet 11–A. **Simplified Method Worksheet for Bill Smith**
(Keep for Your Records)

1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a			**1.**	14,400
2. Enter your cost in the plan (contract) at the annuity starting date	**2.**	31,000		
Note: *If your annuity starting date was* ***before this year*** *and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.*				
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, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6	**5.**	1,200		
6. Enter any amounts previously 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 for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b.			**9.**	13,200
Note: *If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.*				
10. Add lines 6 and 8			**10.**	1,200
11. Balance of cost to be recovered. Subtract line 10 from line 2			**11.**	29,800

TABLE 1 FOR LINE 3 ABOVE

IF the age at annuity starting date was...	**AND your 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

under the ***Three-Year Rule,*** include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the ***General Rule,*** apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree was 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 using the method that applies as if you were the employee.

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

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.

If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before January 2, 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.

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.

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.

- 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.
- 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).
- Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- 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.
- 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 January 2, 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 January 2, 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, the following plans are qualified retirement plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax sheltered annuity plan (403(b) plan).
- An eligible state or local government section 457 deferred compensation plan.

You generally must 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.

TIP *The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.*

Eligible rollover distributions. Generally, you can roll over any part of most nonperiodic distributions from a qualified retirement plan.

Rollover of nontaxable amounts. You may be able to roll over the nontaxable part of a distribution (such as your after-tax contributions) made to another qualified retirement plan or traditional IRA. The transfer must be made either through a direct rollover to a qualified plan that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional IRA.

If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.

Hardship distributions. Hardship distributions are no longer treated as eligible rollover distributions.

Additional exceptions. For more information about exceptions to eligible rollover distributions, see Publication 575.

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.)

CAUTION *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.

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. You can roll over a distribution 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 correctly shows a "1" in box 7. Instead, enter 10% of the taxable part of the distribution on line 57 of Form 1040 and write "No" under the heading "Other Taxes" to the left of line 57.

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 meet an exception to the tax on early distributions but box 7 of your Form 1099–R does not indicate an exception.

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:

- A qualified employee plan,
- A qualified employee annuity plan,
- A tax-sheltered annuity plan, or
- A state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here).

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.

TIP *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 plan (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 June 30, 2003, you were age 70½ on December 31, 2003. If your 70th birthday was on July 1, 2003, you reached age 70½ on January 1, 2004.

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:

- Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or

- 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, 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 generally 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.

TIP *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 35.*

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.

TIP *Disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies) are not included in income. For more information about payments to survivors of terrorist attacks, see Publication 3920,* Tax Relief for Victims of Terrorist Attacks.

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 2003, 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 the SSEB portion of tier 1 railroad retirement 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 may be 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 2003, 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.

TIP *If the only income you received during 2003 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 2003,
- $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 2003.

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 2003, for 2003 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 the* Social Security Benefits Worksheet *in your tax form instruction booklet).*

Example. You and your spouse (both over 65) are filing a joint return for 2003, and you both received social security benefits during the year. In January 2004, you received a Form SSA–1099 showing net benefits of $7,500 in box 5. Your spouse received a Form SSA–1099 showing net benefits of $3,500 in box 5. You also received a taxable pension of $19,000 and interest income of $500. You did not have any tax-exempt interest income. Your benefits are ***not*** taxable for 2003 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 2003 because your taxable gross income ($19,500) 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 2003, for 2003 and earlier years. (If you received more than one form, combine the amounts from box 5 and write in the total.) . . . . . A. $ 11,000

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. 5,500

C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total . . . . . C. 19,500

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. $25,000

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 the* Social Security Benefits Worksheet *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 2003 must be subtracted from the gross benefits you received in 2003. It does not matter whether the repayment was for a benefit you received in 2003 or in an earlier year. If you repaid more than the gross benefits you received in 2003, 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 2003 (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 2004, you can choose withholding at 7%, 10%, 15%, or 25% 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 2003, also enter "D" to the right of the word "benefits" on 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 2003, 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 2003, make the following entries. On Form 1040, enter "D" to the right of the word "benefits" on 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 2003.

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 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 2003 in your 2003 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 2003 income to figure the taxable part of the total benefits received in 2003. 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 2003 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 2003 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 2003. He received the following income in 2003:

Fully taxable pension	$18,600
Wages from part-time job	9,400
Taxable interest income	990
Total	$28,990

George also received social security benefits during 2003. The Form SSA–1099 he received in January 2004 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 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, 9a, 10-13a, 14, 15b, 16b, 17-19, and 21.
Form 1040A: Lines 7, 8a, 8b, 9a, 10a, 11b, 12b, and 13 28,990

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 30).
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 30),
- 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 20, minus any amounts on Form 1040A, lines 18 and 19.
Form 1040 filers: Enter the amount from Form 1040, line 33, minus any amounts on Form 1040, lines 25 and 26 . . . . . –0–

7. Is the amount on line 6 less than the amount on line 5?
No. STOP None of your benefits are taxable.
Yes. Subtract line 6 from line 5 31,980

8. If you are:
- Married filing jointly, enter $32,000
- Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003, enter $25,000

Note: If you are married filing separately and you lived with your spouse at any time in 2003, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17. 25,000

9. Is the amount on line 8 less than the amount on line 7?
No. STOP 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 2003, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b.
Yes. Subtract line 8 from line 7 6,980

10. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003 9,000

11. Subtract line 10 from line 9. If zero or less, enter –0– . . . . . –0–

12. Enter the ***smaller*** of line 9 or line 10 6,980

13. Enter one-half of line 12 3,490

14. Enter the ***smaller*** of line 2 or line 13 2,990

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– . . . . . –0–

16. Add lines 14 and 15 2,990

17. Multiply line 1 by 85% (.85) 5,083

18. **Taxable benefits.** Enter the ***smaller*** of line 16 or line 17 . . . . . $2,990
- Enter the amount from line 1 above on Form 1040, line 20a or on Form 1040A, line 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 2003. Ray is retired and received a fully taxable pension of $15,500. He also received social security benefits, and his Form SSA–1099 for 2003 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

Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*

2. Enter one-half of line 1 2,800

3. Enter the total of the amounts from:
Form 1040: Lines 7, 8a, 8b, 9a, 10-13a, 14, 15b, 16b, 17-19, and 21.
Form 1040A: Lines 7, 8a, 8b, 9a, 10a, 11b, 12b, and 13 29,750

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 30).
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 30),
- Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555–EZ, line 18), and
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico . . . . . –0–

5. Add lines 2, 3, and 4 32,550

6. ***Form 1040A filers:*** Enter the amount from Form 1040A, line 20, minus any amounts on Form 1040A, lines 18 and 19.
Form 1040 filers: Enter the amount from Form 1040, line 33, minus any amounts on Form 1040, lines 25 and 26 1,000

7. Is the amount on line 6 less than the amount on line 5?
No. STOP None of your benefits are taxable.
Yes. Subtract line 6 from line 5 31,550

8. If you are:
- Married filing jointly, enter $32,000
- Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003, enter $25,000

Note: If you are married filing separately and you lived with your spouse at any time in 2003, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17. . . . 32,000

9. Is the amount on line 8 less than the amount on line 7?
No. STOP 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 2003, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b.
Yes. Subtract line 8 from line 7 . . . . . _____

10. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003 . . . . . _____

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 2003. Joe is a retired railroad worker and in 2003 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
Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*	
2. Enter one-half of line 1	5,000
3. Enter the total of the amounts from: ***Form 1040:*** Lines 7, 8a, 8b, 9a, 10-13a, 14, 15b, 16b, 17-19, and 21. ***Form 1040A:*** Lines 7, 8a, 8b, 9a, 10a, 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 30). ***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 30), • 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 20, minus any amounts on Form 1040A, lines 18 and 19. ***Form 1040 filers:*** Enter the amount from Form 1040, line 33, minus any amounts on Form 1040, lines 25 and 26	–0–
7. Is the amount on line 6 less than the amount on line 5? **No.** STOP None of your benefits are taxable. **Yes.** Subtract line 6 from line 5	45,500
8. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003, enter $25,000 **Note:** If you are married filing separately and you lived with your spouse at any time in 2003, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17.	32,000
9. Is the amount on line 8 less than the amount on line 7? **No.** STOP 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 2003, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. **Yes.** Subtract line 8 from line 7	13,500
10. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2003	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 • 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.	$6,275

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 2003. 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 2003 with the itemized deduction included on line 27 of Schedule A.

2) Figure your tax for 2003 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 2003 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 amount from step 2(c) above on line 67 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 67. 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 taxable.

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

- ❑ **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). However, 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, Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,* or a similar statement from the barter exchange should be sent to you by February 2, 2004. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2003. 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 Schedule C–EZ (Form 1040) (or on Schedule F, *Profit or Loss From Farming* (Form 1040), if the debt is farm debt and 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 a 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.

Section 501(c)(3) organizations are defined in Publication 525.

A loan to refinance a qualified student loan will also qualify if it was made by an educational institution or a tax-exempt 501(a) organization under its program designed as described in (3)(b) above.

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.

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, *Bankruptcy Tax Guide.*
- 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.
- The debt is qualified farm debt and is canceled by a qualified person. See chapter 4 of Publication 225, *Farmer's Tax Guide.*
- 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.

Proceeds from an endowment contract. An endowment contract is a policy under which you are paid a specified amount of money on a certain date unless you die before that date, in which case, the money is paid to your designated beneficiary. 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, subtract any amount that you previously received under the contract and excluded from your income from the total premiums (or other consideration) paid for the contract. Include the part of the lump sum payment that is more than your cost in your income.

Public safety officer killed in the line of duty. If you are a survivor of a public safety officer who was killed in the line of duty, you may be able to exclude from income certain amounts you receive.

For this purpose, the term ***public safety officer*** includes law enforcement officers, firefighters, chaplains, and rescue squad and ambulance crew members. See Publication 559 for more information.

Accelerated Death Benefits

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured'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 based on each shareholder's pro rata share.

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 2003, you generally must include it in income if you deducted the tax in an earlier year. The payer should send Form 1099–G, *Certain Government Payments,* to you by February 2, 2004. The IRS will also receive a copy of the Form 1099–G. Use the *State and Local Income Tax Refund Worksheet* in the 2003 Form 1040 Instructions for line 10 to figure the amount (if any) to include in your income.

Mortgage interest refund. If you received a refund or credit in 2003 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 2003. 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 generally must 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 generally are 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 lesser of:

- Your recoveries, or
- The amount by which your itemized deductions exceeded the standard deduction.

Example. For 2002, you filed a joint return. Your taxable income was $20,000 and you were not entitled to any tax credits. Your standard deduction was $7,850, and you had itemized deductions of $9,000. In 2003, you received the following recoveries for amounts deducted on your 2002 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 2002.

Your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($9,000 – 7,850 = $1,150), so you must include your total recoveries in your income for 2003. 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 2003 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 2002, 2001, and 2000 are in Publication 525.

Example. You filed a joint return for 2002 with taxable income of $25,000. Your itemized deductions were $8,700. The standard deduction that you could have claimed was $7,850. In 2003 you recovered $2,400 of your 2002 itemized deductions. None of the recoveries were more than the actual deductions for 2002. Include $850 of the recoveries in your 2003 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 – 7,850 = $850).

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:

- The amount deducted on Schedule A (Form 1040), or
- The amount recovered.

Example. During 2002 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 2003, you received a $500 reimbursement from your medical insurance for your 2002 expenses. The only amount of the $500 reimbursement that must be included in your income for 2003 is $200—the amount actually deducted.

Other recoveries. See *Recoveries* in Publication 525 if:

- You have recoveries of items other than itemized deductions, or
- 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 Schedule 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 next to line 21.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on line 33 of Form 1040. Also enter the amount and "PPR" on the dotted line next to line 33.

If you do not rent personal property for 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 Schedule 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 (see *Type of deduction*, 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 2003 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 2003 claiming a credit for the repaid amount. Follow these steps.

1) Figure your tax for 2003 ***without*** deducting the repaid amount.

2) Refigure your tax from the earlier year without including in income the amount you repaid in 2003.

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 2003 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 67 of Form 1040, and write "I.R.C. 1341" next to line 67.

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 extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 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 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.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act.

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 2003 unemployment compensation you received in 2003, 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 2003 that you included in income in an earlier year, you can deduct the amount repaid on line 22 of Schedule A (Form 1040) if you itemize deductions. If the amount is more than $3,000, 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 10% of your payment.

CAUTION *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. They may be subject to social security and Medicare taxes. For more information, see *Supplemental Unemployment Benefits* in section 5 of Publication 15–A, *Employer's Supplemental Tax Guide*. 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 33 of Form 1040, and write "Sub-Pay TRA" and the amount on the dotted line next to line 33. 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 (nonunion) 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. Do not include post-disaster grants received under the Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. 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* under *Unemployment Benefits,* earlier.

Disaster relief payments. You can exclude from income any amount you receive that is a qualified disaster relief payment. A qualified disaster relief payment is an amount paid to you:

1) To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses that result from a qualified disaster,
2) To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of your home or repair or replacement of its contents to the extent it is due to a qualified disaster,
3) By a person engaged in the furnishing or sale of transportation as a common carrier because of the death or personal physical injuries incurred as a result of a qualified disaster, or
4) By a federal, state, or local government, or agency, or instrumentality in connection with a qualified disaster in order to promote the general welfare.

You can only exclude this amount to the extent any expense it pays for is not paid for by insurance or otherwise. The exclusion does not apply if you were a participant or conspirator in a terroristic action or his or her representative.

A qualified disaster is:

- A disaster which results from a terroristic or military action.
- A Presidentially-declared disaster.
- A disaster which results from an accident involving a common carrier, or from any other event, which is determined to be catastrophic by the Secretary of the Treasury or his or her delegate.

For amounts paid under item (4), a disaster is qualified if it is determined by an applicable federal, state, or local authority to warrant assistance from the federal, state, or local government, agency, or instrumentality.

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.

Alaska Permanent Fund dividend. 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, but you must reduce your basis by the amount of the rebate.

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 basis in the car 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. Emotional distress itself is not a physical injury or physical sickness, but 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 not due to a physical injury or sickness (for example, employment discrimination 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 (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 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:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- 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:

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A notary public, or
- 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 or Schedule C–EZ (Form 1040).

Executor, administrator, or personal representative of an estate. All personal representatives must include in their gross income fees paid to them from 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 are in the trade or business of being an executor, report these fees as self-employment income on Schedule C or Schedule C–EZ (Form 1040).

Notary public. Report payments for these services on Schedule C or Schedule C–EZ (Form 1040). These payments are ***not*** subject to self-employment tax. (See the separate instructions for Schedule SE (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 a qualified foster care 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) A qualified foster care placement agency.

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:

- 10 qualified foster individuals under age 19, or
- 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 Daycare 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 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.

TIP *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. Include the amount shown in box 2 on line 61 of Form 1040 as federal income tax withheld.

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.

CAUTION *If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct the loss.*

Holocaust victims restitution. Restitution payments you receive as a Holocaust victim (or the heir of a Holocaust victim) 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.

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 33 of Form 1040. Write "Jury Pay" and the amount on the dotted line next to line 33.

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 generally do not 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)*.

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 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.

- You were selected without any action on your part to enter the contest or proceeding.
- You are not required to perform substantial future services as a condition to receiving the prize or award.
- 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.

Qualified tuition programs (QTP). A qualified tuition program (also known as a 529 program) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's qualified higher education expenses at an eligible educational institution. A program can be established and maintained by a state, an agency or instrumentality of a state, or an eligible educational institution.

The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.

For 2003, the beneficiary generally does not include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified higher education expenses. However, the beneficiary must include in income any earnings distributed from a QTP established and maintained by an eligible educational institution. See Publication 970, *Tax Benefits for Education,* for more information.

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.

- Tier 1 railroad retirement benefits that are more than the social security equivalent benefit.
- Tier 2 benefits.
- 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:

- Tuition and fees to enroll at or attend an educational institution, or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board ***do not*** qualify for the exclusion. Get Publication 970 for more information on qualified scholarships and fellowship grants.

Payment for services. Generally, you must include in income the part of any scholarship or fellowship that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

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 970.

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.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.

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 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:

- A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 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
- ❑ **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 a 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, and both having 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 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 in your basis.

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) Fire 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) 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.

5) Fees for refinancing a mortgage.

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 property 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 related to 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.

Table 14–1. **Examples of Adjustments to Basis**

Increases to Basis	Decreases to Basis
• Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home	• Exclusion from income of subsidies for energy conservation measures • Casualty or theft loss deductions and insurance reimbursements
• Assessments for local improvements: Water connections Sidewalks Roads	• Credit for qualified electric vehicles • Section 179 deduction
• Casualty losses: Restoring damaged property	• Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property • Depreciation
• Legal fees: Cost of defending and perfecting a title	• Nontaxable corporate distributions
• Zoning costs	

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 from a manufacturer or seller.
- Easements.
- Gas-guzzler tax.
- Adoption tax benefits.
- Credit for employer-provided childcare.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis in 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.

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.

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	22,000
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.

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.

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 maximum credit allowable even if the credit allowed is less than that maximum amount. For 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 under rules in effect before May 7, 1997, you must reduce the basis of the home you acquired as a replacement by the amount of the postponed gain. For more information on the rules for the sale of a home, see chapter 16.

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.

- Qualifying property.
- 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. Like-kind property is property of the same nature or character, even if it differs in grade or quality. 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 total adjusted 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-kind 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.

At the time of the transfer, the transferor must give you 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 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 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 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 2003, 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 $39,000 ($50,000 minus the $11,000 annual exclusion). She paid a gift tax of $9,000 on the property. Your basis is $26,930, figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	–20,000
Net increase in value	$30,000
Gift tax paid	$9,000
Multiplied by ($30,000 ÷ $39,000)	× .77
Gift tax due to net increase in value	$6,930
Adjusted basis of property to your mother	+20,000
Your basis in the property	**$26,930**

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the individual's death.
- The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
- The value under the special-use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes.
- 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, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

Property Changed to Business or Rental Use

If you hold property for personal use and then 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.

- The FMV of the property on the date of the change.
- 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. You paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only 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 property changed to business or rental use, 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 in the property when you sell.

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. Your adjusted 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 2001 you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 2002 you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 2003 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 fund shares 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 who sells property located 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 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 chapter. Certain sales or trades of property are not discussed here.

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

- ❑ **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 (Form 1040)**.

What is a Sale or Trade?

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. Certain other transactions and events are treated as sales or trades.

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). Also enter the amount of your loss in parentheses in column (g) to the extent it is not a collectibles loss (defined in chapter 17).

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 received a note or other debt instrument for the property, see *How To Figure Gain or Loss* in

chapter 4 of Publication 550 to figure the amount realized.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale. 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.

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 – $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 + $8,000). Your gain is $22,000 ($28,000 – $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 trade 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 in writing 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 money 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 money 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 (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 a result 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 nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Additional information. For more information on trades of stock, see *Nontaxable Trades* in chapter 4 of Publication 550.

Insurance policies and annuities. You will not have a recognized gain or loss if the insured or annuitant is the same under both contracts and 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.

You also may not have to recognize gain or loss on an exchange of a portion of an annuity contract for another annuity contract. See Revenue Ruling 2003–76 and Notice 2003–51.

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 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 on the trade.

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 3 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*.

If you sell or trade at a loss property that you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

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 for 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 for 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, 1992, 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, 2003) 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 *Market discount bonds* under *Discounted Debt Instruments* in 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 part 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 *Recoveries* 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). Also enter the amount of the bad debt in parentheses in column (g) if the debt became worthless after May 5, 2003. 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 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 Section 1244 (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, 2002, and sold it on February 5, 2003, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2003, 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.

CAUTION *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 29, 2003. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on January 2, 2004. You received payment of the sales price on that same day. Report your gain on your 2003 return, even though you received the payment in 2004. 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 29. If you had sold the stock at a loss, you would also report it on your 2003 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.

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.

If you sold your main home in 2003, you may be able to exclude from income any gain up to a limit of $250,000 ($500,000 on a joint return in most cases). See *Excluding the Gain*, later. If you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Schedule D (Form 1040). You may also have to include Form 4797, *Sales of Business Property*. See *Reporting the Sale*, later.

If you have a loss on the sale, you cannot deduct it on your return.

The main topics in this chapter are:

- Figuring gain or loss,
- Basis,
- Excluding the gain,
- Ownership and use tests, and
- Reporting the sale.

Other topics include:

- Business use or rental of home, and
- Recapturing a federal mortgage subsidy.

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

This section explains the term "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 4, 2003, 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 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 *Business Use or Rental of Home*, later.

Figuring 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.***

Subtract the adjusted basis from the amount realized to get your gain or loss.

	Selling price
–	Selling expenses
	Amount realized
	Amount realized
–	Adjusted basis
	Gain or loss

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 as wages 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 to indicate your receipt (or expected receipt) of these items.

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. If you do not receive Form 1099–S, 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 must be determined before you can figure gain or loss on the

sale of your home. For information on how to figure your home's adjusted basis, see *Adjusted Basis* under *Determining 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.

Other Dispositions

The following rules apply to foreclosures and repossessions, abandonments, trades, and transfers to a spouse.

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. See 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. See Publication 523 for more information.

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).

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.*

Determining 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. See *Adjusted Basis*, later.

You can find more information on basis and adjusted basis in chapter 14 of this publication and in Publication 523.

Cost As Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Generally, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home. If you build, or contract to build, a new home, your purchase price can include costs of construction, as discussed 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 some of 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 paid 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.

Also see Publication 523 for additional items and a discussion of basis other than cost.

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, *Sale of Your Home*, 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 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 the gain from the sale in your gross income on your tax return for the year of the sale.

Maximum Exclusion

You can exclude up to $250,000 of the gain on the sale of your main home if all of the following are true.

1) You meet the ownership test.
2) You meet the use test.
3) During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.

You can exclude the entire gain on the sale of your main home up to $500,000 if all of the following are true.

1) You are married and file a joint return for the year.
2) Either you or your spouse meets the ownership test.
3) Both you and your spouse meet the use test.
4) 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.

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*, later.

Example 1—home owned and occupied for 3 years. Amanda bought and moved into her main home in September 2000. She sold the home at a gain on September 15, 2003. During the 5-year period ending on the date of sale (September 16, 1998 – September 15, 2003), she owned and lived in the home for 3 years. She meets the ownership and use tests.

Example 2—met ownership test but not use test. Dan bought a home in 1997. After living in it for 6 months, he moved out. He never lived in the home again and sold it at a gain on June 28, 2003. He owned the home during the entire 5-year period ending on the date of sale (June 29, 1998 – June 28, 2003). However, he did not live in it for the required 2 years. He meets the ownership test but not the use test. He cannot exclude any part of his gain on the sale, unless he qualified for a reduced maximum exclusion (explained later).

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 out the property during the absences, are counted as periods of use.

Example. Professor Paul Beard, who is single, bought and moved into a house on August 28, 2000. He lived in it as his main home continuously until January 5, 2002, 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 6, 2003, 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 qualifies for a reduced maximum exclusion (explained later). Even if he does qualify for a reduced maximum exclusion, he cannot exclude the part of the gain equal to the depreciation he claimed or should have claimed while renting the house. See *Depreciation 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 1994, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2000. In 2001, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 2003, 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, 1998, to July 10, 2003, the date she sold the apartment. She owned her apartment from December 1, 2000, to July 10, 2003 (more than 2 years). She lived in the apartment from July 11, 1998 (the beginning of the 5-year period), to April 14, 2001 (more than 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.

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 Exclusion,* earlier.)

Example 1 – one spouse sells a home. Emily sells her home in June 2003. 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 2003.

Example 2 – each spouse sells a home. The facts are the same as in *Example 1* except that Jamie also sells a home in 2003. 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 and you did not remarry 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 and uses it as his or her main 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 the ***primary reason*** you sold the home was:
   a) A change in place of employment,
   b) Health, or
   c) Unforeseen circumstances (as defined 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 the ***primary reason*** you sold the home was:
   a) A change in place of employment,
   b) Health, or
   c) Unforeseen circumstances (as defined next).

Use *Worksheet 3* in Publication 523 to figure your reduced maximum exclusion.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you did not anticipate before buying and occupying your main home. For more information on unforeseen circumstances, see Publication 523.

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.

Exception. You can still claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if the primary reason you sold the home was:

1) A change in place of employment,
2) Health, or
3) Unforeseen circumstances (as defined earlier).

For more information about this exception, see *More Than One Home Sold During 2-Year Period,* in Publication 523.

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, 1997, Amy bought a house. She moved in on that date and lived in it until May 31, 1999, when she moved out of the house and put it up for rent. The house was rented from June 1, 1999, to March 31, 2001. Amy moved back into the house on April 1, 2001, and lived there until she sold it on January 31, 2003. During the 5-year period ending on the date of the sale (February 1, 1998 – January 31, 2003), 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
2/1/98 – 5/31/99	16 months	
6/1/99 – 3/31/01		22 months
4/1/01 – 1/31/03	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, or should have claimed, for renting the house, as explained after *Example 2.*

Example 2. William owned and used a house as his main home from 1997 through 2000. On January 1, 2001, he moved to another state. He rented his house from that date until April 30, 2003, when he sold it. During the 5-year period ending on the date of sale (May 1, 1998 – April 30, 2003), 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, or should have claimed, for renting the house, as explained next.

Depreciation 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 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 amount allowed.

Property used partly for business or rental. If you used property partly as a home and partly for business or to produce income, see Publication 523.

Reporting the Sale

Do ***not*** report the 2003 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 in column (f) of line 1 or line 8 of Schedule D, depending on how long you owned the home. If you sold the home after May 5, 2003, also report the gain in column (g). 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 sold the home after May 5, 2003, also show the exclusion in column (g).

If you used the home for business or to produce rental income, you may have to 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 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.*

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.

Recapturing a Federal Mortgage Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture (pay back) 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 under the rules discussed earlier; 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.

17.

Reporting Gains and Losses

Important Change for 2003

Lower maximum tax rates on net capital gain. For sales and other dispositions of property after May 5, 2003 (including installment payments received after that date), the maximum tax rates on net capital gain have changed as follows.

- The 20% and 10% tax rates have been lowered to 15% and 5%, respectively.
- The 8% tax rate for qualified 5-year gain has been eliminated. Instead, the new 5% rate applies to gain that would have qualified for the 8% rate.

There is no change to the maximum tax rates that apply to collectibles gain, gain on qualified small business stock, and unrecaptured section 1250 gain.

Elimination of 18% rate. In 2006, the 20% rate was scheduled to be lowered to 18% for qualified 5-year gain from property with a holding period that began after 2000. The 18% rate and the 5-year holding period have been eliminated. The new 15% rate applies to gain on property held for more than 1 year.

Taxpayers who owned certain assets on January 1, 2001, could have elected to treat those assets as sold and repurchased on the same date, if they paid tax for 2001 on any resulting gain. The purpose of the election was to make any future gain on the asset eligible for the 18% rate. That election is irrevocable. Thus, if you made the election, you may ***not*** amend your 2001 income tax return to get a refund of the tax you paid on the resulting gain.

Qualified dividends. Qualified dividends are subject to the same 5% or 15% maximum tax rate that applies to net capital gain. They should be shown in box 1b of Form 1099–DIV you receive. See chapter 9 for more information.

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 2003 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.

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

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 25% or higher	**20%** for sales[2] before May 6, 2003
	15% for sales[2] after May 5, 2003
Other gain,[1] and the regular tax rate that would apply is lower than 25%	**8%** or **10%** for sales[3] before May 6, 2003
	5% for sales[2] after May 5, 2003

[1] Other gain means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.
[2] The term "sales" includes trades, involuntary conversions, and installment payments received.
[3] The 8% rate is only for qualified 5-year gain.

amount you report in column (f) and/or column (g) 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 7b of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of investment 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 you report in column (f) or column (g) 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 10a of Form 1040A or line 13a 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).

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 and box 2b of Form 1099–DIV (or substitute statement).
2) You do not have an amount in box 2c, 2d, 2e, or 2f of any Form 1099–DIV (or substitute statement).
3) You do not file Form 4952 or, if you do, and the amount on line 4g of that form includes any qualified dividends, that amount also includes all of your net capital gains from the disposition of property held for investment.

If all the above statements are true, report your capital gain distributions directly on line 13a of Form 1040 and check the box on line 13a. Enter post-May 5 capital gain distributions on line 13b. Also, use the *Qualified Dividends and Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

You can report your capital gain distributions on line 10a 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 2c, 2d, 2e, or 2f.
2) You do not have to file Form 1040 for any other capital gains or any capital losses.

Enter post-May 5 capital gain distributions on line 10b.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7b) with your net long-term capital gain or loss (line 16). Enter the result on line 17a, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses,* next. If both lines 16 and 17a are gains and line 40 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 13a 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 17a 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 17a 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 Publication 550 to determine the part of your capital loss for 2003 that you can carry over to 2004.

Example. Bob and Gloria sold securities in 2003. 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 2003 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 – $3,000), can be carried over to 2004.

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 the short-term capital loss, use the long-term capital 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.

For 2003, the maximum capital gain rates are 5%, 8%, 10%, 15%, 20%, 25%, or 28%. See *Table 17–1* for details.

TIP *If you figure your tax using the maximum capital gain rates and the regular tax computation results in a lower tax, the regular tax computation applies.*

Example. All of your net capital gain is from selling collectibles, so the capital gain rate would be 28%. Because you are single and your taxable income is $25,000, none of your taxable income will be taxed above the 15% rate. The 28% rate does not apply.

8% rate. The 10% maximum 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 sold before May 6, 2003.

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 24–26 of Schedule D, lines 4–6 of the *Qualified Dividends and Capital Gain Tax Worksheet*, or lines 3–10 of the *Schedule D Tax Worksheet*. For more information about the limit on investment interest, see chapter 3 of Publication 550.

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 *Unrecaptured Section 1250 Gain 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 17a of Schedule D are gains. (Line 16 is your net long-term capital gain or loss. Line 17a 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 40, 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 20 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 the Qualified Dividends and Capital Gain Tax Worksheet. If you have qualified dividends or capital gain distributions but do not have to file Schedule D (Form 1040), figure your tax using the *Qualified Dividends and Capital Gain Tax Worksheet* in the instructions for Form 1040A or Form 1040. For more information, see *Capital gain distributions only*, earlier.

Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from stocks and other securities. For the 2003 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 1992, for $1,000. She had bought 100

28% Rate Gain Worksheet for Emily Jones—Line 20

1. Enter the total of all collectibles gain or (loss) from items you reported on line 8, column (f), of Schedules D and D-1	**1.**	0
2. Enter as a positive number the amount of any section 1202 exclusion you reported on line 8, column (f), of Schedules D and D-1	**2.**	1,500
3. Enter the total of all collectibles gain or (loss) from Form 4684, line 4 (but only if Form 4684, line 15, is more than zero); Form 6252; Form 6781, Part II; and Form 8824	**3.**	
4. Enter the total of any collectibles gain reported to you on: • Form 1099-DIV, box 2f; • Form 2439, box 1f; and • Schedule K-1 from a partnership, S corporation, estate, or trust.	**4.**	
5. Enter your long-term capital loss carryovers from Schedule D, line 14, and Schedule K-1 (Form 1041), line 13c	**5.**	(500)
6. If Schedule D, line 7b, is a (loss), enter that (loss) here. Otherwise, enter -0-	**6.**	(550)
7. Combine lines 1 through 6. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 20	**7.**	450

more shares in 1994 for $2,200, and an additional 300 shares in 1997 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 columns (f) and (g) of line 8.

In December, she sold 20 shares of Toy Co. for $4,100. This was qualified small business stock that she had bought in September 1998. 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 claims the exclusion on the line below by entering $1,500 as a loss in column (f). She also enters the exclusion as a positive amount on line 2 of the *28% Rate Gain Worksheet*.

She received a Form 1099–B (not shown) from her broker for each of these transactions.

Capital loss carryover from 2002. Emily has a capital loss carryover to 2003 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 also enters the $500 long-term capital loss carryover on line 5 of the *28% Rate Gain Worksheet*. Her filled-in *28% Rate Gain Worksheet* is shown here.

She kept the completed *Capital Loss Carryover Worksheet* in her 2002 Schedule D instructions (not shown), so she could properly report her loss carryover for the 2003 tax year without refiguring it.

Tax computation. Because Emily has gains on both lines 16 and 17a of Schedule D and has taxable income, she goes to Part IV of Schedule D to figure her tax. But because line 20 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.

After entering the gain from line 17a on line 13 of her Form 1040, she completes the rest of Form 1040 through line 40. She enters the amount from that line, $30,000, on line 1 of the Schedule D Tax Worksheet. After filling out the rest of that worksheet, she figures her tax is $3,651. This is less than the $4,316 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 2003, the total 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

2003

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-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) for the entire year Subtract (e) from (d)	(g) Post-May 5 gain or (loss)* (see below)
1 100 sh Trucking Co.	2-12-03	6-12-03	900	650	250	250
25 sh Computer Co.	6-29-03	7-30-03	2,000	2,500	(500)	(500)

2 Enter your short-term totals, if any, from Schedule D-1, line 2	2		
3 **Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3	2,900	
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4		
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5		
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2002 Capital Loss Carryover Worksheet	6	(300)	
7a Combine lines 1 through 5 in column (g). If the result is a loss, enter the result. Otherwise, enter -0-. **Do not** enter more than zero	7a		(250)
b **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7b	(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-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) for the entire year Subtract (e) from (d)	(g) Post-May 5 gain or (loss)* (see below)
8 60 sh Car Co.	INHERITED	2-3-03	2,100	2,500	(400)	
500 sh Furniture Co.	VARIOUS	6-29-03	14,000	4,700	9,300	9,300
20 sh Toy Co.	9-28-98	12-15-03	4,100	1,100	3,000	
Section 1202 exclusion					(1,500)	

9 Enter your long-term totals, if any, from Schedule D-1, line 9	9		
10 **Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	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	11		
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12		
13 Capital gain distributions. See page D-2	13		
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your 2002 Capital Loss Carryover Worksheet	14	(500)	
15 Combine lines 8 through 13 in column (g). If zero or less, enter -0-	15		9,300
16 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) **Next:** Go to Part III on the back.	16	9,900	

*Include in column (g) all gains and losses from column (f) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, **do not** include gain attributable to unrecaptured section 1250 gain, "collectibles gains and losses" (as defined on page D-8) or eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2003**

Part III Taxable Gain or Deductible Loss

17a	Combine lines 7b and 16 and enter the result. If a loss, enter -0- on line 17b and go to line 18. If a gain, enter the gain on Form 1040, line 13a, and go to line 17b below	17a	9,350
b	Combine lines 7a and 15. If zero or less, enter -0-. Then complete Form 1040 through line 40.	17b	9,050
	Next: • If line 16 of Schedule D is a gain **or** you have qualified dividends on Form 1040, line 9b, complete **Part IV** below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
18	If line 17a is a loss, enter here and on Form 1040, line 13a, the **smaller** of **(a)** that loss or **(b)** ($3,000) (or, if married filing separately, ($1,500)) (see page D-7)	18	( )
	Next: • If you have qualified dividends on Form 1040, line 9b, complete Form 1040 through line 40, and then complete **Part IV** below (but skip lines 19 and 20). • Otherwise, skip **Part IV** below and complete the rest of Form 1040.		

Part IV Tax Computation Using Maximum Capital Gains Rates

If line 16 or line 17a is zero or less, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19.

19	Enter your unrecaptured section 1250 gain, if any, from line 18 of the worksheet on page D-7			19	
20	Enter your 28% rate gain, if any, from line 7 of the worksheet on page D-8			20	450

If lines 19 and 20 are zero, go to line 21. Otherwise, complete the worksheet on page D-11 to figure the amount to enter on lines 35 and 53 below, and skip all other lines below.

21	Enter your taxable income from Form 1040, line 40			21	
22	Enter the **smaller** of line 16 or line 17a, but not less than zero		22		
23	Enter your qualified dividends from Form 1040, line 9b		23		
24	Add lines 22 and 23		24		
25	Amount from line 4g of Form 4952 (investment interest expense)		25		
26	Subtract line 25 from line 24. If zero or less, enter -0-			26	
27	Subtract line 26 from line 21. If zero or less, enter -0-			27	
28	Enter the **smaller** of line 21 **or:** • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household		28		
	If line 27 is more than line 28, skip lines 29–39 and go to line 40.				
29	Enter the amount from line 27		29		
30	Subtract line 29 from line 28. If zero or less, enter -0- and go to line 40		30		
31	Add lines 17b and 23*	31			
32	Enter the **smaller** of line 30 or line 31		32		
33	Multiply line 32 by 5% (.05)			33	
	If lines 30 and 32 are the same, skip lines 34–39 and go to line 40.				
34	Subtract line 32 from line 30		34		
35	Enter your qualified 5-year gain, if any, from line 8 of the worksheet on page D-10	35			
36	Enter the **smaller** of line 34 or line 35		36		
37	Multiply line 36 by 8% (.08)			37	
38	Subtract line 36 from line 34		38		
39	Multiply line 38 by 10% (.10)			39	
	If lines 26 and 30 are the same, skip lines 40–49 and go to line 50.				
40	Enter the **smaller** of line 21 or line 26		40		
41	Enter the amount from line 30 (if line 30 is blank, enter -0-)		41		
42	Subtract line 41 from line 40		42		
43	Add lines 17b and 23*	43			
44	Enter the amount from line 32 (if line 32 is blank, enter -0-)	44			
45	Subtract line 44 from line 43	45			
46	Enter the **smaller** of line 42 or line 45		46		
47	Multiply line 46 by 15% (.15)			47	
48	Subtract line 46 from line 42		48		
49	Multiply line 48 by 20% (.20)			49	
50	Figure the tax on the amount on **line 27.** Use the Tax Table or Tax Rate Schedules, whichever applies			50	
51	Add lines 33, 37, 39, 47, 49, and 50			51	
52	Figure the tax on the amount on **line 21.** Use the Tax Table or Tax Rate Schedules, whichever applies			52	
53	**Tax on all taxable income.** Enter the **smaller** of line 51 or line 52 here and on Form 1040, line 41			53	3,424

*If lines 23 and 25 are more than zero, see **Lines 31 and 43** on page D-9 for the amount to enter.

Schedule D (Form 1040) 2003

Schedule D Tax Worksheet—Line 53

Complete this worksheet only if line 19 or line 20 of Schedule D is more than zero.

1.	Enter your taxable income from Form 1040, line 40						**1.**	30,000
2.	Enter your qualified dividends from Form 1040, line 9b	**2.**						
3.	Enter the amount from Form 4952, line 4g	**3.**						
4.	Enter the amount from Form 4952, line 4e*	**4.**						
5.	Subtract line 4 from line 3. If zero or less, enter -0-	**5.**						
6.	Subtract line 5 from line 2. If zero or less, enter -0-			**6.**				
7.	Enter the **smaller** of line 16 or line 17a of Schedule D	**7.**	9,350					
8.	Enter the **smaller** of line 3 or line 4	**8.**						
9.	Subtract line 8 from line 7. If zero or less, enter -0-			**9.**	9,350			
10.	Add lines 6 and 9					**10.**	9,350	
11.	Add lines 19 and 20 of Schedule D			**11.**	450			
12.	Enter the **smaller** of line 9 or line 11					**12.**	450	
13.	Subtract line 12 from line 10.							**13.** 8,900
14.	Subtract line 13 from line 1. If zero or less, enter -0-.							**14.** 21,100
15.	Enter the **smaller** of line 1 or: • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household.			**15.**	28,400			
16.	Enter the **smaller** of line 14 or line 15			**16.**	21,100			
17.	Subtract line 10 from line 1. If zero or less, enter -0-	**17.**	20,650					
18.	Enter the **larger** of line 16 or line 17 ▶					**18.**	21,100	
	If lines 15 and 16 are the same, skip lines 19 through 28 and go to line 29. Otherwise, go to line 19.							
19.	Subtract line 16 from line 15 ▶					**19.**	7,300	
20.	Add the amounts on Schedule D, line 17b, and line 6 above			**20.**	9,050			
21.	Enter the **smaller** of line 19 or line 20					**21.**	7,300	
22.	Multiply line 21 by 5% (.05)							**22.** 365
	If lines 19 and 21 are the same, skip lines 23 through 28 and go to line 29. Otherwise, go to line 23.							
23.	Subtract line 21 from line 19					**23.**		
24.	Qualified 5-year gain from the worksheet on page D-10. **Also enter on Schedule D, line 35**			**24.**				
25.	Enter the **smaller** of line 23 or line 24					**25.**		
26.	Multiply line 25 by 8% (.08)							**26.**
27.	Subtract line 25 from line 23					**27.**		
28.	Multiply line 27 by 10% (.10)							**28.**
	If lines 1 and 15 are the same, skip lines 29 through 47 and go to line 48. Otherwise, go to line 29.							
29.	Enter the **smaller** of line 1 or line 13			**29.**	8,900			
30.	Enter the amount from line 19 (if line 19 is blank, enter -0-)			**30.**	7,300			
31.	Subtract line 30 from line 29. If zero or less, enter -0- ▶					**31.**	1,600	
32.	Add the amounts on Schedule D, line 17b, and line 6 above			**32.**	9,050			
33.	Enter the amount from line 21 (if line 21 is blank, enter -0-)			**33.**	7,300			
34.	Subtract line 33 from line 32			**34.**	1,750			
35.	Enter the **smaller** of line 31 or line 34					**35.**	1,600	
36.	Multiply line 35 by 15% (.15)							**36.** 240
37.	Subtract line 35 from line 31					**37.**	0	
38.	Multiply line 37 by 20% (.20)							**38.** 0
	If Schedule D, line 19, is zero or blank, skip lines 39 through 44 and go to line 45. Otherwise, go to line 39.							
39.	Enter the **smaller** of line 9 above or Schedule D, line 19			**39.**				
40.	Add lines 10 and 18	**40.**						
41.	Enter the amount from line 1 above	**41.**						
42.	Subtract line 41 from line 40. If zero or less, enter -0-			**42.**				
43.	Subtract line 42 from line 39. If zero or less, enter -0- ▶					**43.**		
44.	Multiply line 43 by 25% (.25)							**44.**
	If Schedule D, line 20, is zero or blank, skip lines 45 through 47 and go to line 48. Otherwise, go to line 45.							
45.	Add lines 18, 19, 31, and 43					**45.**	30,000	
46.	Subtract line 45 from line 1					**46.**	0	
47.	Multiply line 46 by 28% (.28)							**47.** 0
48.	Figure the tax on the amount on **line 18**. Use the Tax Table or Tax Rate Schedules, whichever applies							**48.** 2,819
49.	Add lines 22, 26, 28, 36, 38, 44, 47, and 48							**49.** 3,424
50.	Figure the tax on the amount on **line 1.** Use the Tax Table or Tax Rate Schedules, whichever applies							**50.** 4,316
51.	**Tax on all taxable income (including capital gains and qualified dividends).** Enter the **smaller** of line 49 or line 50. Also enter this amount on Schedule D, line 53, **and** Form 1040, line 41							**51.** 3,424

*Or, if applicable, the smaller amount entered on the dotted line next to line 4e of Form 4952.

Part Four.

Adjustments to Income

The four chapters in this part discuss six 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,*
- *Alimony you pay — chapter 20, and*
- *Educator expenses, student loan interest, and tuition and fees you pay— chapter 21.*

Other adjustments to income are discussed in other parts of this publication. For details, see Table V below.

Table V. **Other Adjustments to Income**

Use this table to find information about other adjustments to income not covered in this part of the publication.

IF you are looking for more information about the deduction for...	**THEN see...**
One-half of 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*.
Contributions to an Archer MSA	Chapter 23.
Penalty on the 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)(D) 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.
Overnight travel expenses of Reserve Component members	Chapter 28.
Certain required repayments of supplemental unemployment benefits (sub-pay)	Chapter 13.
Foreign housing costs	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*.
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 2003

Modified AGI limit for traditional IRAs increased. For 2003, if you were covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is:

- More than $60,000 but less than $70,000 for a married couple filing a joint return or a qualifying widow(er),
- More than $40,000 but less than $50,000 for a single individual or head of household, or
- Less than $10,000 for a married individual filing a separate return.

For all filing statuses other than married filing separately, the upper and lower limits of the phaseout range increased by $6,000. For more information, see *How Much Can You Deduct?* under *Traditional IRAs,* later.

Deemed IRAs. For plan years beginning after 2002, a qualified employer plan (retirement plan) can maintain a separate account or annuity under the plan (a deemed IRA) to receive voluntary employee contributions. If the separate account or annuity otherwise meets the requirements of an IRA, it will be subject only to IRA rules. An employee's account can be treated as a traditional IRA or a Roth IRA.

For this purpose, a "qualified employer plan" includes:

- A qualified pension, profit-sharing, or stock bonus plan (section 401(a) plan),
- A qualified employee annuity plan (section 403(a) plan),
- A tax-sheltered annuity plan (section 403(b) plan), and
- A deferred compensation plan (section 457 plan) maintained by a state, a political subdivision of a state, or an agency or instrumentality of a state or political subdivision of a state.

Important Changes for 2004

Modified AGI limit for traditional IRA contributions increased. For 2004, 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:

- more than $65,000 but less than $75,000 for a married couple filing a joint return or a qualifying widow(er),
- more than $45,000 but less than $55,000 for a single individual or head of household, or
- less than $10,000 for a married individual filing a separate return.

For all filing statuses other than married filing separately, the upper and lower limits of the phaseout range will increase by $5,000. See *How Much Can You Deduct?* under *Traditional IRAs,* later.

New method for figuring net income on returned or recharacterized IRA contributions. There is a new method for figuring the net income on IRA contributions made after 2003 that are returned to you or recharacterized. For more information, see *How Do You Recharacterize a Contribution* or *Contributions Returned Before the Due Date* in chapter 1 of Publication 590.

Important Reminders

Traditional IRA contribution and deduction limit. Unless you reached age 50 before 2004, the most that can be contributed to your traditional IRA for 2003 is the smaller of the following amounts:

- ***$3,000***, or
- Your taxable compensation for the year.

If you reached age 50 before 2004, the most that can be contributed to your traditional IRA for 2003 is the smaller of the following amounts:

- ***$3,500***, or
- Your taxable compensation for the year.

For more information, see *How Much Can Be Contributed?* under *Traditional IRAs,* later.

Note. The $3,000 and $3,500 amounts do not increase for 2004.

Credit for IRA contributions and salary reduction contributions. 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 or salary reduction contributions to your SIMPLE. 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 chapter 39.

Rollovers of distributions from employer plans. You can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA. For more information, see *Rollover From Employer's Plan Into an IRA* under *Can You Move Retirement Plan Assets?* under *Traditional IRAs,* later.

Kinds of rollovers from a traditional IRA. You can roll over, tax free, a distribution from your traditional IRA into a qualified plan. For more information, see *Rollovers* under *Can You Move Retirement Plan Assets?* under *Traditional IRAs,* later.

Rollovers of deferred compensation plans of state and local governments (section 457 plans) into traditional IRAs. If you participate in an eligible deferred compensation plan of a state or local government, you may be able to roll over part or all of your account tax free into an eligible retirement plan. The most that you can roll over is the amount that qualifies as an eligible rollover distribution. The rollover may be either direct or indirect. For more information, see *Rollovers* under *Traditional IRAs,* later.

Roth IRA contribution limit. If contributions on your behalf are made only to Roth IRAs, your contribution limit for 2003 generally is the lesser of:

- ***$3,000***, or
- Your taxable compensation.

If you were 50 years of age or older in 2003 and contributions on your behalf are made only to Roth IRAs, your contribution limit for 2003 generally is the lesser of:

- ***$3,500***, 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 *Can You Contribute to a Roth IRA?* under *Roth IRAs,* later.

Note. The $3,000 and $3,500 amounts do not increase for 2004.

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 2003 is the lesser of:

- ***$3,000*** (***$3,500*** if you were 50 years of age or older in 2003) 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 *Can You Contribute to a Roth IRA?* under *Roth IRAs,* later.

Note. The $3,000 and $3,500 amounts do not increase for 2004.

Statement of required minimum distribution. If a minimum distribution is required from your IRA, the trustee, custodian, or issuer that held the IRA at the end of the preceding year must either report the amount of the required minimum distribution to you, or offer to calculate it for you. The report or offer must include the date by which the amount must be distributed. The report is due January 31 of the year in which the minimum distribution is required. It can be provided with the year-end fair market value statement that you normally get each year. No report is required for IRAs of owners who have died.

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,* 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 $3,000 ($3,500 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 *Can you contribute to a Roth IRA for your spouse?* under *Roth IRAs,* later.

TIP *The term "**50 or older**" is used several times in this chapter. It refers to an IRA owner who is age 50 or older by the end of the tax year.*

Note. Employer contributions under a SEP plan are not counted when figuring the limits just discussed. SEP plans are discussed in Publication 560.

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 You Deduct?* under *Traditional IRAs*.

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 gives you tax advantages for setting aside money for your retirement.

This chapter discusses:

1) The rules for a ***traditional IRA*** (any IRA that is not a Roth or SIMPLE IRA), 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 Publications 560 and 590.

Useful Items

You may want to see:

Publication

- ❑ **560** Retirement Plans for Small Business
- ❑ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ❑ **5329** Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts
- ❑ **8606** Nondeductible IRAs

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? Generally, compensation is what you earn from working. 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.

CAUTION *Contributions to your traditional IRAs reduce your 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) $3,000 ($3,500 if you are 50 or older), or
2) Your taxable compensation (defined earlier) for the year.

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 34 years old and single, earned $24,000 in 2003. Her IRA contributions for 2003 are limited to $3,000.

Example 2. John, an unmarried college student working part time, earned $1,500 in 2003. His IRA contributions for 2003 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) $3,000 ($3,500 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 IRA 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 $6,000 ($6,500 if only one of you is 50 or older, or $7,000 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 2003 must be made by April 15, 2004, and contributions for 2004 must be made by April 15, 2005.

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.

You attain age 70½ on the date that is six calendar months after the 70th anniversary of your birth. If you were born on June 30, 1933, the 70th anniversary of your birth is June 30, 2003, and you attained age 70½ on December 30, 2003. If you were born on July 1, 1933, the 70th anniversary of your birth was July 1, 2003, and you attained age 70½ on January 1, 2004.

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 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 You 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.

TIP *You may be eligible to claim a credit for contributions to your traditional IRA. For more information see chapter 39.*

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) $3,000 ($3,500 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) $3,000 ($3,500 if the spouse with the lower compensation is 50 or older), or
2) The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.
   a) The IRA deduction for the year of the spouse with the ***greater*** compensation.
   b) Any designated nondeductible contribution for the year made on behalf of the spouse with the ***greater*** compensation.
   c) Any contributions for the year to a Roth IRA on behalf of the spouse with the ***greater*** 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. 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.

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.

Table 18–1. **Effect of Modified AGI[1] on Deduction if You Are 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 AGI is...	THEN you can take...
single or **head of household**	$40,000 or less	a full deduction.
	more than $40,000 but less than $50,000	a partial deduction.
	$50,000 or more	no deduction.
married filing jointly or **qualifying widow(er)**	$60,000 or less	a full deduction.
	more than $60,000 but less than $70,000	a partial deduction.
	$70,000 or more	no deduction.
married filing separately[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 (AGI)*.
[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).

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 almost all 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. 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.

Table 18–2. **Effect of Modified AGI[1] on Deduction if You Are 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 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 ***is not*** covered by a plan at work	any amount	a full deduction.
married filing jointly with a spouse who ***is*** covered by a plan at work	$150,000 or less	a full deduction.
	more than $150,000 but less than $160,000	a partial deduction.
	$160,000 or more	no deduction.
married filing separately with a spouse who ***is*** 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 (AGI)*.
[2]You are entitled to the full deduction if you did not live with your spouse at any time during the year.

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. See *Filing status* and *Modified adjusted gross income (AGI)*, later. 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.

1) You received social security benefits.
2) You received taxable compensation.

3) Contributions were made to your traditional IRA.

4) 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 and you did not receive any social security retirement benefits, your IRA deduction may be reduced or eliminated depending on your filing status and modified AGI as shown in *Table 18–1*.

TIP *For 2004, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified AGI is:*

- *More than $45,000 but less than $55,000 for a single individual (or head of household),*
- *More than $65,000 but less than $75,000 for a married couple filing a joint return (or a qualifying widow(er)), or*
- *Less than $10,000 for a married individual filing a separate return.*

For all filing statuses other than married filing separately, the upper and lower limits of the phaseout range will increase by $5,000.

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 may be 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 2003 and received a distribution from your IRA in 2003, see Publication 590.

CAUTION *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.
- Tuition and fees 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-provided adoption benefits 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.
- Tuition and fees deduction.
- Exclusion of qualified savings bond interest shown on Form 8815.
- Exclusion of employer-provided adoption benefits shown on Form 8839.

This is your modified AGI.

Both contributions for 2003 and distributions in 2003. If ***all three*** of the following apply, any IRA distributions you received in 2003 may be partly tax free and partly taxable.

1) You received distributions in 2003 from one or more traditional IRAs.

2) You made contributions to a traditional IRA for 2003.

3) Some of those contributions may be nondeductible contributions depending on whether your IRA deduction for 2003 is reduced.

If this is your situation, 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 1–5, Figuring the Taxable Part of Your IRA Distribution,* in Publication 590.

If at least one of the above does not apply, 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 24 of that form. If you file Form 1040A, enter your IRA deduction on line 17. You cannot deduct IRA contributions on Form 1040EZ.

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 22, Form 1040A, or line 35, Form 1040 figured without taking into account line 17, Form 1040A, or line 24, Form 1040	**1.**	
2. Enter any *Student loan interest deduction* from line 18, Form 1040A, or line 25, Form 1040	**2.**	
3. Enter any *Tuition and fees deduction* from line 19, Form 1040A, or line 26, Form 1040	**3.**	
4. Enter any *Foreign earned income and/or housing exclusion* from line 18, Form 2555–EZ, or line 43, Form 2555	**4.**	
5. Enter any *Foreign housing deduction* from line 48, Form 2555	**5.**	
6. Enter any *Excluded qualified savings bond interest* shown on line 3, Schedule 1, Form 1040A, or line 3, Schedule B, Form 1040 (from line 14, Form 8815)	**6.**	
7. Enter any *Exclusion of employer-provided adoption benefits* shown on line 30, Form 8839	**7.**	
8. Add lines 1 through 7. This is your **Modified AGI** for traditional IRA purposes	**8.**	

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 or, if it applies, the spousal IRA limit. The difference between your total permitted contributions and your IRA deduction, if any, is your nondeductible contribution.

Example. Mike is 28 years old and single. In 2003, he was covered by a retirement plan at work. His salary was $52,312. His modified AGI was $55,000. Mike made a $3,000 IRA contribution for 2003. Because he was covered by a retirement plan and his modified AGI was over $50,000, he cannot deduct his $3,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606, 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 contributions (deductible or nondeductible) will be taxed until they are distributed. See *When Can You Withdraw or Use IRA Assets,* later.

Cost basis. You will have a cost basis in your traditional IRA if you made any 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, you are called a ***beneficiary.*** A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

Inherited from spouse. If you inherit a traditional IRA from your spouse, you generally have the following three choices. You can:

1) Treat it as your own by designating yourself as the account owner.
2) Treat it as your own by rolling it over into your traditional IRA, or to the extent it is taxable, into a:
   a) Qualified employer plan,
   b) Qualified employee annuity plan (section 403(a) plan),
   c) Tax-sheltered annuity plan (section 403(b) plan),
   d) Deferred compensation plan of a state or local government (section 457 plan), or
3) Treat yourself as the beneficiary rather than treating the IRA as your own.

Treating it as your own. You will be considered to have chosen to treat the IRA as your own if:

- Contributions (including rollover contributions) are made to the inherited IRA, or
- You do not take the required minimum distribution for a year *as a beneficiary* of the IRA.

You will only be considered to have chosen to treat the IRA as your own if:

- You are the sole beneficiary of the IRA, and
- You have an unlimited right to withdraw amounts from it.

However, if you receive a distribution from your deceased spouse's IRA, you can roll that distribution over into your own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if you are not the sole beneficiary of your deceased spouse's IRA.

Inherited from someone other than spouse. 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 you cannot make any contributions to the IRA. It also means you cannot roll over any amounts into or out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.

For more information, see the discussion of inherited IRAs under *Rollover From One IRA Into Another,* later.

Can You Move Retirement Plan Assets?

You can transfer tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. You can make 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 You 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. An amount rolled over tax free from one retirement plan to another is generally includible in income when it is distributed from the second plan.

Kinds of rollovers to a traditional IRA. You can roll over amounts from the following plans into a traditional IRA:

1) A traditional IRA,
2) An employer's qualified retirement plan for its employees,
3) A deferred compensation plan of a state or local government (section 457 plan), or
4) A tax-sheltered annuity plan (section 403(b) plan).

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 a traditional IRA. You may be able to roll over, tax free, a distribution from your traditional IRA into a qualified plan. These plans include the federal Thrift Savings Fund (for federal employees), deferred compensation plans of state or local governments (section 457 plans), and tax-sheltered annuity plans (section 403(b) plans). 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.

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.

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control. For more information, see Publication 590.

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, see Publication 590.

More information. For more information on rollovers, see 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. Generally, 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. You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.

However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

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). The amount you keep may be subject to the 10% additional tax on early distributions, discussed later under *What Acts Result in Penalties or Additional Taxes*.

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, or you can choose to make the inherited IRA your own. See *Treating it as your own,* earlier.

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. If the total distribution was not rolled over, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040 or line 11b, Form 1040A. Put "Rollover" next to line 15b, Form 1040 or line 11b, Form 1040A. See the forms instructions.

If you rolled over the distribution in 2004 or from an IRA into a qualified plan (other than an IRA), attach a statement explaining what you did.

Rollover From Employer's Plan Into an IRA

You can roll over into a traditional IRA all or part of an ***eligible rollover distribution*** you receive from your (or your deceased spouse's):

1) Employer's qualified pension, profit-sharing or stock bonus plan,
2) Annuity plan,
3) Tax-sheltered annuity plan (section 403(b) plan), or
4) Governmental deferred compensation plan (section 457 plan).

A qualified plan is one that meets the requirements of the Internal Revenue Code.

Eligible rollover distribution. Generally, an eligible rollover distribution is any distribution of all or part of the balance to your credit in a qualified retirement plan ***except*** the following.

1) A required minimum distribution (explained later under *When Must You Withdraw IRA Assets? (Required Minimum Distributions).*
2) Hardship distributions.
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.
4) Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or of excess annual additions and any allocable gains.
5) A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant's accrued benefits are reduced (offset) to repay the loan.
6) Dividends on employer securities.
7) The cost of life insurance coverage.
8) Generally, a distribution to the plan participant's beneficiary.

Reporting rollovers from employer plans. Enter the total distribution (before income tax or other deductions were withheld) on line 16a of Form 1040 or line 12a of Form 1040A. This amount should be shown in box 1 of Form 1099–R. From this amount, subtract any contributions (usually shown in box 5 of Form 1099–R) that were taxable to you when made. From that result, subtract the amount that was rolled over either directly or within 60 days of receiving the distribution. Enter the remaining amount, even if zero, on line 16b of Form 1040 or line 12b of Form 1040A. Also, enter ''Rollover'' next to line 16b on Form 1040 or line 12b of Form 1040A.

Converting From Any Traditional IRA to a Roth 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 later under *Roth IRAs*) is not more than $100,000.
2) You are not a married individual filing a separate return.

Note. 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.

Required distributions. You cannot convert 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 later).

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 later.

If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments. See chapter 5.

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. You cannot deduct the contribution to the first IRA. Any net income you transfer 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. If you recharacterize your contribution, you must do all three of the following.

1) Include in the transfer any net income allocable to the contribution. If there was a loss, the net income you must transfer may be a negative amount.
2) Report the recharacterization on your tax return for the year during which the contribution was made.
3) Treat the contribution as having been made to the second IRA on the 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 (the one to which the contribution is being moved) that you have elected to treat 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 (or loss) allocable to the contribution to the trustee of the second IRA. If both IRAs involved in the trustee-to-trustee transfer are maintained by the same trustee, you need only direct that trustee to transfer the contribution.
- 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.

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.

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 You 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 or Additional Taxes,* later.

Contributions returned before the due date of return. If you made IRA contributions in 2003, 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 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. To calculate the amount you must withdraw, see Publication 590.

CAUTION *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 or Additional Taxes, *later.*

Earnings includible in income. 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.

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 You Withdraw IRA Assets? (Required Minimum 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 minimum distribution. The amount that must be distributed each year is referred to as the required minimum distribution.

Required distributions not eligible for rollover. Amounts that must be distributed (required minimum distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, you must start receiving distributions from your IRA by April 1 of the year following the year in which you reach age 70½. April 1 of the year following the year in which you reach age 70½ is referred to as the ***required beginning date***.

Distributions by the required beginning date. You must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year.

If an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

CAUTION *Even if you begin receiving distributions before you attain age 70½, you must begin calculating and receiving required minimum distributions by your required beginning date.*

Distributions after the required beginning date. The required minimum distribution for any year after the year you reach 70½ 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 generally depend on whether the IRA owner died before or after the required beginning date for distributions.

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 distributions from traditional IRAs being taxable in the year you receive them are:

- Rollovers,
- Tax-free withdrawals of contributions, discussed earlier, and
- The return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable.*

CAUTION *Although a conversion of a traditional IRA is considered a rollover for Roth IRA purposes, it is not an exception to the rule that distributions from a traditional IRA are taxable in the year you receive them. Conversion distributions are includible in your gross*

income subject to this rule and the special rules for conversions explained in 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 2003 and your total IRA basis for 2003 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 2a 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, or line 11b, Form 1040A (no entry is required on line 15a, Form 1040, or line 11a, 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 or Additional Taxes?

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.

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 descendent, and any spouse of a lineal descendent).

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 your account stops being an IRA because you or your beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to you at their fair market values on the first day of the year. If the total of those values is more than your basis in the IRA, you will have a taxable gain that is includible in your income. For information on figuring your gain and reporting it in income, see *Are Distributions Taxable,* earlier. The distribution may be subject to additional taxes or penalties.

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, see 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:

- $3,000 ($3,500 if 50 or older), or
- Your taxable compensation for the year.

Tax on excess contributions. In general, if the excess contributions for a year 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 2003 to your IRA were not more than $3,000 ($3,500 if 50 or older).
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 not more than the maximum deductible amount for that year ($2,000 for 2001 and earlier years, $3,000 for 2002 ($3,500 for 2002 if 50 or older)), 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 generally are amounts distributed from your traditional IRA account or annuity before you are age 59½.

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,* earlier.) This also applies to transfers incident to divorce, as discussed 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. The required minimum distribution for any year after the year in which you reach age 70½ must be made by December 31 of that later year.

Tax on excess. If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to excuse the tax. If the excess accumulation is due to reasonable error, and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused.

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 take 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 distributions, and excess accumulations. If you must file Form 5329, you cannot use Form 1040A or Form 1040EZ.

Filing a tax return. If you must file an individual income tax return, complete Form 5329 and attach it to your Form 1040. Enter the total amount of additional taxes due on line 57, Form 1040.

Not filing a tax return. If you do not have to file a tax return but do have to pay one of the additional 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. Enter your social security number and “2003 Form 5329” on your check or money order.

Form 5329 not required. You do not have to use Form 5329 if either of the following situations exist.

- Distribution code 1 (early distribution) is correctly 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 57 of Form 1040. Put "No" to the left of line 57 to indicate that you do not have to file Form 5329. However, if you 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.
- If you rolled over part or all of a distribution from a qualified retirement plan, the part rolled over is not subject to the tax on early distributions.

Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

Contributions not reported. You do not 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 earlier). 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. A deemed IRA can be a Roth IRA, but 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 made to your Roth IRA after you reach age 70½ and you can leave amounts in your Roth IRA as long as you live.

When Can a Roth IRA Be Set Up?

You can set up a Roth IRA at any time. However, the time for making contributions for any year is limited. See *When Can You Make Contributions*, later under *Can You Contribute to a Roth IRA.*

Can You 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 or qualifying widow(er),
- $10,000 for married filing separately and you lived with your spouse at any time during the year, or
- $110,000 for single, head of household, or married filing separately and you did not live with your spouse at any time during the year.

TIP *You may be eligible to claim a credit for contributions to your Roth IRA. For more information, see chapter 39.*

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can you contribute to a Roth IRA for your 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:

- $160,000 for married filing jointly,
- $10,000 for married filing separately and you lived with your spouse at any time during the year, or
- $110,000 for married filing separately and you did not live with your spouse at any time during the year.

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.

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*** conversion income. This is any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA.
2) ***Add*** the following deductions and exclusions:

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 35, or Form 1040A, line 22)	**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 24, or Form 1040A, line 17)	**4.** _____
5.	Enter any student loan interest deduction (Form 1040, line 25, or Form 1040A, line 18)	**5.** _____
6.	Enter any tuition and fees deduction (Form 1040, line 26, or Form 1040A, line 19)	**6.** _____
7.	Enter any foreign earned income and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	**7.** _____
8.	Enter any foreign housing deduction (Form 2555, line 48)	**8.** _____
9.	Enter any exclusion of bond interest (Form 8815, line 14)	**9.** _____
10.	Enter any exclusion of employer-provided adoption benefits (Form 8839, line 30)	**10.** _____
11.	Add the amounts on lines 3 through 10	**11.** _____
12.	Enter: • $160,000 if married filing jointly or qualifying widow(er) • $10,000 if married filing separately and you lived with your spouse at any time during the year • $110,000 for all others	**12.** _____

Next. Is the amount on line 11 more than the amount on line 12?
Yes. See the ***Note*** below.
No. The amount on line 11 is your ***modified AGI*** for Roth IRA purposes.

Note. If the amount on line 11 is more than the amount on line 12 and you have other income or loss items, such as social security income or passive activity losses, that are subject to AGI-based phaseouts, you can refigure your AGI solely for the purpose of figuring your modified AGI for Roth IRA purposes. Refigure your AGI without taking into account any income from conversions. (If you receive social security benefits, use *Worksheet 1* in *Appendix B* of Publication 590 to refigure your AGI.) Then go to list item (2) under *Modified AGI* or line 4 above in *Worksheet 18–2* to refigure your modified AGI. If you do not have other income or loss items subject to AGI-based phaseouts, your modified AGI for Roth IRA purposes is the amount on line 11.

a) Traditional IRA deduction,

b) Student loan interest deduction,

c) Tuition and fees deduction,

d) Foreign earned income exclusion,

e) Foreign housing exclusion or deduction,

f) Exclusion of qualified savings bond interest shown on Form 8815, and

g) Exclusion of employer-provided adoption benefits 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:

- $3,000 ($3,500 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:

- $3,000 ($3,500 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.*

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.

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, or **qualifying widow(er)**	less than $150,000	you can contribute up to $3,000 ($3,500 if age 50 or older).
	at least $150,000 but less than $160,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$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 $3,000 ($3,500 if age 50 or older).
	more than zero (-0-) but less than $10,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$10,000 or more	you cannot contribute to a Roth IRA.
single, head of household, 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 $3,000 ($3,500 if age 50 or older).
	at least $95,000 but less than $110,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$110,000 or more	you cannot contribute to a Roth IRA.

When Can You 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).

TIP *You can make contributions for 2003 by the due date (not including extensions) for filing your 2003 tax return. This means that most people can make contributions for 2003 by April 15, 2004.*

What If You 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. The earnings are considered to have been earned and received in the year the excess 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 You 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 earlier under *Rollover From One IRA Into Another* under *Traditional IRAs,* 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 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 to a Roth 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.

Failed Conversions

If, when you converted amounts from a traditional IRA or SIMPLE IRA 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 your expectations did not come true, you have made a failed conversion.

Results of failed conversions. If the converted amount (contribution) is not recharacterized (explained earlier), 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,* earlier, for more information.

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 earlier under *Rollover From One IRA Into Another* under *Traditional IRAs,* apply to these rollovers.

Are Distributions 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-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 up to $10,000 (lifetime limit) of certain qualified first-time homebuyer amounts. See Publication 590 for more information.

Additional tax on distributions of conversion contributions within 5-year period. If, within the 5-year period starting with the first day of your tax year in which you convert an amount from a traditional IRA to a Roth IRA, you take a distribution from a Roth IRA, you may have to pay the 10% additional tax on early distributions. You generally must pay the 10% additional tax on any amount attributable to the part of the amount converted (the conversion contribution) that you had to include in income. A separate 5-year period applies to each conversion. See *Ordering rules for distributions,* later, to determine the amount, if any, of the distribution that is attributable to the part of the conversion contribution that you had to include in income.

Additional tax on other early distributions. Unless an exception applies, the taxable part of other distributions from your Roth IRA(s) that are not qualified distributions is subject to the 10% 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.

Must you withdraw or use Roth IRA assets? 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 decreased from 13 cents 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. It includes the following topics.

- Who can deduct moving expenses.
- What moving expenses are deductible.
- What moving expenses are not deductible.
- How a reimbursement affects your moving expense deduction.
- How and when to report moving expenses.
- Special rules for members of the Armed Forces.

You may be able to deduct moving expenses whether you are self-employed or an employee. Your expenses generally must be related to starting work at your new job location. However, certain retirees and survivors may qualify to claim the deduction even if they are not starting work at a new job location. See *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

❑ **8822** Change of Address

Who Can Deduct Moving Expenses

You can deduct your moving expenses if you meet all three of the following requirements.

1) Your move is closely related to the start of work.
2) You meet the distance test.
3) You meet the time test.

After you have read these rules, you may want to use *Figure 19–B* to help you decide if you can deduct your moving expenses.

Different rules may apply if you are a member of the Armed Forces or a retiree or survivor moving to the United States. These rules are discussed later in this chapter.

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 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. If your move does not meet this requirement, you may still be able to deduct moving expenses if you can show that:

1) You are required to live at your new 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.

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.

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.

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.

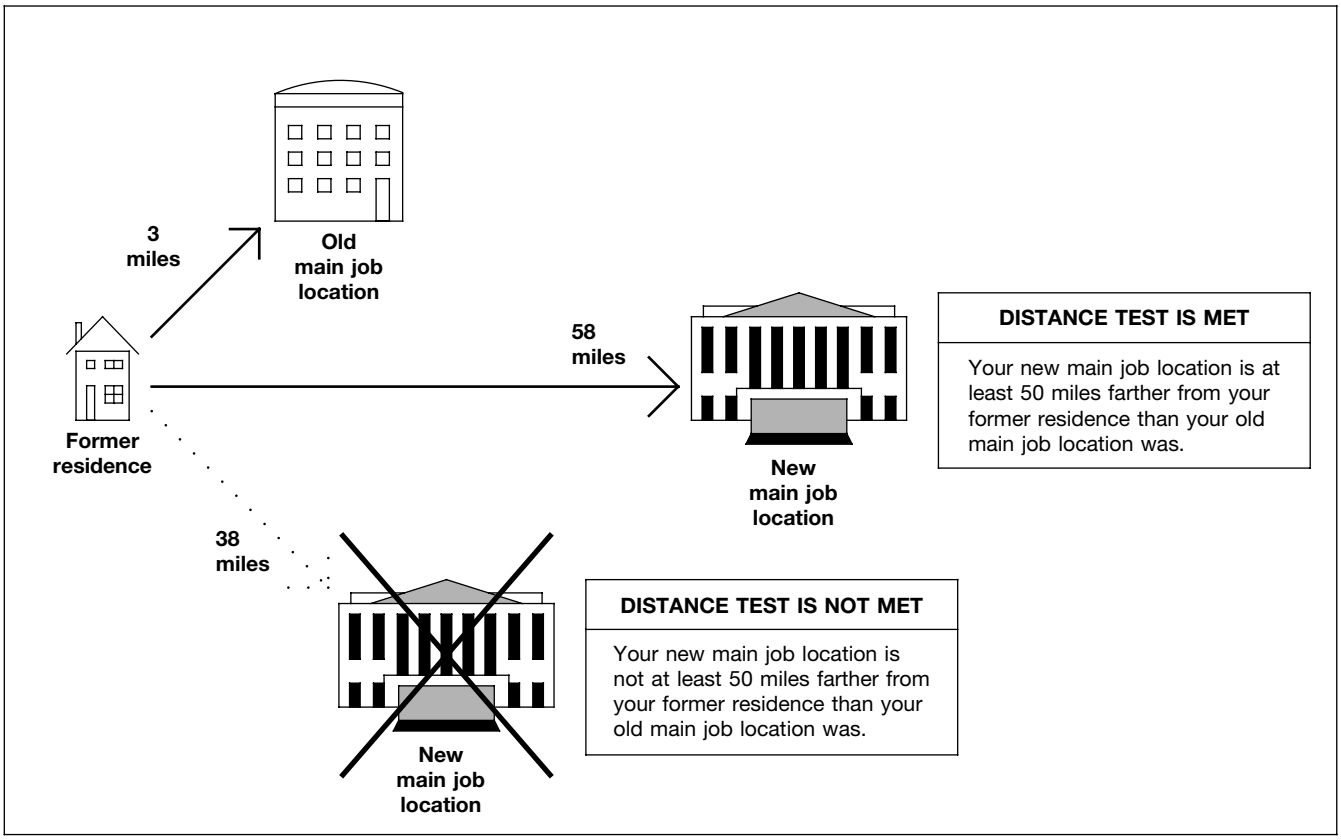
If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

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.

Figure 19–A. **Illustration of Distance Test**



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.

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.

Both of these tests are explained below. 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*** (39-week test) 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 of 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

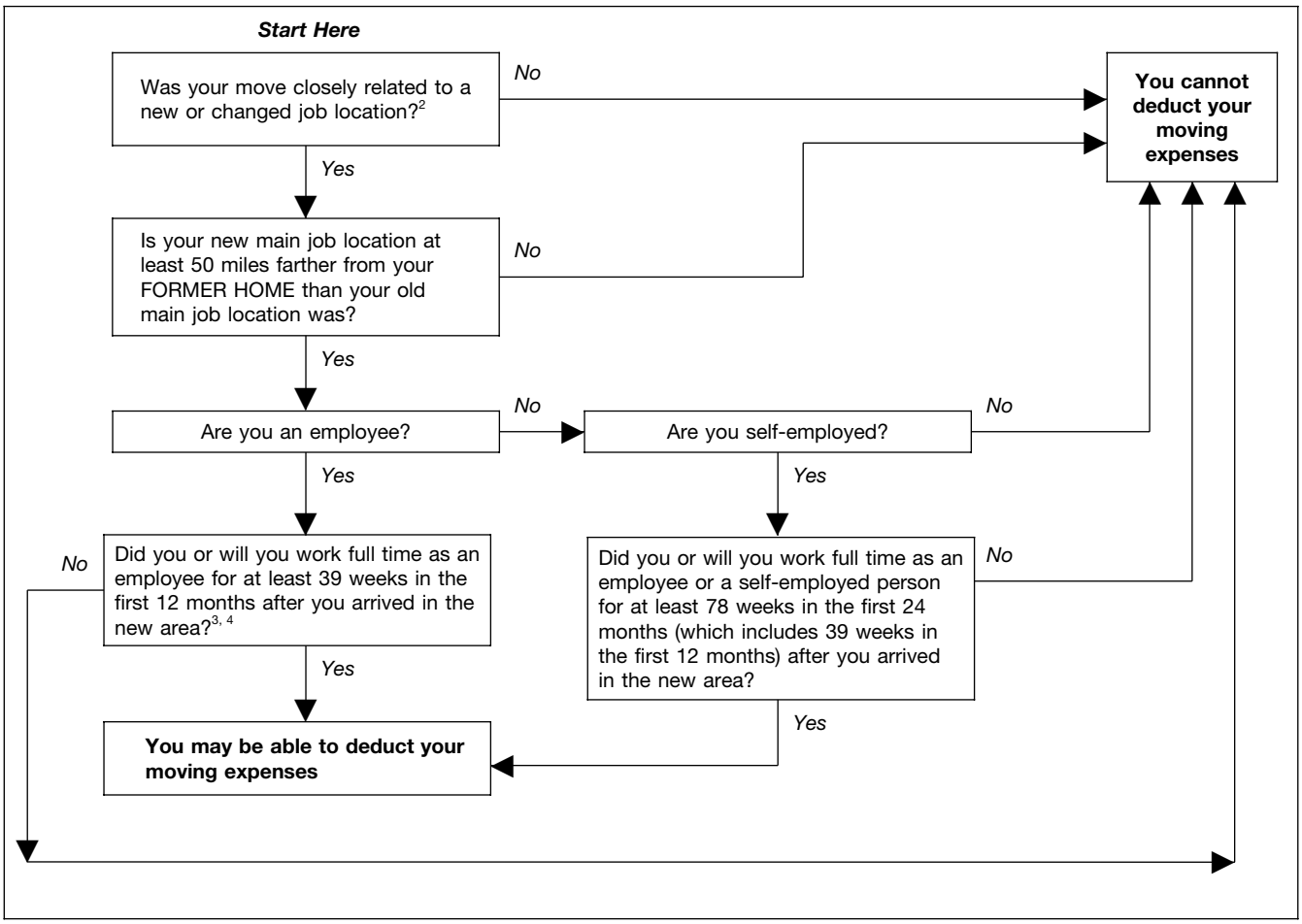
If you are self-employed, you must work full time for at least ***39 weeks during the first 12 months AND*** for a total of at least ***78 weeks during the first 24 months*** (78-week test) after you arrive in the general area of your new job location.

For purposes of the time test for self-employed persons, the following three rules apply.

Table 19–1. **Satisfying the Time Test for Employees and Self-Employed Persons**

IF you are...	THEN you satisfy the time test by meeting the...
an employee	39-week test for employees.
both self-employed and an employee, but unable to satisfy the 39-week test for employees	78-week test for self-employed persons.
both self-employed and an employee at the same time	78-week test for a self-employed person or the 39-week test for an employee. Your principal place of work determines which test applies.
self-employed	78-week test for self-employed persons.

Figure 19–B. **Can You Deduct Expenses for a Non-Military Move Within the United States?**[1]



[1]Military persons should see *Members of the Armed Forces* for special rules that apply to them.

[2]Your move must be closely related to the start of work at your new job location. See *Related to Start of Work.*

[3]If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See *Time test not yet met.*

[4]If you 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.

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.

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.

If you were both an employee and self-employed, see *Table 19–1* for the requirements.

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 2003 tax return even if you have not yet met the time test by the date your 2003 return is due. You can do this if you expect to meet the 39-week test in 2004, or the 78-week test in 2004 or 2005. If you deduct moving expenses but do not meet the time test in 2004, or 2005, 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 2003 return.

If you do not deduct your moving expenses on your 2003 return and you later meet the time test, you can file an amended return for 2003 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) Your main job location was outside the United States and 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 moving expenses.

A permanent change of station includes:

- A move from your home to your first post of active duty,
- A move from one permanent post of duty to another, and
- 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 this 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 receive 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 dependent 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.

CAUTION *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 that person is your 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 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.

CAUTION *You cannot deduct the cost of moving furniture you buy on the way to your new home.*

Storage expenses. 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.

Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your house-

hold 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 considered 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 and When To Report

This section explains how and when to report your moving expenses and any reimbursements or allowances you received for your move.

Form 3903. Use Form 3903 to figure your moving expense deduction.

Where to deduct. Deduct your moving expenses on line 27 of Form 1040. The amount of moving expenses you can deduct is shown on line 5 of Form 3903.

CAUTION *You cannot deduct moving expenses on Form 1040EZ or Form 1040A.*

Reimbursements. If you receive a reimbursement for your moving expenses, how you report this amount and your expenses depends on whether the reimbursement is paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

When To Deduct Expenses

You may have a choice of when to deduct your moving expenses and report any reimbursement.

Expenses not reimbursed. 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 2002, 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 2002, you paid for moving your furniture and you deducted these expenses on your 2002 tax return. In January 2003, you paid for travel to the new city. You can deduct these additional expenses on your 2003 tax return.

Expenses reimbursed. If you are reimbursed for your expenses, you may be able to deduct your 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 and you deduct moving expenses that will be 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 choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.

CAUTION *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.)*

20.

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 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)**

Payments ARE alimony if all of the following are true:	**Payments are NOT alimony if any of the following are true:**
Payments are required by a divorce or separation instrument.	Payments are not required by a divorce or separation instrument.
Payer and recipient spouse do not file a joint return.	Payer and recipient spouse file a joint return.
Payment is in cash (including checks or money orders).	Payment is: • Not in cash, • A noncash property settlement, • Spouse's part of community income, or • To keep up the payer's property.
Payment is not designated in the instrument as not alimony.	Payment is designated in the instrument as not alimony.
Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.	Spouses legally separated under a decree of divorce or separate maintenance are members of the same household.
Payments are not required after death of the recipient spouse.	Payments are required after death of the recipient spouse.
Payment is not treated as child support.	Payment is treated as child support.
These payments are deductible by the payer and includible in income by the recipient.	*These payments are neither deductible by the payer nor includible in income by the recipient.*

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, the part of the payment that would continue is not alimony whether made before or after the death. If all of the payment would continue, then 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 recipient.

Specifically designated as child support. A payment will be treated as specifically designated as child support to the extent that the payment is reduced either:

1) On the happening of a contingency relating to your child, or
2) At a time that can be clearly associated with 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 32a of Form 1040. In the space provided on line 32b, 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 32a.

CAUTION *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.

CAUTION *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. You can use *Worksheet A* in Publication 504 to figure recaptured alimony.

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 32a ("Alimony paid"). Cross out "paid" and print "recapture." In the space provided, enter your spouse's social security number.

21.

Education-Related Adjustments

Important Change for 2004

Maximum tuition and fees deduction increases to $4,000. Beginning in 2004, the amount of qualified education expenses you may take into account in figuring your tuition and fees deduction increases from $3,000 to $4,000 if your modified adjusted gross income (MAGI) is not more than $65,000 ($130,000 if you are married filing jointly). If your MAGI is larger than $65,000 ($130,000), but is not more than $80,000 ($160,000 if you are married filing jointly), your maximum tuition and fees deduction will be $2,000. No tuition and fees deduction will be allowed if your MAGI is larger than $80,000 ($160,000).

Introduction

This chapter discusses the education-related adjustments you can deduct in figuring your adjusted gross income.

This chapter covers:

- Educator expenses,
- Student loan interest deduction, and
- The tuition and fees deduction.

Useful Items

You may want to see:

Publication

❑ **970** Tax Benefits for Education

Educator Expenses

If you were an eligible educator in 2003, you may deduct up to $250 of qualified expenses you paid in 2003. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is $500. However, neither spouse may deduct more than $250 of his or her qualified expenses. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.

Qualified expenses. Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. An ordinary expense is one that is common and accepted in your educational field. A necessary expense is one that is helpful and appropriate for your profession as an educator. An expense does not have to be required to be considered necessary.

Qualified expenses do not include expenses for home schooling or for nonathletic supplies for courses in health or physical education. You must reduce your qualified expenses by the following amounts.

- Excludable U.S. series EE and I savings bond interest from **Form 8815**.
- Nontaxable qualified state tuition program earnings.
- Nontaxable earnings from Coverdell education savings accounts.
- Any reimbursements you received for these expenses that were not reported to you in box 1 of your Form W-2.

How the deduction is claimed. To claim the deduction, enter the allowable amount on line 23 of Form 1040, or line 16 of Form 1040A.

Student Loan Interest Deduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible on your tax return. However, there is a special deduction allowed for paying interest on a student loan (also known as an education loan). This deduction can reduce the amount of your income subject to tax by up to $2,500 in 2003. *Table 21–1* summarizes the features of the student loan interest deduction.

Student Loan Interest Defined

Student loan interest is interest you paid during the year on a ***qualified student loan***. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay ***qualified education expenses*** (defined later) that were:

1) For you, your spouse, or a person who was your dependent (defined in chapter 3) when you took out the loan,
2) Paid or incurred within a ***reasonable period of time*** before or after you took out the loan, and
3) For education provided during an ***academic period*** for an ***eligible student***.

Loans from the following sources are ***not*** qualified student loans.

- A ***related person***.
- A ***qualified employer plan***.

Reasonable period of time. Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met.

1) The expenses relate to a specific ***academic period***, and
2) The loan proceeds are disbursed within a period that begins 60 days before the start of that academic period and ends 60 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

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. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Table 21–1. **Student Loan Interest Deduction at a Glance**

Do not rely on this table alone. Refer to the text for more details.

Feature	Description
Maximum benefit	You can decrease your income subject to tax by up to $2,500.
Loan qualifications	Your student loan • must have been taken out solely to pay qualified education expenses, and • cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be • you, your spouse, or your dependent, and • enrolled at least half-time in a degree program.
Time limit on deduction	You can deduct interest paid during the remaining period of your student loan.
Phaseout	The amount of your deduction depends on your income level.

Eligible student. This is a student who was ***enrolled at least half-time*** in a program leading to a degree, certificate, or other recognized educational credential.

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 standard may not be lower than any of those established by the Department of Education under the Higher Education Act of 1965.

Loan from a related person. You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grandchildren, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

Loan from a qualified employer plan. You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

Generally, for purposes of the student loan interest deduction, these expenses are the total costs of attending an ***eligible educational institution***, including graduate school. They include amounts paid for the following items.

1) Tuition and fees.
2) Room and board.
3) Books, supplies, and equipment.
4) Other necessary expenses (such as transportation).

The cost of room and board qualifies only to the extent that it is not more than the greater of the following two amounts.

1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

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.

For purposes of the student loan interest deduction, the term also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

TIP *The educational institution should be able to tell you if it is an eligible educational institution.*

Adjustments to qualified education expenses. You must reduce your qualified education expenses by certain tax-free items (such as the tax-free part of scholarships and fellowships). See chapter 4 of Publication 970 for details.

Include As Interest

Loan origination fees (other than fees for services), capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans are student loan interest if all other requirements are met. In addition to simple interest on the loan, the items discussed below can be student loan interest.

Loan origination fees. These are the costs of getting the loan.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan.

Interest on revolving lines of credit. Revolving lines of credit, such as credit card debt, qualify if the borrower uses the line of credit (credit card) ***only*** to pay qualified education expenses. See *Qualified Education Expenses*, earlier.

Interest on refinanced student loans. This includes interest on both:

- Consolidated loans — loans used to refinance more than one student loan of the same borrower, and
- Collapsed loans — two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.

Voluntary interest payments. These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment.

Do Not Include As Interest

You cannot claim a student loan interest deduction for interest on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.

Can You Claim the Deduction?

Generally, you can claim the deduction if ***all four*** of the following requirements are met.

1) Your filing status is any filing status ***except*** married filing separately.
2) No one else is ***claiming an exemption*** for you on his or her tax return.
3) Your modified adjusted gross income (MAGI) is less than $65,000 ($130,000 if you file a joint return). For details on figuring your MAGI, see chapter 4 of Publication 970.
4) You paid interest on a qualified student loan.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount you can deduct under any other provision of the tax law (for example, home mortgage interest).

Who Can Claim a Dependent's Expenses?

You can deduct interest paid on a student loan for your dependent only if ***you***:

1) Are legally obligated to make the interest payments,
2) Actually made the payments during the tax year, and
3) Claim an exemption for your dependent on your tax return.

You are not considered to have made student loan interest payments actually made by your dependent, regardless of whether your dependent is legally liable for the loan. Also, payments made by anyone other than your dependent are not considered made by your dependent.

How Much Can You Deduct?

Your student loan interest deduction for 2003 is generally the smaller of:

1) $2,500, or
2) The interest you paid in 2003.

The amount determined above is phased out if your MAGI is between $50,000 and $65,000 ($100,000 and $130,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is $65,000 or more ($130,000 or more if you file a joint return). For details on figuring your MAGI, see Publication 970.

The amount of your student loan interest deduction

How Do You Figure the Deduction?

Generally, you figure the deduction using the *Student Loan Interest Deduction Worksheet* in the Form 1040 or Form 1040A instructions. However, if you are filing **Form 2555**, **2555–EZ**, or **4563**, or you are excluding income from sources within Puerto Rico, you must complete *Worksheet 4–1* in chapter 4 of Publication 970.

To help you figure your student loan interest deduction, you should receive **Form 1098–E**, *Student Loan Interest Statement*. Generally, an institution (such as a bank or governmental agency) that received interest payments of $600 or more during 2003 on one or more qualified student loans must issue Form 1098–E (or ac-

ceptable substitute) to each borrower by February 2, 2004.

To claim the deduction, enter the allowable amount on line 25 of Form 1040, or line 18 of Form 1040A.

Tuition and Fees Deduction

You may be able to deduct qualified education expenses paid during the year for yourself, your spouse, or a dependent.

The tuition and fees deduction can reduce your income subject to tax by up to $3,000. It is available through 2005.

Table 21–2 summarizes the features of the tuition and fees deduction.

Table 21–2. **Tuition and Fees Deduction at a Glance**

Do not rely on this table alone. Refer to the text for more details.

Question	Answer
What is the maximum benefit?	You can decrease your income subject to tax by up to $3,000.
Where is the deduction taken?	As an adjustment to income on Form 1040 or 1040A.
For whom must the expenses be paid?	A student enrolled in an eligible educational institution who is • you, • your spouse, or • your dependent.
What tuition and fees are deductible?	Tuition and fees required for enrollment or attendance at an eligible postsecondary educational institution, but not including personal, living, or family expenses, such as room and board.

Can You Claim the Deduction?

The following rules will help you determine if you can claim the tuition and fees deduction.

Who Can Claim the Deduction?

Generally, you can claim the tuition and fees deduction if ***all three*** of the following requirements are met.

1) You paid ***qualified education expenses*** of higher education.
2) You paid the expenses for an ***eligible student***.
3) The eligible student is yourself, your spouse, or a ***dependent for whom you claim an exemption*** on your tax return.

Qualified education expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*.

Who Cannot Take the Deduction?

You cannot take the tuition and fees deduction if any of the following apply.

- Your filing status is married filing separately.
- Another person is entitled to claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.
- Your modified adjusted gross income (MAGI) is more than $65,000 ($130,000 if filing a joint return).
- You were a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You or anyone else claims a Hope or lifetime learning credit in 2003 with respect to expenses of the student for whom the tuition and related expenses were paid.

What Expenses Qualify?

The tuition and fees deduction is based on qualified education expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally, the deduction is allowed for qualified education expenses paid in 2003 in connection with enrollment at an institution of higher education during 2003 or for an ***academic period*** (defined earlier under *Student Loan Interest Deduction*) beginning in 2003 or in the first 3 months of 2004.

Payments with borrowed funds. You can claim a tuition and fees deduction for qualified education expenses paid with the proceeds of a loan. You use the expenses to figure the deduction for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Qualified Education Expenses

For purposes of the tuition and fees deduction, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an ***eligible educational institution***.

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.

Related expenses. 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.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct higher education expenses you deduct under any other provision of the law, for example, as a business expense,
- Deduct qualified education expenses for a student on your income tax return if you or anyone else claims a Hope or lifetime learning credit for that same student in the same year,
- Deduct qualified education expenses that have been used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP). For a QTP, this applies only to the amount of tax-free earnings that were distributed, not to the recovery of contributions to the program. See *Figuring the Taxable Portion of a Distribution* in chapter 7 (Coverdell ESA) and in chapter 8 (QTP) of Publication 970.
- Deduct qualified education expenses that have been paid with tax-free interest on U.S. savings bonds (Form 8815). See *Figuring the Tax-Free Amount* in chapter 10 of Publication 970.
- Deduct qualified education expenses that have been paid with tax-free scholarship, grant, or employer-provided educational assistance. See the following section on *Adjustments to qualified expenses*.

Adjustments to qualified expenses. If you paid qualified higher education expenses with certain ***tax-free*** funds, you cannot claim a deduction for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance and refunds you received.

Tax-free educational assistance. This includes:

- Tax-free part of scholarships and fellowships (see chapter 1 of Publication 970),
- Pell grants (see chapter 1 of Publication 970),
- Employer-provided educational assistance (see chapter 11 of Publication 970),
- Veterans' educational assistance (see chapter 1 of Publication 970), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund. (For information on expenses paid by a dependent student or third party, see *Who Can Claim a Dependent's Expenses*, later.)

If a refund of expenses paid in 2003 is received before you file your tax return for 2003, simply reduce the amount of the expenses paid by the amount of the refund received. If the refund is received after you file your 2003 tax return, see *When Must the Deduction Be Repaid (Recaptured)*, in chapter 6 of Publication 970.

The above rule also applies to loan proceeds the eligible education institution refunds to the lender on behalf of the borrower.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and the money is used to pay education expenses that are not qualified (such as room and board).

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- 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.

Sports, games, hobbies, and noncredit courses. Qualified education expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on **Form 1098–T**, *Tuition Statement*. See *How Much Can You Deduct*, later, for more information about Form 1098–T.

Who Is an Eligible Student?

For purposes of the tuition and fees deduction, an eligible student is a student who is enrolled in one or more courses at an ***eligible educational institution***. The student must have either a high school diploma or a General Educational Development (GED) credential.

Who Can Claim a Dependent's Expenses?

Generally, to claim the tuition and fees deduction for qualified education expenses for a dependent, you must:

1) Have paid the expenses, and
2) Claim an exemption for the student as a dependent.

Table 21–3 summarizes who can claim the deduction.

How Much Can You Deduct?

The maximum deduction you can claim in 2003 is $3,000. However, the amount of your modified adjusted gross income (MAGI) determines whether the deduction is allowed. For details on figuring your MAGI, see chapter 6 of Publication 970.

How Do You Figure the Deduction?

Generally, you figure the deduction using the *Tuition and Fees Deduction Worksheet* in the Form 1040 or Form 1040A instructions. However, if you are filing Form 2555, Form 2555-EZ, or Form 4563, or if you exclude income from sources within Puerto Rico, you must complete the worksheet in chapter 6 of Publication 970.

To help you figure your tuition and fees deduction, you should receive **Form 1098–T**, *Tuition Statement*. Generally, an eligible educational institution (such as a college or university) must issue Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004.

To claim the deduction, enter the allowable amount on Form 1040, line 26, or Form 1040A, line 19.

Table 21–3. **Who Can Claim a Dependent's Expenses?**

Do not rely on this table alone. See *Who Can Claim a Dependent's Expenses* in chapter 6 of Publication 970.

IF your dependent is an eligible student and you...	**AND...**	**THEN...**
claim an exemption for your dependent	**you** paid all qualified education expenses for your student	only **you** can deduct the qualified education expenses that you paid. Your dependent cannot take a deduction.
claim an exemption for your dependent	**your dependent** paid all qualified education expenses	**no one** is allowed to take a deduction.
do not claim an exemption for your dependent, but are **eligible** to	**you** paid all qualified education expenses	**no one** is allowed to take a deduction.
do not claim an exemption for your dependent, but are **eligible** to	**your dependent** paid all qualified education expenses	**no one** is allowed to take a deduction.
are **not** eligible to claim an exemption for your dependent	**you** paid all qualified education expenses	only your **dependent** can deduct the amount you paid. The amount you paid is treated as a gift to your dependent.
are **not** eligible to claim an exemption for your dependent	**your dependent** paid all qualified education expenses	only your **dependent** can take a deduction.

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 22 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions. Figure 2, Finding Schedule A Information in Publication 17, below, shows you where the items found on Schedule A are discussed in this publication.

Figure 2—Finding Schedule A Information in Publication 17

Questions about what to put on a line? Help is on the page number in the circle.

SCHEDULES A&B (Form 1040)

Department of the Treasury
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

► **Attach to Form 1040.** ► **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

2003

Attachment Sequence No. **07**

Name(s) shown on Form 1040 | **Your social security number**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.			
	1	Medical and dental expenses (see page A-2)	1 (154)		
	2	Enter amount from Form 1040, line 35 [2]			
	3	Multiply line 2 by 7.5% (.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5 (160)		
	6	Real estate taxes (see page A-2)	6 (161)		
	7	Personal property taxes	7 (163)		
	8	Other taxes. List type and amount ►	8 (163)		
	9	Add lines 5 through 8		9	
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10 (164)		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ►	11 (166)		
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12 (168)		
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13 (168)		
	14	Add lines 10 through 13		14	
Gifts to Charity	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4.	15 (171)		
If you made a gift and got a benefit for it, see page A-4.	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16 (177)		
	17	Carryover from prior year	17 (176)		
	18	Add lines 15 through 17		18	
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)		19	(179)
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-5.) ►	20 (185)		
	21	Tax preparation fees	21 (211)		
(See page A-5.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ►	22 (209)		
	23	Add lines 20 through 22	23		
	24	Enter amount from Form 1040, line 35 [24]			
	25	Multiply line 24 by 2% (.02)	25		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-		26	
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ►		27	(212)
Total Itemized Deductions	28	Is Form 1040, line 35, over $139,500 (over $69,750 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 37. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter.		► 28	(215)

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2003**

22.

Standard Deduction

Important Changes

Increase in standard deduction. The standard deduction for most taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 2003 than it was in 2002. The amount depends on your filing status. *2003 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 $139,500 ($69,750 if you are married filing separately). See chapter 31 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, and taxes, on Schedule A of Form 1040. 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.

TIP *You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.*

Persons not eligible for the standard deduction. Your standard deduction is ***zero*** and you should itemize any deductions you have if:

1) You are married and filing a separate return, and your spouse itemizes deductions,
2) You are filing a tax return for a short tax year 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.

CAUTION *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

The standard deduction amount depends on your filing status, whether you are 65 or older or blind, and whether an exemption can be claimed for you by another taxpayer. Generally, the standard deduction amounts are adjusted each year for inflation. The standard deduction amounts for most taxpayers for 2003 are shown in *Table 22–1.*

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 2003 if you were born before January 2, 1939.

Use *Table 22–2* 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 22–2.* 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.

CAUTION *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 22–1* and *22–2*.

Example 1. Larry, 46, and Donna, 33, are filing a joint return for 2003. Neither is blind. They decide not to itemize their deductions. They use *Table 22–1.* Their standard deduction is $9,500.

Example 2. Assume the same facts as in Example 1, except that Larry is blind at the end of 2003. Larry and Donna use *Table 22–2.* Their standard deduction is $10,450.

Example 3. Bill, 72, and Terry, 66, are filing a joint return for 2003. Neither is blind. They decide not to itemize their deductions. They use *Table 22–2.* Their standard deduction is $11,400.

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 $4,750).

However, if the individual is 65 or older or blind, the standard deduction may be higher.

If an exemption for you (or your spouse if you are filing jointly) can be claimed on someone else's return, use *Table 22–3* 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 1 of Publication 970 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 2003 tax return. He has interest income of $780 and wages of $150. He has no itemized deductions. Michael uses *Table 22–3* 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 $4,750 on line 6. The amount of his standard deduction, on line 7a, is $750 (the smaller of $750 and $4,750).

Example 2. Joe, a 22-year-old full-time college student, is claimed on his parents' 2003 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 $3,800. He has no itemized deductions. Joe finds his standard deduction by using *Table 21–3.* He enters his earned income, $3,800, on line 1. He adds lines 1 and 2 and enters $4,050 on line 3. On line 5 he enters $4,050, the larger of lines 3 and 4. Since Joe is married filing a separate return, he enters $4,750 on line 6. On line 7a he enters $4,050 as his standard deduction because it is smaller than $4,750, the amount on line 6.

Example 3. Amy, who is single, is claimed on her parents' 2003 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 22–3* 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 $4,750 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 $1,150 on line 7b. She then adds the amounts on lines 7a and 7b and enters her standard deduction of $4,300 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.

CAUTION *You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than $139,500 ($69,750 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 37.

Electing to itemize for state tax or other purposes. Even if your itemized deductions are less than the amount of your standard deduction, you can elect to itemize deductions on your federal return rather than take the standard deduction. You may want to do this, for example, if the tax benefit of being able to itemize your deductions on your state tax return is greater than the tax benefit you lose on your federal return by not taking the standard deduction. To make this election, you must enter "IE" (itemized elected) on the dotted line next to line 37 (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.)

2003 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 22–1. **Standard Deduction Chart for Most People***

IF your filing status is ...	Your standard deduction is:
Single or Married filing separate return	$4,750
Married filing joint return or Qualifying widow(er) with dependent child	9,500
Head of household	7,000

*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 22–2 or 22–3 instead.

Table 22–2. **Standard Deduction Chart for People Age 65 or Older or Blind***

Check the correct number of boxes below. Then go to the chart.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

IF your filing status is ...	AND the number in the box above is ...	THEN your standard deduction is:
Single	1	$5,900
	2	7,050
Married filing joint return or Qualifying widow(er) with dependent child	1	10,450
	2	11,400
	3	12,350
	4	13,300
Married filing separate return	1	5,700
	2	6,650
	3	7,600
	4	8,550
Head of household	1	8,150
	2	9,300
	3	10,450
	4	11,600

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 22–3 instead.

Table 22–3. **Standard Deduction Worksheet for Dependents***

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

1. Enter your **earned income** (defined below). If none, enter -0-.	**1.** _____
2. Additional amount	**2.** $250
3. Add lines 1 and 2.	**3.** _____
4. Minimum amount	**4.** $750
5. Enter the **larger** of line 3 or line 4.	**5.** _____
6. Enter the amount shown below for your filing status. • Single or Married filing separately—$4,750 • Married filing jointly or Qualifying widow(er) with dependent child—$9,500 • Head of household—$7,000	**6.** _____
7. Standard deduction. **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.	**7a.** _____
b. If 65 or older or blind, multiply $1,150 ($950 if married or qualifying widow(er) with dependent child) by the number in the box above.	**7b.** _____
c. Add lines 7a and 7b. This is your standard deduction for 2003.	**7c.** _____

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.*

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

23.

Medical and Dental Expenses

Important Changes

Standard mileage rate. The standard mileage rate allowed for out-of-pocket expenses for a car when you use it for medical reasons is ***12*** cents a mile for 2003. See *Transportation* under *What Expenses Are Includible*.

Self-employed health insurance deduction rate increase. If you are self-employed, you may be able to deduct, as an adjustment to income, up to ***100%*** of the amount you paid for medical and qualified long-term care insurance in 2003 for yourself, your spouse, and your dependents. This is an increase from the 70% of such expenses you were allowed to deduct in 2002. See *Health Insurance Costs for Self-Employed Persons.*

Health coverage tax credit. There is a new credit for health insurance premiums paid by certain workers who are displaced by foreign trade or who are receiving a pension from the Pension Benefit Guaranty Corporation. For more information, see *Health Coverage Tax Credit* in chapter 39.

Important Reminders

Deduction threshold. Even if you have medical and dental expenses, you may not be able to claim a deduction for those expenses. This is because you can deduct only the part of your medical and dental expenses that is more than 7.5% of your adjusted gross income.

Obesity as a disease. The cost of participation in a weight-loss program as a treatment for the disease of obesity is an amount paid for medical care. However, the cost of purchasing reduced-calorie diet foods is not a medical expense if these foods substitute for food you would normally consume to satisfy your nutritional requirements.

Introduction

This chapter will help you determine:

- What medical expenses are,
- 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 includible,
- How you treat reimbursements,
- How to report the deduction on your tax return,
- How to report impairment-related work expenses, and
- How to report health insurance costs if you are self-employed.

Useful Items

You may want to see:

Publication

❑ **502** Medical and Dental Expenses

Form (and Instructions)

❑ **Schedule A (Form 1040)** Itemized Deductions

What Are Medical Expenses?

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs 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 expenses include dental expenses. Medical expenses do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.

Medical 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 expenses also include amounts paid for qualified long-term care services and 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.

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.*

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 35, 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.

Whose Medical Expenses Can You Include?

You can generally include medical expenses you pay for yourself as well as those you pay for someone who was your spouse or your dependent either when the services were provided or when you paid for them. There are different rules for decedents and for individuals who are the subject of multiple support agreements.

Spouse. You can include medical expenses you paid for your spouse. To include 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, 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 received the medical services, he can include those expenses in figuring his medical deduction for this year.

Dependent. You can include medical expenses you paid for your dependent. For you to include 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 all three of the following requirements are met.

1) That person lived with you for the entire year as a member of your household or is:

   a) Your child, grandchild, great grandchild, etc. (a legally adopted child is considered your child).

   b) Your stepchild.

   c) Your brother, sister, half brother, half sister, stepbrother, or stepsister.

   d) Your parent, grandparent, or other direct ancestor, but not foster parent.

   e) Your stepfather or stepmother.

   f) A brother or sister of your father or mother.

   g) A son or daughter of your brother or sister.

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

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.

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 2002 your son was your dependent. In 2003 he no longer qualified as your dependent. However, you paid $800 in 2003 for medical services provided to your son in 2002 when he was your dependent. You can include the $800 in your medical expenses for 2003. You cannot include this amount in your 2002 medical expenses.

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

Table 23–1. **Medical and Dental Expenses Checklist**

You can include:		You cannot include:	
• Bandages • Birth control pills prescribed by your doctor • Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502) • Certain fertility enhancement procedures (see Publication 502) • Certain weight-loss expenses for obesity • Diagnostic devices • Expenses of an organ donor • Eye surgery—to promote the correct function of the eye • Guide dogs or other animals aiding the blind, deaf, and disabled • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Lead-based paint removal (see Publication 502) • Legal abortion • Legal operation to prevent having children such as a vasectomy • 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) • 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 and psychological treatment • Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services*, below) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special education 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)	• Archer MSAs (see Publication 969) • Baby sitting and childcare • Bottled water • Diaper service • Expenses for your general health (even if following your doctor's advice) such as— —Health club dues —Household help (even if recommended by a doctor) —Social activities, such as dancing or swimming lessons —Trip for general health improvement • 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 • Nutritional supplements, vitamins, herbal supplements, "natural medicines," etc., unless recommended by a medical practitioner as a treatment for a specific medical condition diagnosed by a physician • Surgery for purely cosmetic reasons (see Publication 502) • Toothpaste, toiletries, cosmetics, etc. • Teeth whitening • Weight-loss expenses not for the treatment of obesity or other disease

substantiate that the payment is directly attributable to the medical care of the child.

But if you pay the agency or other person for medical care that was provided and paid for before adoption negotiations began, you cannot include them as medical expenses.

TIP *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. For purposes of the medical and dental expenses deduction, a child of divorced or separated parents can be treated as a dependent of both parents. Each parent can include the medical expenses he or she pays for the child, even if the other parent claims the child's dependency exemption, if:

1) The child is in the custody of one or both parents for more than half the year,
2) The child receives over half of his or her support during the year from his or her parents, and
3) The child's parents:
   a) Are divorced or legally separated under a decree of divorce or separate maintenance,
   b) Are separated under a written separation agreement, or
   c) Live apart at all times during the last 6 months of the year.

This does not apply if the child's exemption is being claimed under a multiple support agreement.

Support claimed under a multiple support agreement. If you are considered to have provided more than half of a person's support under a multiple support agreement, you can include medical expenses you pay for that person, even if you cannot claim an exemption for that person. 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.

For rules regarding what expenses you can include this year, see *What Expenses Can You Include This Year,* earlier.

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 treat your mother as your 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

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.

The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's medical care as paid by the decedent at the time the medical services were provided. The expenses must be paid within the 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.

CAUTION *Qualified medical expenses paid before death by the decedent are not deductible if paid with a tax-free distribution from any 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 Includible?

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.

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.

Note. If advance payments of the health coverage tax credit were made on your behalf to your insurance company, do not include any advance payments made for you when figuring the amount you may deduct for insurance premiums. Also, if you are claiming the health coverage tax credit, subtract the amount shown on line 4 of Form 8885 (reduced by any advance payments shown on line 6 of that form) from the total insurance premiums you paid.

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.

Example. You are a federal employee participating in the Federal Employee Health Benefits (FEHB) program. Your share of the FEHB premium is paid with pre-tax dollars. Because you are an employee whose insurance premiums are paid with money that is never included in your gross income, you cannot deduct the premiums paid with that money.

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.

Health reimbursement arrangement (HRA). If you have medical expenses that are reimbursed by a health reimbursement arrangement, you cannot include those expenses in your medical expenses. This is because an HRA is funded solely by the employer.

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.

Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if a principal 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 all of the following requirements are met.

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. You can include lodging for a person 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, home for the aged, or similar institution, for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if a principal 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.

Car expenses. You can include out-of-pocket expenses, such as the cost of 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, for 2003 you can use a standard rate of ***12*** cents a mile for use of a car for medical reasons.

You can also include 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.

Transportation expenses you cannot include. You cannot include in medical expenses the cost of transportation expenses in the following situations.

- Going to and from work, even if your condition requires an unusual means of transportation.
- Travel for purely personal reasons to another city for an operation or other medical care.
- Travel that is merely for the general improvement of one's health.

Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as either:

- Medical expenses or
- Work-related expenses for purposes of taking a credit for dependent care. (See chapter 34.)

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.

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.

Even if a policy only provides reimbursement for certain specific medical expenses, you must use amounts you receive from that policy to reduce your total medical expenses, including those it does not provide reimbursement for.

Example. You have insurance policies which cover your hospital and doctors' bills but not your nursing bills. The insurance you receive for the hospital and doctors' bills is more than their charges. In figuring your medical deduction, you must reduce the total amount you spent for medical care by the total amount of insurance you received even if the policies do not cover some of your medical expenses.

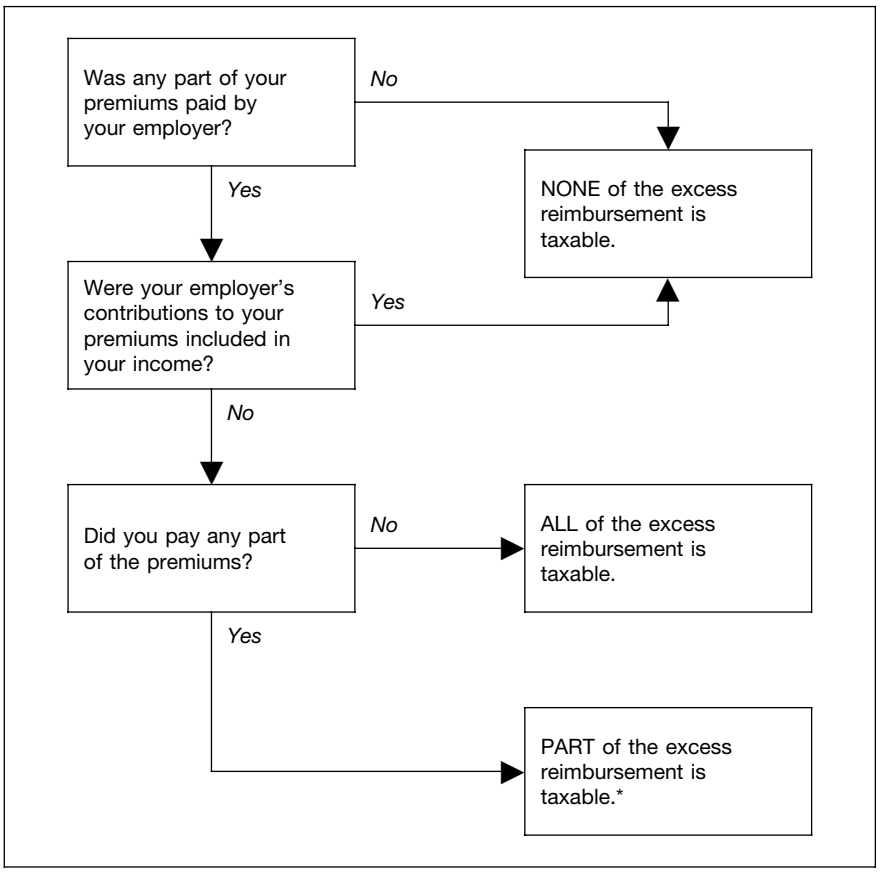
Health reimbursement arrangement (HRA). A health reimbursement arrangement is an employer-funded plan that reimburses employees for medical care expenses and allows unused amounts to be carried forward. An HRA is funded solely by the employer and the reimbursements for medical expenses, up to a maximum dollar amount for a coverage period, are not included in your income.

Other reimbursements. Generally, you do not reduce medical expenses by payments you receive for:

- Permanent loss or loss of use of a member or function of the body (loss of limb, sight, hearing, etc.) or disfigurement to the extent the payment is based on the nature of the injury without regard to the amount of time lost from work, or
- Loss of earnings.

You must, however, reduce your medical expenses by any part of these payments that is designated for medical costs. See *How Do You*

Figure 23–A. **Is Your Excess Medical Reimbursement Taxable?**



*See *Premiums paid by you and your employer* in this chapter.

Figure and Report the Deduction on Your Tax Return, later.

For how to treat damages received for personal injury or sickness, see *Damages For Personal Injuries,* later.

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 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 is taxable.

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 your excess reimbursement that is from your employer's contribution.

See Publication 502 to figure the amount of the excess reimbursement you must include in gross income.

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 the reimbursement up to the amount of the expense in income. However, 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 in medical expenses, you do not include that amount in your gross income.

Damages For Personal Injuries

If you receive an amount in settlement of a personal injury suit, part of that award may be for medical expenses that you deducted in an earlier year. If it is, you must include that part in your income in the year you receive it to the extent it reduced your taxable income in the earlier year. See *Reimbursement in a Later Year*, discussed earlier.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries, part of that award may be for future medical expenses. If it is, you must reduce any future medical expenses for these injuries until the amount you received has been completely used.

How Do You Figure and Report the Deduction on Your Tax Return?

Once you have determined which medical care expenses you can include, you figure and 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 22 and 31.

Enter the amount you paid for medical and dental expenses 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 35, Form 1040. For an example, see the partial Schedule A.

Impairment-Related Work Expenses (Business or Medical)

If you are disabled, you can take a business deduction for expenses that are necessary for you to be able to work. If you take a business deduction for these impairment-related work expenses, they are not subject to the 7.5% limit that applies to medical expenses.

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.

SCHEDULES A&B
(Form 1040)

Department of the Treasury
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

► **Attach to Form 1040.** ► **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

2003

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		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1	3,434		
	2	Enter amount from Form 1040, line 35	2	33,000		
	3	Multiply line 2 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

Impairment-related expenses defined. Impairment-related expenses are those ordinary and necessary business expenses that are:

- Necessary for you to do your work satisfactorily,
- For goods and services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

Where to report. If you are self-employed, deduct the business expenses on the appropriate form (Schedule C, C–EZ, E, or F) used to report your business income and expenses.

If you are an employee, complete **Form 2106**, *Employee Business Expenses*, or **Form 2106–EZ**, *Unreimbursed Employee Business Expenses.* 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). Your impairment-related work expenses are not subject to the 2%-of-adjusted-gross-income limit that applies to other employee business expenses.

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.

Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, were a general partner (or a limited partner receiving guaranteed payments), or received wages from an S corporation in which you were a more than 2% shareholder (who is treated as a partner), you may be able to deduct, as an adjustment to income, up to 100% of the amount paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, and dependents.

The insurance plan must be established under your trade or business, and you cannot take this deduction to the extent that the amount of the deduction is more than your earned income from that trade or business.

You may not take this deduction for any month in which you were eligible to participate in any subsidized health plan maintained by your employer or your spouse's employer. This rule is applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance.

If you qualify to take the deduction, use the *Self-Employed Health Insurance Deduction Worksheet* in the Form 1040 instructions to figure the amount you can deduct. But, if any of the following applies, do not use the worksheet.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, *Foreign Earned Income*, or Form 2555–EZ, *Foreign Earned Income Exclusion*.
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

If you cannot use the worksheet in the Form 1040 instructions, use the worksheet in Publication 535, *Business Expenses*, to figure your deduction.

Note. If advance payments of the health coverage tax credit were made on your behalf to your insurance company, do not include any advance payments made for you when figuring the amount you may deduct for insurance premiums. Also, if you are claiming the health coverage tax credit, subtract the amount shown on line 4 of Form 8885 (reduced by any advance payments shown on line 6 of that form) from the total insurance premiums you paid.

Where to report. You take this deduction on Form 1040, line 29. If you itemize your deductions and do not claim 100% of your self-employed health insurance on line 29, include any 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.

24.

Taxes

Important Reminder

Limit on itemized deductions. If your adjusted gross income is more than $139,500 ($69,750 if you are married filing separately), the overall amount of your itemized deductions may be limited. See chapter 31 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, and foreign),
- Real estate taxes (state, local, and foreign),
- Personal property taxes (state and local), and
- Taxes and fees you cannot deduct.

Use *Table 24–1* as a guide to determine which taxes you can deduct.

At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.

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 the date of payment, provided the check is honored by the financial institution. 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 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. You can deduct state and local income taxes withheld from your salary in the year they are withheld. For 2003, 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. You can deduct estimated tax payments you made during the year to 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. You can deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 2003 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 2003.
- Any refund of (or credit for) prior year state and local income taxes you actually received in 2003.

However, part or all of this refund (or credit) may be taxable. 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 Nonoccupational Disability Benefit Fund.
- New Jersey Nonoccupational Disability Benefit Fund.
- New Jersey Unemployment Compensation Fund.
- New York Nonoccupational Disability Benefit Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Worker's Compensation Fund.
- West Virginia Unemployment Compensation Fund.

CAUTION *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. You can deduct these taxes only if they are based on the assessed value of the real property and 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 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 (for leap years, divide line 2 by 366)	____.
4.	Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	_____

Note. Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

Real estate taxes for prior years. 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 365 (for leap years, divide line 2 by 366)	.345
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 365 (for leap years, divide line 2 by 366)	.666
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, 2003. Their real property tax year for the new home is the calendar year. Real estate taxes for 2002 were assessed in their state on January 1, 2003. The taxes became due on May 31, 2003, and October 31, 2003.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 2002 were $680. They paid $340 on May 31, 2003, and $340 on October 31, 2003. These taxes were for the 2002 real property tax year. The

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 *Contributions to state benefit funds.* One-half of self-employment tax paid.	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.	Import duties.
Other Taxes	Taxes that are expenses of your trade or business or of producing income. Taxes on property producing rent or royalty income. Occupational taxes.	State and local sales and use taxes. Federal excise taxes, such as telephone taxes (see *Taxes and Fees You Cannot Deduct*).
Fees and Charges	Fees and charges that are expenses of your trade or business or of producing income.	Fees and charges that are ***not*** expenses of your trade or business or of producing income, such as fees for driver's licenses, car inspections, parking, or charges for water bills (see *Taxes and Fees You Cannot Deduct*). Fines and penalties.

Browns cannot deduct them since they did not own the property until 2003. Instead, they must add $680 to the cost of their new home.

In January 2004, the Browns receive their 2003 property tax statement for $752, which they will pay in 2004. The Browns owned their new home during the 2003 real property tax year for 243 days (May 3 to December 31). They will figure their 2004 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 365 (for leap years, divide line 2 by 366) 666
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 2004, along with the $680 paid in 2003, is added to the cost of their new home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 2003 tax deduction of $931. This is the sum of the $680 for 2002 and the $251 for the 122 days the seller owned the home in 2003. 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 2004 to find out how much real estate tax is due for 2003.

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 federal 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 *Taxes and insurance*, in chapter 20, for more 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 2003 of real estate taxes you paid in 2003, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 2003 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 tending to 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).

CAUTION *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 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.

If the tax is partly based on value and partly based on other criteria, it may qualify in part.

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, because it is based on the value. The remaining $17 ($.50 × 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. See *Table 24–1*.

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 chapter 4.
- ***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 34.

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 44 of Form 1040. To claim the credit, you may have to complete and attach Form 1116. For more information, see chapter 39 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 or Schedule F (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 28, 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 Education.*

Limit on itemized deductions. Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than $139,500 ($69,750 if you are married filing a separate return). For more information, see chapter 31.

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 2003 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 2003 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 39.

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 for lower-income families 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.

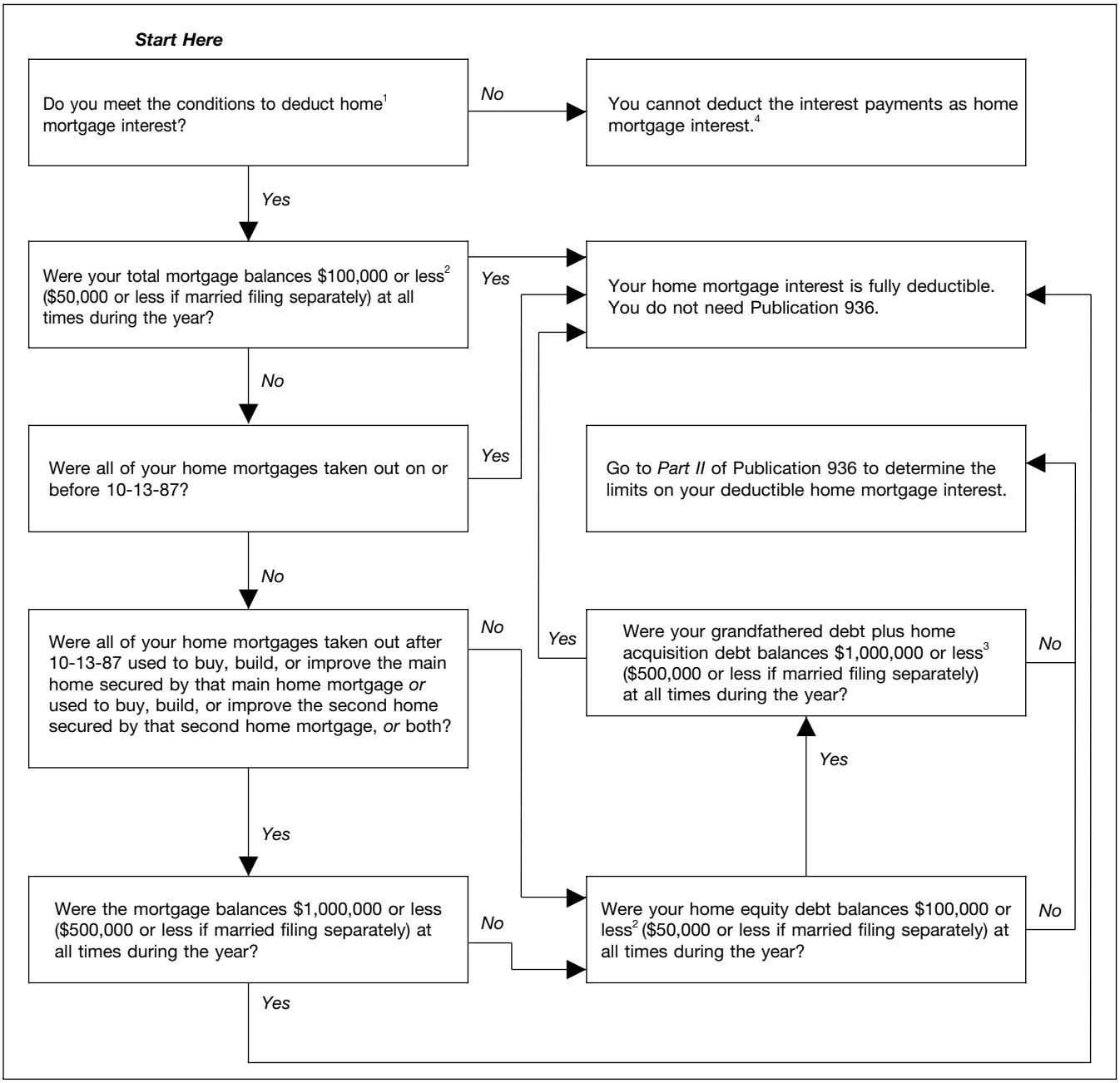
Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony. See the discussion of *Payments for jointly-owned home* in chapter 20.

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.



[1]You 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.*

[2]If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in *Part II* of Publication 936.

[3]Amounts over the $1,000,000 limit ($500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

[4]See *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.

CAUTION **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.

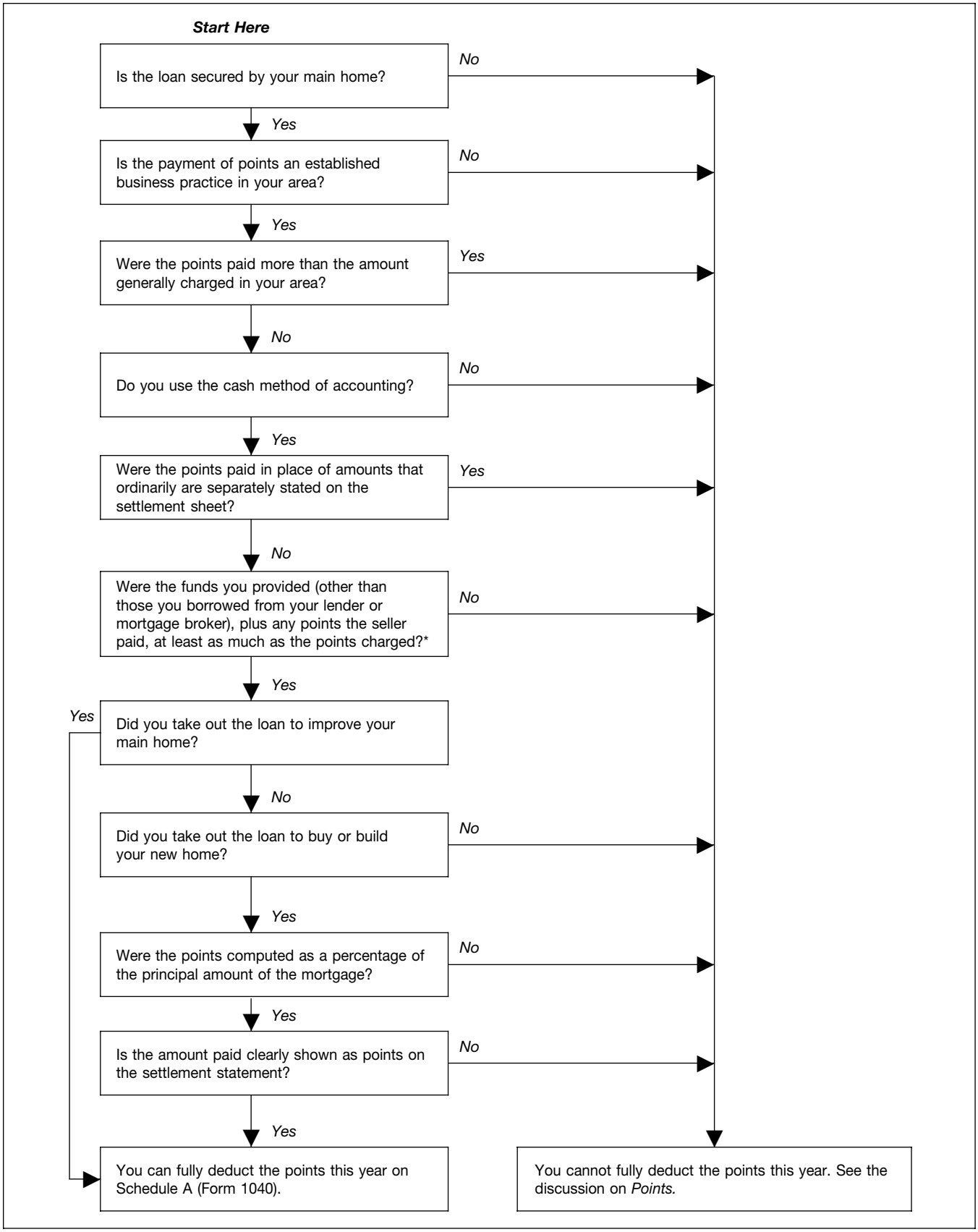
Example 2. The facts are the same as in *Example 1,* except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You spread the remaining $250 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.

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.

Example. Dan paid $3,000 in points in 1993 that he had to spread out over the 15-year life of the mortgage. He had deducted $2,000 of these points through 2002.

Dan prepaid his mortgage in full in 2003. He can deduct the remaining $1,000 of points in 2003.

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 2003, 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 2003 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 2003. He can deduct two points ($2,000) ratably over the life of the loan. He deducts $67 [($2,000 ÷ 180 months) × 6 payments] of the points in 2003. 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 ÷ $100,000) of the points ($2,000) in 2003. His deduction is $500 ($2,000 × 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 ÷ 180 months) × 6 payments] in 2003. The total amount Bill deducts in 2003 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 cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

The statement for each year should be sent to you 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 government 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 2003 that accrued in full by January 15, 2004, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2004 in 2003. (See *Prepaid interest,* earlier.) You will have to figure the interest that accrued for 2004 and subtract it from the amount in box 1. You will include the interest for January 2004 with the other interest you pay for 2004. 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. It also does not include qualified dividends or capital gain distributions unless you choose to include them.

Choosing to include qualified dividends. Investment income generally does not include qualified dividends (discussed in chapter 9). However, you can choose to include all or part of your qualified dividends in investment income.

You make this choice by completing line 4g of Form 4952 according to its instructions.

If you choose to include any amount of your qualified dividends in investment income, you must reduce your qualified dividends that are eligible for the lower capital gains tax rates by the same amount.

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 4g 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.

TIP *Before making either choice, consider the overall effect on your tax liability. Compare your tax if you make one or both of these choices 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 qualified dividends, 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.*

Child's qualified dividends. If part of the amount you report is your child's qualified dividends, that part (which is reported on line 9b of Form 1040 or Form 1040A) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under *Choosing to include qualified dividends,* earlier.

Your investment income also includes the amount on line 6 of Form 8814 (or, if applicable, the amount figured next under *Child's Alaska Permanent Fund dividends).*

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 13a of Form 1040) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained in *Choosing to include net capital gain,* earlier.

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 minus any qualified dividends.
- You have no other deductible investment expenses.
- You have no disallowed investment interest expense from 2002.

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.

Table 25–1. **Where To Deduct Your Interest Expense**

IF you have ...	THEN deduct it on ...	AND for more information go to ...
Deductible student loan interest	Form 1040, line 25 or Form 1040A, line 18	Publication 970
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest *not* reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Deductible points *not* reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Deductible investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Deductible business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publication 535
Deductible farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Deductible interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not Deductible	

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 paid to a government 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.

TIP *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.

26.

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.

Limit on itemized deductions. If your adjusted gross income is more than $139,500 ($69,750 if you are married filing separately), the overall amount of your itemized deductions may be limited. See chapter 31 for more information about this limit.

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.

TIP *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 IRS 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 Boy and Girl 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. Generally, you must have income from sources in that country. 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**

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.

Deductible As Charitable Contributions	Not Deductible As Charitable Contributions
Money or property you give to: • 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	Money or property you give to: • 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 • Groups whose purpose is to lobby for law changes • Homeowners' associations • Individuals • Political groups or candidates for public office
Costs you pay for a student living with you, sponsored by a qualified organization	Cost of raffle, bingo, or lottery tickets
Out-of-pocket expenses when you serve a qualified organization as a volunteer	Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups
	Tuition
	Value of your time or services
	Value of blood given to a blood bank

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.

CAUTION *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:

   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.

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?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to and from 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 34.)

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 $8.

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. See *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.

TIP *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 are 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 you help take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing adult supervision for 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 help 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 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 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. 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 contri-

bution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive or expect to 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 information on how to report gambling winnings and losses, see chapter 13 and 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 nonprofit day-care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a "donation."

Value of Time or Services

You cannot deduct the value of your time or services, including:

- ***Blood donations*** to the Red Cross or to blood banks, 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 exclude from your gross income adoption expenses paid or reimbursed by your employer. See *Adoption Credit* in chapter 39 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.

Right to use 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. See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

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 $50. The fair market value of the coat is therefore $50. Dawn's donation is limited to $50.

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 used car pricing 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 capi-

tal 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 is limited to ***50%*** of your adjusted gross income and may be limited to ***30%*** or ***20%*** 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,* later.

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.

Generally, the 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations.* But there is one ***exception.*** A 30% limit also applies to these gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *Special 30% Limit for Capital Gain Property,* 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 can check IRS Publication 78 or call the IRS 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 contributions.
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

A 30% limit applies to the following gifts.

- Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.
- Gifts ***for the use of*** any organization.

However, if these gifts are of capital gain property, they are subject to the 20% limit, described later, rather than the 30% limit.

Student living with you. Amounts you spend on behalf of a student living with you are subject to the 30% limit. These amounts are considered a contribution ***for the use of*** a qualified organization.

Special 30% Limit for Capital Gain Property

A special 30% limit applies to gifts of capital gain property to 50% limit organizations. (For gifts of capital gain property to other organizations, see *20% Limit,* next.) However, the special 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.

20% Limit

This limit applies to all gifts of capital gain property to or for the use of qualified organizations (other than gifts of capital gain property to 50% limit organizations).

Carryovers

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted-gross-income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond

that time. For more information, see *Carryovers* in Publication 526.

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 organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, 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 the 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.

TIP *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 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.

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

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 both 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.

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.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.
- Storms, including hurricanes and tornadoes.
- Terrorist attacks.
- 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. ***However***, 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. ***However,*** 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. Sudden, unexpected, and unusual events are defined earlier.

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 in-

solvent 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.

The loss you can deduct as an ordinary loss is limited to $20,000 ($10,000 if you are married filing separately) reduced by any expected state insurance proceeds. You cannot claim an ordinary loss if any part of the deposit is federally insured.

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. However, you can take a nonbusiness bad debt deduction for any amount of loss that is more than the estimated amount you deducted as a casualty or ordinary loss. 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 year the actual loss is determined and deduct the loss as a nonbusiness bad debt in that year.

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.

- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- 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.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following.

- When you discovered that your property was missing.
- That your property was stolen.
- That you were the owner of the property.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

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 other reimbursement you receive or expect to receive.

Adjusted Basis

Adjusted basis is your basis in the property (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 has 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 just before 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.

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 FMV.

Decline in market value of property in or near casualty area. 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.

Costs of photographs and appraisals. 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.

Appraisals are used to figure the decrease in FMV because of a casualty or theft. See *Appraisal*, earlier, under *Figuring Decrease in FMV — Items To Consider*, for information about appraisals.

The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss. You can claim these costs 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 must 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 smaller 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 reimbursement from your insurance company was $10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received $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 limits 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 or the threat of one.

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 for 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 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 2001. You regained use of your home in November 2002. The insurance payments you received in 2001 and 2002 were $1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 2002 Form 1040. If, in 2003, you receive further payments to cover the living expenses you had in 2001 and 2002, you must include those payments in income on your 2003 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.

TIP *Qualified disaster relief payments you receive for expenses you incurred as a result of a Presidentially declared disaster, are not taxable income to you. For more information, see* Disaster Area Losses *in Publication 547.*

Disaster unemployment assistance payments are unemployment benefits that are taxable.

Generally, disaster relief grants received under the Disaster Relief and Emergency Assistance Act are not includible in your income. See *Disaster Area Losses* in Publication 547.

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 as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. Your personal car had a FMV of $2,000 when it was destroyed in a collision with another car in 2002. The accident was due to the negligence of the other driver. At the end of 2002, 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 in 2002.

In January 2003, 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 in 2003 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.

CAUTION *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. In December 2003, 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 in 2003.

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 in 2004, 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 a FMV of $500 just before the fire. The rug cost $3,000 and had a 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:

	Chair	Rug	Table
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 on each item, 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 after reimbursement	**$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 use, 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).

Table 27–1. **How To Apply the Deduction Limits for Personal-Use Property**

		$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.

2) You must further reduce the total of all your casualty or theft 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 on personal-use property, 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 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 on personal-use property 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 for the year you discovered the theft 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 after you apply the $100 rule ($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 for the year that the accident and fire occurred 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	$1,100	$1,600
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 any reimbursements and by $100.

CAUTION *Casualty or theft gains do not include gains you choose to postpone. See Publication 547 for information on the postponement of gain.*

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, if any, 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 gains.

When To Report Gains and Losses

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 reporting 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 generally can deduct a theft loss only in the year you discover your property was stolen. You must be able to show that there

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.

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 from a disaster that occurred in a Presidentially declared disaster area, you can choose to deduct the loss on your tax return or amended return for either of the following years.

- The year the disaster occurred.
- The year immediately preceding the year the disaster occurred.

Postponed tax deadlines. The IRS may postpone for up to 1 year 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.

- Any individual whose main home is located in a covered disaster area (defined next).
- 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 1 year.

Abatement of interest and penalties. The IRS may abate the interest and penalties on underpaid income tax for the length of any postponement of tax deadlines.

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. In addition, you must use the appropriate schedule to report a gain or loss. The schedule you use depends on whether you have a gain or loss.

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 Changes

Standard mileage rate. The standard mileage rate for the cost of operating your car in 2003 is 36 cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained under *Transportation Expenses,* later.

Special depreciation allowance. The special depreciation allowance increases from 30% to 50% for most new vehicles acquired after May 5, 2003. If the 50% allowance applies, you can choose to use the 30% allowance or elect out entirely for any class of property. For more information, see *Special Depreciation Allowance* in Publication 463.

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 a day from January 1, 2003, through September 30, 2003, and $31 a day from October 1, 2003, through December 31, 2003. However, the standard meal allowance is higher for most major cities and many other localities in the continental United States. For more information, see *Standard meal allowance* under *What Travel Expenses Are Deductible,* later.

Armed Forces reservists. Beginning in 2003, if you are a member of a reserve component of the Armed Forces of the United States, you may be able to deduct some of your reserve-related travel costs as an adjustment to gross income rather than as an itemized deduction. For more information, see *Armed Forces reservists traveling more than 100 miles from home* under *Special Rules*, later.

Important Reminders

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 65% for 2003. 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 $139,500 ($69,750 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 required 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 chapter. 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) There is no amount shown with a code "L" in box 12 of your Form W–2, *Wage and Tax Statement.*

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.

TIP *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
- 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.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

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.

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 business or 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 business or 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.

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

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 *Luxury Water Travel* and *Cruise ships* (under *Conventions*) 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: • 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 *Meals and incidental expenses* 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.

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.

RECORDS

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*, later.

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 as-

sisting 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 and Incidental Expenses

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.

You can deduct incidental expenses if requirement (1) above is met.

Business-related entertainment is discussed under *Entertainment Expenses,* later. The following discussion deals with meals that are not business-related entertainment and with incidental expenses.

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. The term "incidental expenses" means:

- Fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries,
- Transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the temporary duty site, and
- Mailing costs associated with filing travel vouchers and payment of employer-sponsored charge card billings.

Incidental expenses do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.

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.*

CAUTION *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. The rate is ***$30 a day*** for January 1, 2003, through September 30, 2003, and ***$31 a day*** for the period from October 1, 2003, through December 31, 2003, 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 these rates are listed in Publication 1542.

You can also find this information on the Internet at **www.policyworks.gov/perdiem**. Click on "2003 Domestic Per Diem Rates" for the period January 1, 2003 — September 30, 2003, and "2004 Domestic Per Diem Rates" for the period October 1, 2003 — December 31, 2003. However, you can apply the rates in effect before October 1, 2003, for expenses of all travel within the United States for 2003 instead of the updated rates. You must consistently use either the rates for the first 9 months for all of 2003 or the updated rates for the period of October 1, 2003, through December 31, 2003.

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).

You can access foreign per diem rates at: **www.state.gov/m/a/als/prdm**.

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 ***$40 a day*** standard meal allowance ($45 for travel outside the continental United States) with respect to meal and incidental expenses paid or incurred for travel from January 1, 2003, to October 31, 2003. For travel in November and December, the rates are $41 and $46.

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 ¾ 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.

Incidental expenses only method. You can use an optional method (instead of actual cost) for deducting incidental expenses only. The amount of the deduction is $2 a day for incidental expenses paid or incurred for travel away from home from January 1 through October 31, 2003, and $3 a day for travel from November 1 through December 31, 2003. You can use this method only if you did ***not*** pay or incur any meal expenses. You cannot use this method on any day that you use the standard meal allowance.

CAUTION *Federal employees should refer to the Federal Travel Regulations at* **www.policyworks.gov/ftr** *for changes affecting their claims for reimbursement of these expenses.*

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 en-

tirely 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.

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.

TIP *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.

CAUTION *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 official 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.

CAUTION *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 deduct 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.

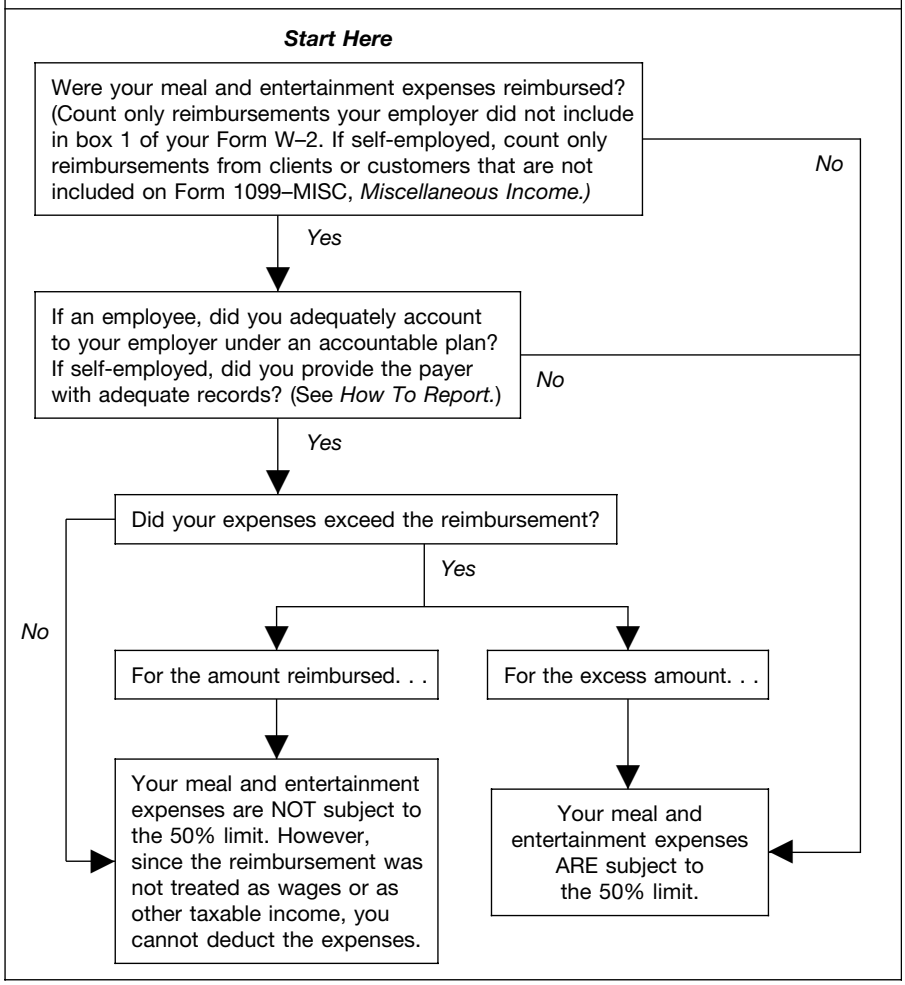
If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the cost of the tickets as a gift expense.

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.

Figure 28–A. **Does the 50% Limit Apply to Your Expenses?**

There are exceptions to these rules. See *Exceptions to the 50% Limit.*

All employees and self-employed persons can use this chart. For more information, see 50% Limit.



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.

CAUTION *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

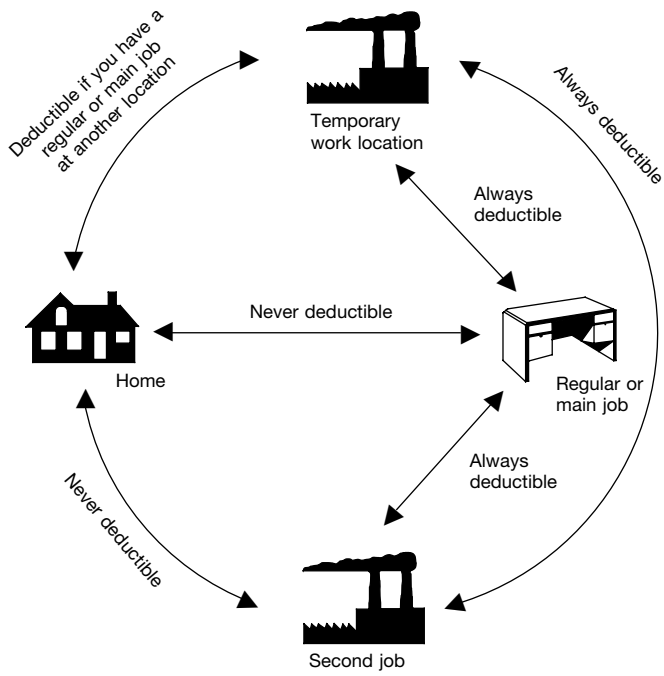
Generally, business-related meal and entertainment expenses are subject to the 50% limit. *Figure 28–A* can help you determine if the 50% limit applies to you.

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.*

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*.)



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is realistically expected to last (and does in fact last) one year or less. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary work location outside your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. You cannot deduct your transportation costs between your home and a second job on a day off from your main job.

Individuals subject to "hours of service" limits. You can deduct a higher percentage of your meal expenses while traveling away from your tax home 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 65% for 2003, 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.

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 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 work locations 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, regardless of distance.

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 employment 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 expenses.

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 expense. 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.*

If you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, see *Armed Forces reservists traveling more than 100 miles from home* under *Special Rules*, later.

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.)

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 the two following methods to figure your deductible expenses.

- Standard mileage rate.
- Actual car expenses.

If you use actual car 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 39) 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.

CAUTION *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 2003, the standard mileage rate is ***36 cents*** a mile for all business miles.

CAUTION *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 1997.

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 any method other than straight line depreciation,
4) Claimed a section 179 deduction on the car,
5) Claimed the special depreciation allowance on the car,
6) Claimed actual car expenses after 1997 for a car you leased, or
7) 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.

TIP *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:

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.

TIP *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 sales taxes, even if you use your car 100% for business. 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 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 through the section 179 deduction (the deduction allowed by section 179 of the Internal Revenue Code), the special depreciation allowance, and depreciation deductions. By using depreciation, you recover the cost over more than one year by deducting part of it each year. The section 179 deduction, the special depreciation allowance, and the depreciation deduction are discussed in more detail in chapter 4 of Publication 463.

Generally, there are limits on 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. Publication 544 has information on sales of property used in a trade or business, and details on how to report the disposition.

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.

RECORDS

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.

CAUTION

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

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).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: 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 *Business Purpose*.)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see *Business Purpose*.)	Purpose: 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. Relationship: 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.	Purpose: Business purpose for the expense. Relationship: N/A

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 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, Armed Forces reservists, 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.

Employees. 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 all 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.

CAUTION *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.

TIP *If your employer included reimbursements in box 1 of your Form W–2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W–2.*

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.

TIP *The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.*

Adequate Accounting

One of the three rules 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 of 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 a day for January 1 through September 30, 2003, and $31 a day for the period from October 1 through December 31, 2003. 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 October of 2003 is $204 (including $45 for M&IE) for certain high-cost locations. All other areas have a per diem amount of $125 (including $35 for M&IE). (Employers can get Publication 1542 (Revised February 2003), which gives the areas eligible for the $204 per diem amount under the high-low method for all or part of this period.)

CAUTION *Effective November 1, 2003, the per diem rate under this method for certain high-cost locations is $207 (including $46 for M&IE). The rate for all other locations is $126 (including $36 for M&IE). However, an employer can continue to use the rates described in the preceding paragraph for the remainder of 2003 if those rates and locations are used consistently during November and December for all employees. Employers who did not use the high-low method during the first 10 months of 2003 cannot begin to use it before 2004. See* Revenue Procedure 2003–80 *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 3/4 of the standard meal allowance amount for that day.
   b) For the day you return, add 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 consistently 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 2003, the standard mileage rate is ***36 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

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:		
Actual expense reimbursement: Adequate accounting made and excess returned.	No amount.	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned.	The excess amount as wages in box 1.	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting made and excess returned.	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form is not filed.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.	No amount.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting up to the federal rate only and excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.	All expenses (and reimbursement reported on Form W–2, box 12) 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 *Completing Forms 2106 and 2106–EZ*.		

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 $3,600 expenses computed under the standard mileage rate (10,000 miles × 36 cents) are more than her $2,000 reimbursement (10,000 miles × 20 cents), she itemizes her deductions to claim the excess expenses. Nicole completes Form 2106 (showing ***all*** of her expenses and reimbursements) and enters $1,600 ($3,600 – $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 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 $60 a day for his meals and incidental expenses. The federal rate for San Diego is $50 a day.

Joe can prove that his actual meal expenses totaled $325. His employer's accountable plan will not pay more than $60 a day for travel to San Diego, so Joe does not give his employer the records that prove that he actually spent $325. 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 $240 ($60 × 4 days), which is $40 more than the federal rate of $200 ($50 × 4 days). The employer includes the $40 as income on Joe's Form W–2 in box 1. The employer also enters $200 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 ($325) on Form 2106. He also enters the reimbursements that were not included in his income ($200). His total deductible expense, before the 50% limit, is $125. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, $63, 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 $250 ($50 × 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses for Phoenix is $46. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the $100 ($50 × 2 days) advance for the 2 days you did not travel. You do not have to return the $12 difference between the allowance you received and the federal rate for Phoenix [($50 – $46) × 3 days]. However, the $12 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.

TIP *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 65% 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 12 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, an Armed Forces reservist, 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 35 of Form 1040) is more than $139,500 ($69,750 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 to government officials who are paid on a fee basis, performing artists, Armed Forces reservists, 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 33 of Form 1040. Write "FBO" and the amount of your employee business expenses in the space to the left of line 33 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 as an employee 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 33 of Form 1040. Write "QPA" and the amount of your performing-arts-related expenses in the space to the left of line 33 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).

Armed Forces reservists traveling more than 100 miles from home. If you are a ***member of a reserve component*** of the Armed Forces of the United States and you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, you can deduct your travel expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. The amount of expenses you can deduct is limited to the *federal rate* (explained earlier under *Per Diem and Car Allowances).*

Member of a reserve component. You are a member of a reserve component of the Armed Forces of the United States if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve, the Army National Guard of the United States, the Air National Guard of the United States, or the Reserve Corps of the Public Health Service.

How to report. If you have reserve-related travel that takes you more than 100 miles from home, you should first complete Form 2106 or Form 2106–EZ. Then include your expenses for reserve travel over 100 miles from home, up to the federal rate, from line 10 of Form 2106 or line 6 of Form 2106–EZ in the total on line 33 of Form 1040. Write "RC" and the amount of these expenses in the space to the left of line 33 of Form 1040. Subtract this amount from the total on line 10 of Form 2106 or line 6 of Form 2106–EZ and deduct the balance as an itemized deduction on line 20 of Schedule A (Form 1040).

You cannot deduct expenses of travel that does not take you more than 100 miles from home as an adjustment to gross income. Instead, you must complete Form 2106 or 2106–EZ and deduct those 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, 2000. 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-EZ. He figures his car expense to be $7,200 (20,000 business miles × 36 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	7,200
Meals	2,632
Lodging, laundry, dry cleaning	8,975
Entertainment	1,870
Gifts, education, etc.	430
Total	**$21,432**

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.

Form **2106-EZ**

Department of the Treasury
Internal Revenue Service

Unreimbursed Employee Business Expenses

▶ **Attach to Form 1040.**

OMB No. 1545-1441

2003

Attachment Sequence No. **54A**

Your name	Occupation in which you incurred expenses	Social security number
Bill Wilson	Sales	555 : 00 : 5555

You May Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. 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 required to be considered necessary.
- 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 2003.

Caution: *You can use the standard mileage rate for 2003* ***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 36¢ (.36)	1	7,200
2	Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	325
3	Travel expense while away from home overnight, including lodging, 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: $ 4,502 x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) 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	19,181

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 / 00

8 Of the total number of miles you drove your vehicle during 2003, 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

Standard mileage rate. The standard mileage rate is 36 cents for each mile of business use in 2003.

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 Daycare Providers)

Pub. 946, How To Depreciate Property

Specific Instructions

Part I—Figure Your Expenses

Line 2. See the line 8b instructions for the definition of commuting.

Line 3. Enter lodging and transportation expenses connected with overnight travel away from your tax home (defined on this page). You cannot deduct expenses for travel away from your tax home for any period of temporary employment of more than 1 year. **Do not** include expenses for meals and entertainment. For more details, including limits, see Pub. 463.

Instead of keeping records of your actual incidental expenses, you can use an **optional method for deducting incidental expenses only** if you did **not** pay or incur meal expenses on a day you were traveling away from your tax home. The amount of the deduction is $2 per day. Incidental expenses include fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries. They do **not** include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls. You cannot use this method on any day that you use the standard meal allowance (as explained in the instructions for line 5).

Generally, your **tax home** is your main place of business or post of duty regardless of where you maintain your family home. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit in either of these categories, you are considered an itinerant

For Paperwork Reduction Act Notice, see back of form. Cat. No. 20604Q Form **2106-EZ** (2003)

29.

Tax Benefits for Work-Related Education

Important Change for 2003

Standard mileage rate. Generally, if you claim a business deduction for work-related education and you drive your car to and from school, the amount you can deduct in 2003 is 36 cents per mile. See *Transportation Expenses* under *Qualified Education Expenses*, for more information.

Introduction

This chapter discusses work-related education expenses that you may be able to deduct as business expenses.

To claim such a deduction, you must:

1) Be working,
2) Itemize your deductions on Schedule A (Form 1040) ***if you are an employee***,
3) File Schedule C (Form 1040) or Schedule F (Form 1040) ***if you are self-employed***, and
4) Have expenses for education that meet the requirements discussed under *Qualifying Work-Related Education.*

If you are an employee, you may be able to claim a deduction for the expenses you pay for your work-related education. The deduction you are allowed will be the amount by which your work-related education expenses plus other job and certain miscellaneous expenses is greater than 2% of your adjusted gross income. See chapter 30.

If you are self-employed, you deduct your expenses for work-related education directly from your self-employment income.

Your work-related education expenses may also qualify you for other tax benefits, such as the tuition and fees deduction (see chapter 21) and the Hope and lifetime learning credits (see chapter 37). You may qualify for these other benefits even if you do not meet the requirements listed above.

Also, keep in mind that your work-related education expenses may qualify you to claim more than one tax benefit. Generally, you may claim any number of benefits as long as you use different expenses to figure each one.

TIP *When you figure your taxes, you may want to compare these tax benefits so you can choose the method(s) that give you the lowest tax liability. First, figure your taxes using the expenses as business deductions. Then, figure your taxes again using any of the other deductions and credits for which you qualify. You may find that a combination of credit(s) and deduction(s) gives you the lowest tax.*

Useful Items

You may want to see:

Publication

- ❑ **463** Travel, Entertainment, Gift, and Car Expenses
- ❑ **970** Tax Benefits for Education

Form (and Instructions)

- ❑ **2106** Employee Business Expenses
- ❑ **2106–EZ** Unreimbursed Employee Business Expenses
- ❑ **Schedule A (Form 1040)** Itemized Deductions

Qualifying Work-Related Education

You can deduct the costs of qualifying work-related education as business expenses. 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 work-related 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 costs of qualifying work-related education as a business expense even if the education could lead to a degree.

Use *Figure 29–A* (see next page) 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 work-related 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.

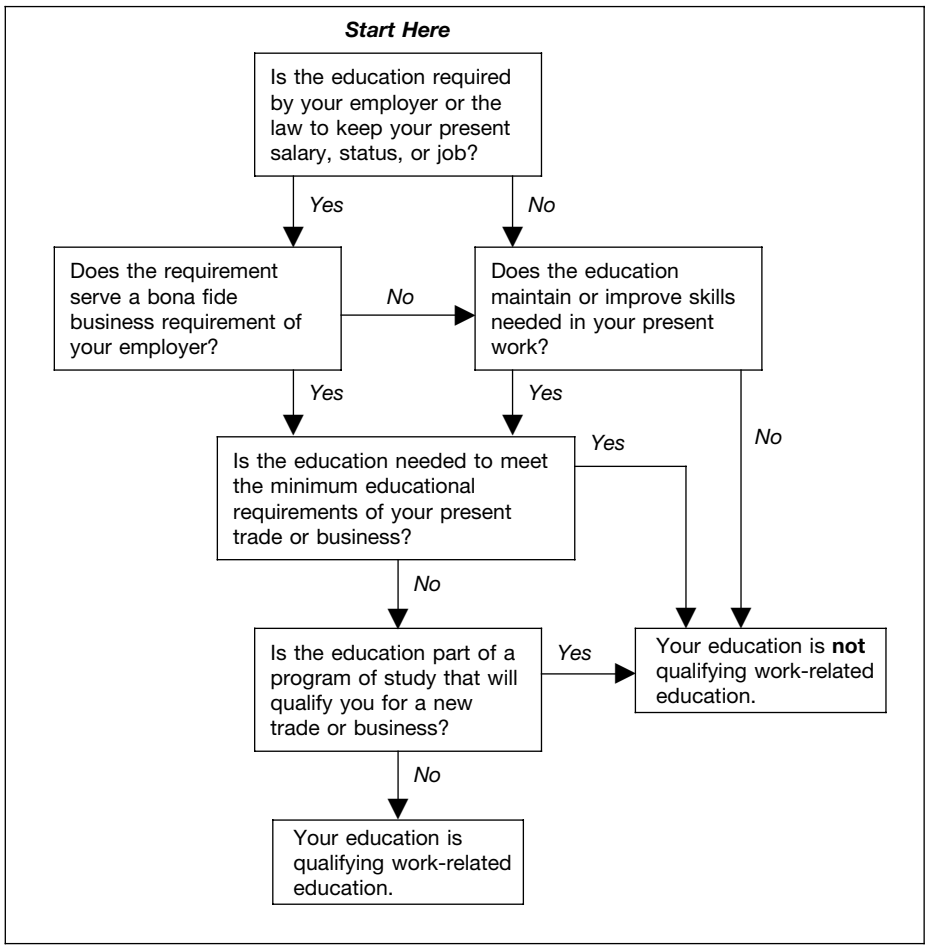
Maintaining skills vs. qualifying for new job. Education to maintain or improve skills needed in your present work is not qualifying education if it will also qualify you for a new trade or business.

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 general type of 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.

Figure 29-A. **Does Your Work-Related Education Qualify?**



Education To Meet Minimum Requirements

Education you need to meet the minimum educational requirements for your present trade or business is not qualifying work-related 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 the new requirements can be qualifying education.

CAUTION *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 10 professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school 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 10 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.

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 work-related 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.

Example 3. While working in the private practice of psychiatry, you enter a program to study and train at an accredited psychoanalytic institute. The program will lead to qualifying you to practice psychoanalysis. The psychoanalytic training does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are 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.

Qualified Education Expenses

If your education meets the requirements described earlier under *Qualifying Work-Related Education,* you can generally deduct your education expenses as business expenses. If you are not self-employed, you can deduct business expenses only if you itemize your deductions.

You cannot deduct expenses related to tax-exempt and excluded income.

Deductible expenses. The following education expenses can be deducted.

1) Tuition, books, supplies, lab fees, and similar items.
2) Certain transportation and travel costs.
3) Other education expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. Qualified education 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 education 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.

Attendance on a temporary basis. You go to school on a temporary basis or are considered to go on a temporary basis if either of the following situations applies to you.

1) Your attendance at school is realistically expected to last ***1 year or less*** and does indeed last for 1 year or less.
2) Initially your attendance at school is realistically expected to last ***1 year or less***, but at a later date your attendance is reasonably expected to last ***more than 1 year***. Your attendance will be considered temporary up to the date you determine it will last more than 1 year.

Note: If you are in either situation described in (1) or (2) above, your attendance may be considered not temporary if facts and circumstances indicate otherwise.

Attendance not on a temporary basis. You do not go to school on a temporary basis if any of the following situations apply to you.

1) Your attendance is ***not*** realistically expected to last ***1 year or less***. It does not matter how long you actually attend.
2) Your attendance at school is realistically expected to last ***more than 1 year***. It does not matter how long you actually attend.
3) Initially your attendance at school is realistically expected to last ***1 year or less***, but at a later date your attendance is reasonably expected to last ***more than 1 year***. Your attendance will not be considered temporary after the date you determine it will last more than 1 year.

Deductible Transportation 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 a nearby town, and go directly from work to home. You also attend school every work 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 2003 is 36 cents per mile. Whichever method you use, you can also deduct parking fees and tolls. See 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 on Meals*, 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 work-related education are treated the same as travel expenses for other employee business purposes. For more information, see chapter 28.

CAUTION *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, John 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. Sue works in Boston. She went to a university in Michigan to take a course for work. The course is qualifying education.

She took one course, which is one-fourth of a full course load of study. She spent the rest of the time on personal activities. Her reasons for taking the course in Michigan were all personal.

Sue's trip is mainly personal because three-fourths of her time is considered personal time. She cannot deduct the cost of her round-trip train ticket to Michigan. She can deduct one-fourth of the meals (subject to the 50% limit) and lodging costs for the time she attended the university.

Example 3. 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.

Dave 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 on meals. You can deduct only 50% of the cost of your meals while traveling away from home to obtain qualifying 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, even if it is directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as education 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.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct work-related education expenses as business expenses if you deduct these expenses under any other provision of the law, for example, as a tuition and fees deduction. See chapter 21.
- Deduct work-related education 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 qualified work-related education expenses with certain ***tax-free*** funds, you cannot claim a deduction 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 excludable from gross income (see chapter 1 of Publication 970),
- Pell grants (see chapter 1 of Publication 970),
- Employer-provided educational assistance (see chapter 11 of Publication 970),
- Veterans' educational assistance (see chapter 1 of Publication 970), 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.

Reimbursements

How you treat reimbursements depends on the arrangement you have with your employer.

There are two basic types of reimbursement arrangements — ***accountable plans*** and ***nonaccountable plans.*** You can tell the type of plan you are reimbursed under by the way the reimbursement is reported on your Form W–2.

For information about how to treat reimbursements under both accountable and nonaccountable plans, see *Reimbursements* in chapter 28.

Deducting Business Expenses

Self-employed persons and employees report business expenses differently.

The following information explains what forms you must use to deduct the cost of your qualifying education as a business expense.

Self-Employed Persons

If you are self-employed, you must report the cost of your qualifying work-related education on the appropriate form used to report your business income and expenses (generally Schedule C, C–EZ, or F). If your educational expenses include expenses for a car or truck, travel, or meals, report those expenses 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 work-related education only if you were not reimbursed by your employer or if the costs were more than the reimbursement from a nonaccountable plan included in box 1 of your Form W–2.

In order to deduct the cost of your qualifying work-related education as a business expense, include the amount 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. See chapter 30.

Form 2106 or 2106–EZ. To figure your deduction for employee business expenses, including qualifying work-related 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:

- All reimbursements, if any, were included in box 1 of your Form W-2, and
- You are not claiming travel, transportation, meal, or entertainment 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:

- All reimbursements, if any, were included in box 1 of your Form W-2, 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 work-related education as an adjustment to gross income rather than as an itemized deduction.

Include the cost of your qualifying education with any other employee business expenses on line 33 of Form 1040. You do not have to itemize your deductions on Schedule A (Form 1040), and, therefore, the deduction is not subject to the 2%-of-adjusted-gross-income limit. You must complete Form 2106 or 2106–EZ to figure your deduction, even if you meet the requirements described earlier under *Form not required.*

For more information on qualified performing artists, see Publication 463.

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 work-related 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. To deduct these expenses, you must complete Form 2106 or 2106–EZ, even if you meet the requirements, described earlier, under *Form not required.*

For more information on impairment-related work expenses, see Publication 463.

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 2003, if your adjusted gross income is more than $139,500 ($69,750 if you are married filing separately), you may have to reduce the amount of certain itemized deductions, including most miscellaneous deductions. See chapter 31 for more information.

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.

RECORDS 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

- ❑ **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 35, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit. For example, you apply the 50% (or 65%) 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 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 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.

- 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 that 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 *Nondeductible 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 job search 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 responsible 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 2003 is 36 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.

CAUTION *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 2003 return, you can deduct fees paid in 2003 for preparing your 2002 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(1) 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 the estate's personal exemption 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, *Dividends and Distributions,* 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, 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). See *Tax Preparation Fees*, earlier.

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.

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(1) 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.

CAUTION *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.*

RECORDS **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 limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and for 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 33 of Form 1040. Then write "FBO" and the amount of those expenses on the dotted line next to line 33 of Form 1040.

Nondeductible Expenses

Examples of nondeductible expenses are listed next. The list is followed by discussions of additional nondeductible expenses.

List of Nondeductible 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.

Adoption Expenses

You cannot deduct the expenses of adopting a child, but you may be able to take a credit for those expenses. See chapter 39.

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, hotel, golf, and country 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.

31.

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 $139,500 ($69,750 if you are married filing separately). Your AGI is the amount on line 35 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 $139,500 ($69,750 if married filing separately), or
2) 80% of your itemized deductions that are affected by the limit. See *Which Itemized Deductions Are Limited,* earlier.

Table 31-1. **Itemized Deductions Worksheet—Line 28**

Keep for Your Records

1.	Enter the total of the amounts from Schedule A, lines 4, 9, 14, 18, 19, 26, and 27		**1.** 142,140
2.	Enter the total of the amounts from Schedule A, lines 4, 13, and 19, plus any gambling and casualty or theft losses included on line 27		**2.** 41,000
	CAUTION Be sure your total gambling and casualty or theft losses are clearly identified on the dotted lines next to line 27.		
3.	Is the amount on line 2 less than the amount on line 1?		
	☐ **No.** STOP Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.		
	☑ **Yes.** Subtract line 2 from line 1		**3.** 101,140
4.	Multiply line 3 above by 80% (.80)	**4.** 80,912	
5.	Enter the amount from Form 1040, line 36	**5.** 259,600	
6.	Enter: $139,500 ($69,750 if married filing separately)	**6.** 139,500	
7.	Is the amount on line 6 less than the amount on line 5?		
	☐ **No.** STOP Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.		
	☑ **Yes.** Subtract line 6 from line 5	**7.** 120,100	
8.	Multiply line 7 above by 3% (.03)	**8.** 3,603	
9.	Enter the **smaller** of line 4 or line 8		**9.** 3,603
10.	**Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28		**10.** 138,537

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 37 of your Form 1040. See chapter 22 for information on how to figure your standard deduction.*

Example

For tax year 2003, Bill and Terry Willow are filing a joint return on Form 1040. Their adjusted gross income is $259,600. 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	$142,140

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 as *Table 31–1.*

Of their $142,140 total itemized deductions, the Willows can deduct only $138,537 ($142,140 – $3,603). They enter $138,537 on Schedule A, line 28.

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 38 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.

32.

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).
- Qualified dividends taxed at the capital gains rates (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 33).

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 34 through 39 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	39
Child and dependent care	34
Child tax credit	36
Education	37
Elderly or disabled	35
Foreign tax	39
Mortgage interest	39
Prior year minimum tax	39
Qualified electric vehicle	39
Qualified retirement savings contributions	39

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 and renewal community employment credit, which is for certain employers who are engaged in a business in an empowerment zone, a renewal community, or the DC zone. See Publication 954, *Tax Incentives for Distressed Communities,* and the instructions for Form 8844, *Empowerment Zone and Renewal Community 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 52 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:
Additional taxes on qualified retirement plans and IRAs	11, 18
Advance earned income credit payments	38
Household employment taxes	34
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) Your net earnings from self-employment from other than church employee income 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 new markets credit, a qualified electric vehicle credit, a credit for employer-provided child care facilities, or an Indian employment credit. For more information about recapture of an education credit, see chapter 37. For more information about other recapture taxes, see the instructions for line 60 of Form 1040.

3) *Section 72(m)(5) excess benefits tax.* If you are (or were) a 5% owner of a busi-

ness 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 chapter 4 of 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 received an "excess parachute payment" (EPP) due to a change in a corporation's ownership or control. See the instructions for line 60 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),* Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts,* and Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.*

8) *Additional tax on Coverdell ESAs.* This applies if amounts contributed to, or distributed from, your Coverdell ESA do not meet the rules for these accounts. See Publication 970, *Tax Benefits for Education,* and Form 5329.

9) *Additional tax on qualified tuition programs*. This applies to amounts distributed from qualified tuition programs that do not meet the rules for these accounts. See Publication 970 and Form 5329.

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

For information on:	See chapter:
Child tax credit (additional)	36
Earned income credit	38
Estimated tax paid	5
Excess social security and RRTA tax withheld	39
Federal income tax withheld	5
Health coverage tax credit	39
Regulated investment company credit	39
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 67 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 checking or savings 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:

- $58,000 if your filing status is married filing a joint return (or qualifying widow(er) with dependent child),
- $40,250 if your filing status is single or head of household, or
- $29,000 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 42, and Form 6251, *Alternative Minimum Tax—Individuals.*

Tax Figured by IRS

If you file by April 15, 2004, 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 part of your refund applied to your 2004 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.*
   i) Form 8615, *Tax for Children Under Age 14 With 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, as 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 8 and fill in the lines that apply to you. Do not complete lines 10 through 12. If you are filing a joint return, use the space to the left of line 6 to separately show your taxable income and your spouse's taxable income.

Earned income credit. If you can take this credit, as discussed in chapter 38, the IRS can figure it for you. Print "EIC" in the space to the left of line 8.

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 the Form 1040EZ instructions.

Form 1040A Line Entries

Read lines 1 through 27 and fill in the lines that apply to you. If you are filing a joint return, use the space to the left of line 27 to separately show your taxable income and your spouse's taxable income. Do not complete line 28. Complete lines 29 through 33, 37, and 39 through 42 if they apply to you. Do not fill in lines 30 and 41 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 43. Do not complete lines 35, 36, 38, and 43 through 48.

Credit for child and dependent care expenses. If you can take this credit, as discussed in chapter 34, complete Schedule 2 and attach it to your return. Enter the amount of the credit on line 29 (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 35, attach Schedule 3 (1040A), *Credit for the Elderly or the Disabled for Form 1040A Filers*. Print "CFE" next to line 30 (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 38, the IRS will figure it for you. Print "EIC" to the left of the entry space for line 41. 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 the Form 1040A instructions.

Form 1040 Line Entries

Read lines 1 through 40 and fill in the lines that apply to you. Do not complete line 41.

If you are filing a joint return, use the space under the words "Adjusted Gross Income" on the front of your return to separately show your taxable income and your spouse's taxable income.

Read lines 42 through 67. Fill in the lines that apply to you, but do not fill in the "Total" lines. Also, do not complete line 54 and lines 68 through 73. Do not fill in lines 46 and 63 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 34, complete Form 2441 and attach it to your return. Enter the amount of the credit on line 45. The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, as discussed in chapter 35, attach Schedule R, *Credit for the Elderly or the Disabled*. Print "CFE" on the dotted line next to line 46 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 38, the IRS will figure it for you. Print "EIC" on the dotted line next to line 63 of Form 1040. 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 the Form 1040 instructions.

33.

Tax on Investment Income of Certain Minor Children

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 rules that apply to the tax on 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) If the child's interest and dividend income total less than $7,500, the child's parent may be able to choose to include that 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. The tax rate and other return information from that return are used to figure the child's tax as explained later under *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,500.*

Parents Who Do Not File a Joint Return

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.*

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 2003 only if ***all*** the following conditions are met.

1) Your child was under age 14 at the end of 2003. (A child born on January 1,1990, is considered to be age 14 at the end of 2003. You cannot make the election for this child.)
2) Your child is required to file a return for 2003, 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 2003 and no 2002 overpayment was applied to 2003 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 33–A.*

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.

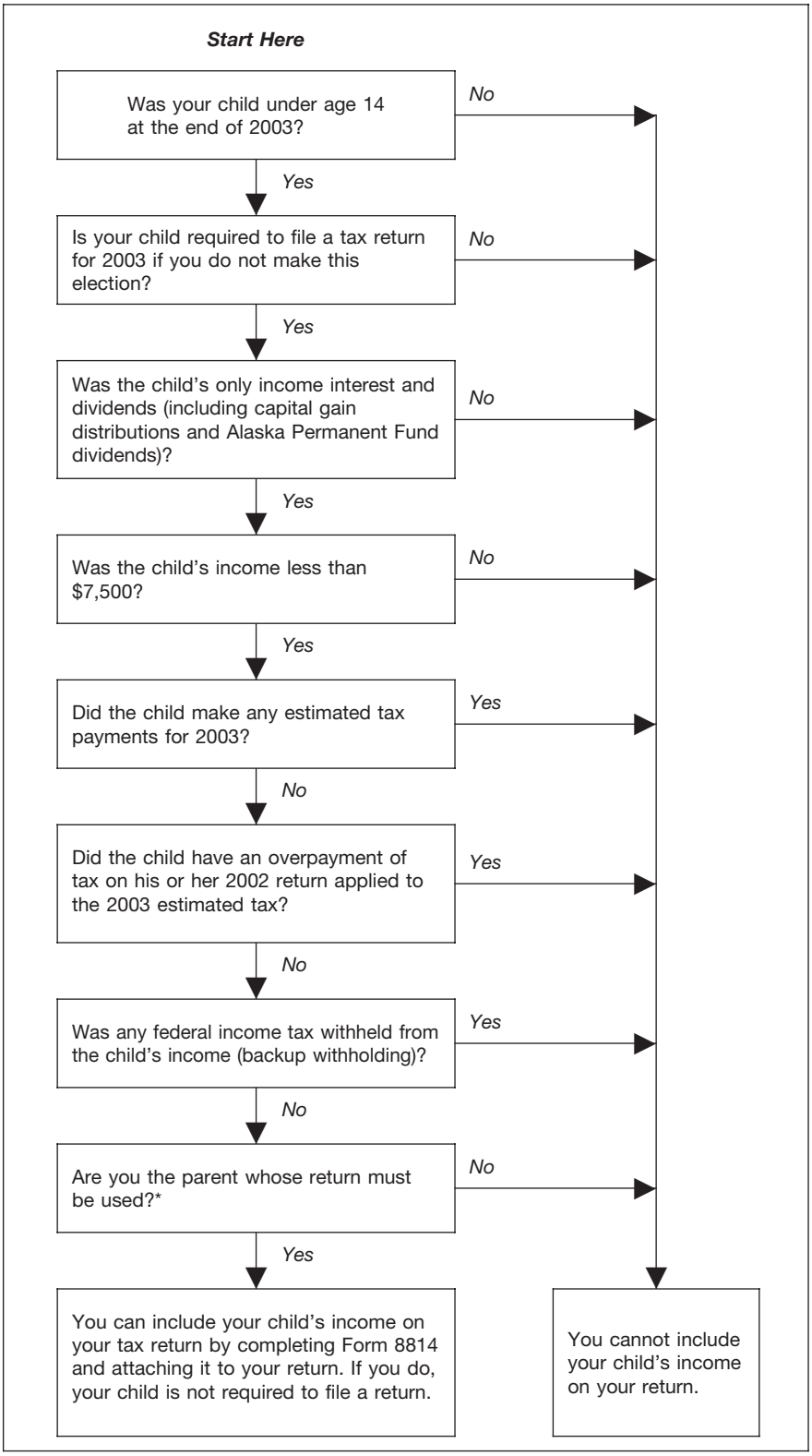
Effect of Making the Election

The federal income tax on your child's income may be more if you make the Form 8814 election.

Rate 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 that the child would be entitled to on his or her return.

Figure 33–A. **Can You Include Your Child's Income On Your Tax Return?**



*See *Which Parent's Return To Use*

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) Personal exemptions.
6) Credit for child and dependent care expenses.
7) Child tax credit.
8) Education tax credits.
9) Earned income credit.

Penalty for underpayment of estimated tax. If you make this election for 2003 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 2004, 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 and qualified dividends. If your child's dividend income included any capital gain distributions see *Capital gain distributions* under *Figuring Child's Income* in Part 2 of Publication 929. If your child's dividend income included any qualified dividends, see *Qualified dividends* under *Figuring Child's Income* in Part 2 of Publication 929.

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:

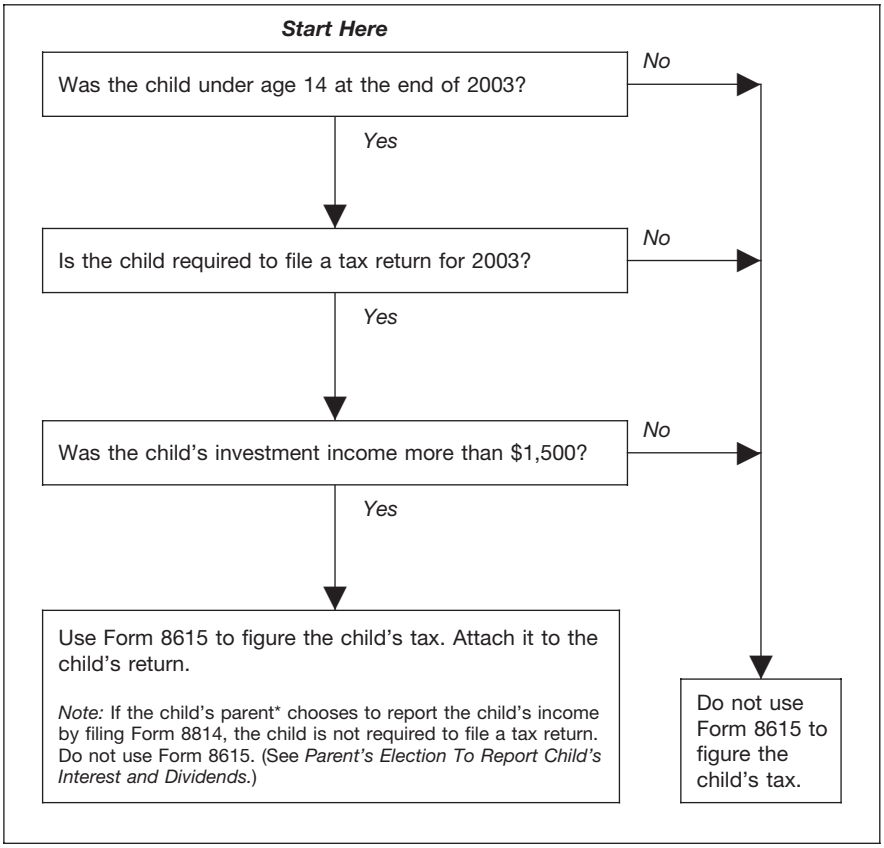
1) 10% × (your child's gross income – $750), or
2) $75.

Include the amount from line 9 of all your Forms 8814 in the total on line 41, Form 1040, or line 39, Form 1040NR. Check box **a** on Form 1040, line 41, or Form 1040NR, line 39.

Illustrated Example

David and Linda Parks are married and will file separate tax returns for 2003. Their only child, Philip, is 8. Philip received a Form 1099–INT showing $3,500 taxable interest income. His

Figure 33–B. **Do You Have To Use Form 8615 To Figure Your Child's Tax?**



*See *Which Parent's Return To Use*

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 40) 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. See *Which Parent's Return To Use,* earlier.

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, $3,500, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. Philip did not have any dividends or capital gain distributions, so she leaves lines 2 and 3 blank.

Linda enters $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, 34, 35, 38, and 40 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 40 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 $12,261. She adds $75, and enters the $12,336 total on line 41 of Form 1040, and checks box **a**.

Linda attaches Form 8814 to her Form 1040.

Tax for Children Under Age 14 Who Have Investment Income of More Than $1,500

Part of a child's 2003 investment income may be subject to tax at the parent's tax rate if all of the following statements are true.

1) The child's investment income was more than $1,500.
2) The child is required to file a return for 2003.
3) The child was under age 14 at the end of 2003. (A child born on January 1, 1990, is considered to be age 14 at the end of 2003. This child's investment income is not taxed at the parent's rate.)

These conditions are also shown in *Figure 33–B* .

If neither parent was alive on December 31, 2003, **do not use Form 8615.** Instead, figure the child's tax in the normal manner.

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.

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 35 of Form 1040, line 22 of Form 1040A, or line 34 of Form 1040NR. Form 1040EZ and Form 1040NR-EZ 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.

Form **8814**

Department of the Treasury
Internal Revenue Service

Parents' Election To Report Child's Interest and Dividends

▶ See instructions below and on back.
▶ Attach to parents' Form 1040 or Form 1040NR.

OMB No. 1545-1128

2003

Attachment Sequence No. **40**

Name(s) shown on your return	Your social security number
Linda Parks	111 00 1111

Caution: *The Federal income tax on your child's income, including qualified dividends and 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)	B Child's social security number
Philip Parks	000 00 0000

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	3,500	
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		
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. See the instructions for where to report this 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? ☑ **No.** Enter $75 here and see the **Note** below. ☐ **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 41, or Form 1040NR, line 39. Be sure to check box* ***a*** *on Form 1040, line 41, 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.

- The child was under age 14 at the end of 2003. A child born on January 1, 1990, is considered to be age 14 at the end of 2003.
- The child's only income was from interest and dividends, including capital gain distributions and Alaska Permanent Fund dividends.
- The child's gross income for 2003 was less than $7,500.
- The child is required to file a 2003 return.
- There were no estimated tax payments for the child for 2003 (including any overpayment of tax from his or her 2002 return applied to 2003 estimated tax).
- There was no Federal income tax withheld from the child's 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 2003 with the child's other parent.
- You and the child's other parent were married to each other but file separate returns for 2003 **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)

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 (including capital gain distributions), 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 because they are 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 entered on line 1, 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 35 of Form 1040 and on line 1 of Form 8615. 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). The amount on 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.

Line 3. Subtract line 2 from line 1 and enter the result on this line. If zero or less, do not complete the rest of the form. However, you must still attach Form 8615 to the child's tax return. Figure the tax on the child's taxable income in the normal manner.

Line 4 (child's taxable income). Enter on line 4 the child's taxable income from Form 1040, line 40; Form 1040A, line 27; or Form 1040NR, line 38.

Line 5 (net investment income). A child's net investment income cannot be more than his or her taxable income. Enter on line 5 the smaller of line 3 or line 4 of Form 8615. This is the child's ***net investment income***.

If zero or less, do not complete the rest of the form. However, you must still attach Form 8615 to the child's tax return. Figure the tax on the child's taxable income in the normal manner.

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 at the parent's tax rate, 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.

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. The amount entered on 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.

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 law. See *Alternative Minimum Tax* in chapter 32.

For more information on who is liable for AMT and how to figure it, get 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. Form 1040A is not shown.

John and Laura Brown have one child, Sara. She is 13 and has $2,800 taxable interest income and $1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara 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, $2,800, on line 1. Sara does not itemize deductions, so John enters $1,500 on line 2. He enters $1,300 ($2,800 – $1,500) on line 3.

Sara's taxable income, as shown on line 27 of her Form 1040A, is $2,550. This is her total income ($4,300) minus her standard deduction ($1,750). Her standard deduction is limited to the amount of her earned income plus $250. John enters $2,550 on line 4.

John compares lines 3 and 4 and enters the smaller amount, $1,300, on line 5.

John enters $48,000 on line 6. This is the taxable income from line 40 of their joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds line 5 ($1,300), line 6 ($48,000), and line 7 (blank), and enters $49,300 on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on $49,300. He enters the tax, $6,699 on line 9. He enters $6,504 on line 10. This is the tax from line 41 of John and Laura's Form 1040. He enters $195 on line 11 ($6,699 – $6,504).

Because line 7 is blank, John skips lines 12a and 12b and enters $195 on line 13.

John subtracts line 5 ($1,300) from line 4 ($2,550) 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 enters this tax, $126, on line 15. He adds lines 13 ($195) and 15 ($126) and enters $321 on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on $2,550 (line 4) and enters this tax, $256, on line 17.

John compares lines 16 and 17 and enters the larger amount, $321, on line 18 of Sara's Form 8615. He also enters that amount on line 28 of Sara's Form 1040A.

John also completes Schedule 1 (Form 1040A) for Sara.

Form **8615**

Department of the Treasury
Internal Revenue Service

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.**

OMB No. 1545-0998

2003

Attachment Sequence No. **33**

Child's name shown on return	Child's social security number
Sara L. Brown	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 qualified dividends, or farm income, see **Pub. 929,** Tax Rules for Children and Dependents. It explains how to figure the child's tax using the **Qualified Dividends and Capital Gain Tax Worksheet** in the Form 1040 or Form 1040A instructions, or **Schedule D** or **J** (Form 1040).

A Parent's name (first, initial, and last). **Caution:** *See instructions before completing.*	**B** Parent's social security number
John J. Brown	007 00 0001

C Parent's filing status (check one):
☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Investment Income

1	Enter the child's investment income (see instructions)	1	2,800
2	If the child **did not** itemize deductions on **Schedule A** (Form 1040 or Form 1040NR), enter $1,500. Otherwise, see instructions	2	1,500
3	Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return	3	1,300
4	Enter the child's **taxable income** from Form 1040, line 40; Form 1040A, line 27; or Form 1040NR, line 38	4	2,550
5	Enter the **smaller** of line 3 or line 4. If zero, **stop;** do not complete the rest of this form but **do** attach it to the child's return	5	1,300

Part II Tentative Tax Based on the Tax Rate of the Parent

6	Enter the parent's **taxable income** from Form 1040, line 40; Form 1040A, line 27; Form 1040EZ, line 6; TeleFile Tax Record, line K(1); 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.	8	49,300
9	Enter the tax on the amount on line 8 based on the **parent's** filing status above (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used, check here ▶ ☐	9	6,699
10	Enter the parent's tax from Form 1040, line 41; Form 1040A, line 28, minus any alternative minimum tax; Form 1040EZ, line 10; TeleFile Tax Record, line K(2); Form 1040NR, line 39; or Form 1040NR-EZ, line 15. **Do not** include any tax from **Form 4972** or **8814.** If the Qualified Dividends and Capital Gain Tax Worksheet or Schedule D or J (Form 1040) was used to figure the tax, check here ▶ ☐	10	6,504
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	195
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	× .
13	Multiply line 11 by line 12b	13	195

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 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 Qualified Dividends and Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used to figure the tax, check here ▶ ☐	15	126
16	Add lines 13 and 15	16	321
17	Enter the tax on the amount on line 4 based on the **child's** filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used to figure the tax, check here ▶ ☐	17	256
18	Enter the **larger** of line 16 or line 17 here and on the **child's** Form 1040, line 41; Form 1040A, line 28; or Form 1040NR, line 39	18	321

Proof as of October 29, 2003 (subject to change)

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 64113U Form **8615** (2003)

34.

Child and Dependent Care Credit

Important Changes

Credit percentage. The credit can be as much as 35% (increased from 30% in 2002) of your qualified expenses. For more information, see *Amount of Credit.*

Income that qualifies for highest percentage. The maximum adjusted gross income amount that qualifies for the highest credit percentage increased to $15,000. See *Amount of Credit.*

Dollar limit. The dollar limit on the amount of qualifying expenses increased to $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals. For more information, see *Dollar Limit.*

Earned income amount for nonworking spouse. If your spouse is either a full-time student or not able to care for himself or herself, the amount of income he or she is treated as having earned has increased to $250 a month if there is one qualifying person and to $500 a month if there are two or more qualifying persons. For more information, see *Earned Income Limit.*

Important Reminders

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 35% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

CAUTION *This credit should not be confused with the* Child Tax Credit *discussed in chapter 36.*

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, $3,000 if one qualifying person was cared for or $6,000 if two or more qualifying persons were cared for). (If two or more qualifying persons were cared for, the amount you exclude will always be less than the dollar limit, since the amount you can exclude is limited to $5,000. See *Reduced Dollar Limit* under *How To Figure the Credit,* later.)

These tests are presented in *Figure 34–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.

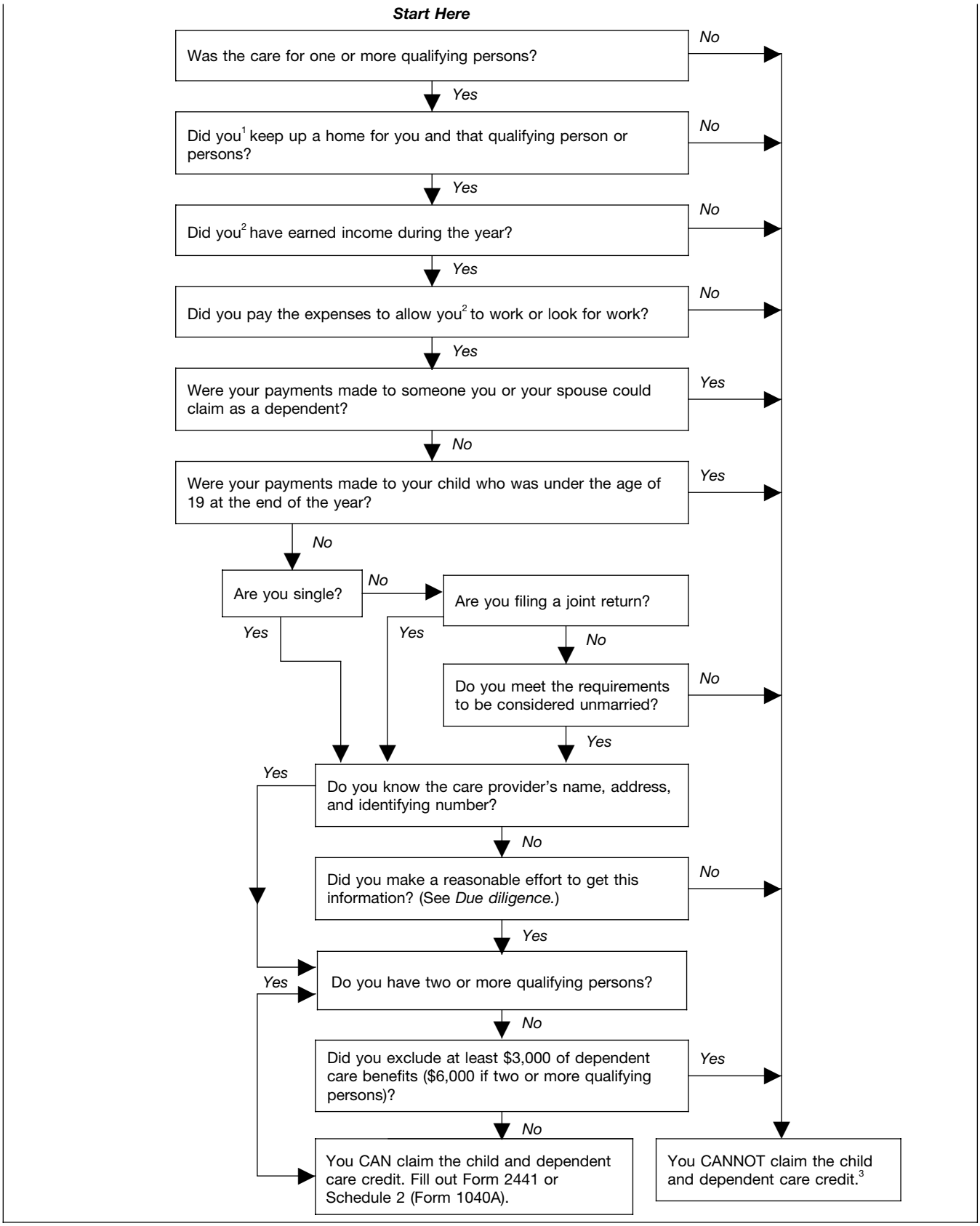
A qualifying person is:

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 $3,050 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

Figure 34–A. **Can You Claim the Child and Dependent Care Credit?**



[1]This includes your spouse if you were married.
[2]This also applies to your spouse, unless your spouse was disabled or a full-time student.
[3]If you had expenses that met the requirements for 2002, except that you did not pay them until 2003, you may be able to claim those expenses in 2003. See *Expenses not paid until the following year* under *How To Figure the Credit.*

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 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 there is an exception to this rule that applies if all of the following are true.

1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement, or you lived apart from the other parent at all times during the last 6 months of the year.
2) One or both parents had custody of the child for more than half of the year.
3) One or both parents provided more than half of the child's support for the year.
4) The child was under age 13 or was physically or mentally not able to care for himself or herself.
5) 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 5(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..

If the exception applies and you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the noncustodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

If the exception does not apply, use the rules described earlier to determine whether your child is a qualifying person.

You can use *Figure 34–B* to see whether this exception applies to you.

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.

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 taxable 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.

Nontaxable employee compensation not included. When figuring your earned income for the child and dependent care credit, do not count nontaxable employee compensation 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.

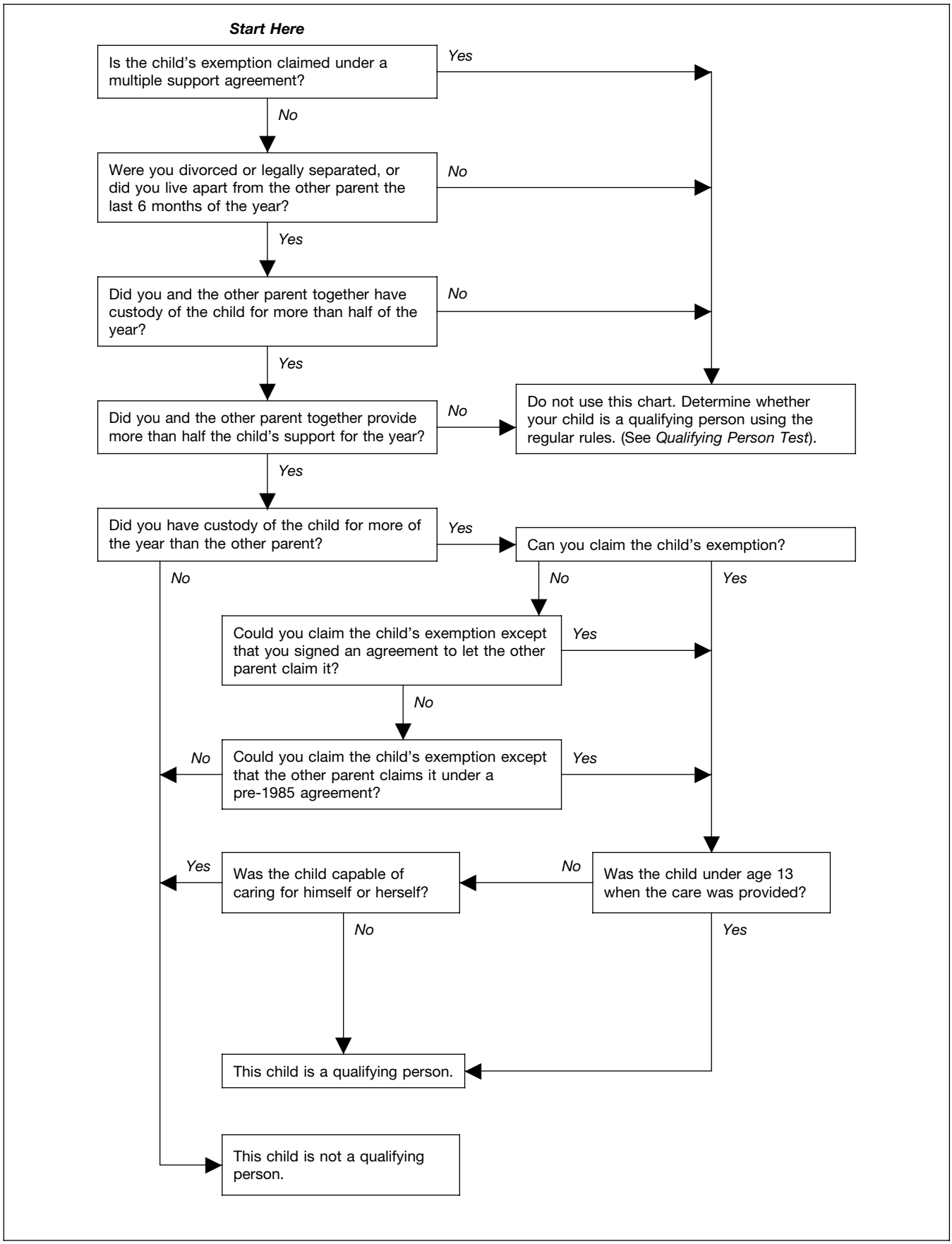
Figure the earned income of the nonworking spouse described under (1) or (2) above as explained under *Earned Income Limit,* later.

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

Figure 34–B. **Is a Child of Divorced or Separated Parents a Qualifying Person?**



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 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. For this purpose, you are not considered to be working 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 $250 a month ($3,000 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 $250 a month, your work-related expenses are limited to $625 (2½ months × $250).

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.

RECORDS 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 2003 work-related expenses, count only those you paid by December 31, 2003.

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 2002 expenses that you paid in 2003 as work-related expenses for 2003. You may be able to claim an additional credit for them on your 2003 return, but you must figure it separately. See *Payments for previous year's expenses* under *Amount of Credit* in Publication 503.

TIP *If you had expenses in 2003 that you did not pay until 2004, you cannot count them when figuring your 2003 credit. You may be able to claim a credit for them on your 2004 return.*

Expenses reimbursed. If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

Example. You paid work-related expenses of $3,000. You are reimbursed $2,000 by a state social services agency. You can use only $1,000 to figure your credit.

Medical expenses. Some expenses for the care of qualifying persons who are not able to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.

CAUTION *Amounts excluded from your income under your employer's dependent care benefits plan* ***cannot*** *be used to claim a medical expense deduction.*

Employer-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 13 of Form 2441 or Schedule 2 (Form 1040A).

CAUTION *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.

TIP *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 $250 if there is one qualifying person in your home, or at least $500 if there are two or more.

Spouse works. If your spouse works during that month, use the higher of $250 (or $500) 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 $250 (or $500) 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 $250 (or $500) 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 $3,000 for one qualifying person, or $6,000 for two or more qualifying persons.

TIP *If you paid work-related expenses for the care of two or more qualifying persons, the $6,000 limit does not need to be divided equally among them. For example, if your work-related expenses for the care of one qualifying person are $3,200 and your work-related expenses for another qualifying person are $2,800, you can use the total, $6,000, when figuring the credit.*

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 $3,000 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use $6,000 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 22 through 26 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 $2,900 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 $3,000 (one qualifying person), George figures his credit on only $2,000 of the $2,900 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	$3,000
2)	***Minus:*** Dependent care benefits George excludes from income	–1,000
3)	Reduced dollar limit on expenses George can use for the credit	$2,000

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 35 of Form 1040 or line 22 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

IF your adjusted gross income is: Over	But not over	THEN the percentage is:
$ 0	$15,000	35%
15,000	17,000	34%
17,000	19,000	33%
19,000	21,000	32%
21,000	23,000	31%
23,000	25,000	30%
25,000	27,000	29%
27,000	29,000	28%
29,000	31,000	27%
31,000	33,000	26%
33,000	35,000	25%
35,000	37,000	24%
37,000	39,000	23%
39,000	41,000	22%
41,000	43,000	21%
43,000	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 45 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 29 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.

RECORDS **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 tax. 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-provided 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.

1)	Work-related expenses Joan paid	$2,400
2)	Dollar limit (2 or more qualified individuals)	$6,000
3)	Minus: Dependent care benefits excluded from Joan's income	–3,000
4)	Reduced dollar limit	$3,000
5)	***Lesser of*** expenses paid ($2,400) or dollar limit ($3,000)	$2,400
6)	Percentage for AGI of $29,000	28%(.28)
7)	Multiply the amount on line 5 by the percentage on line 6 ($2,400x .28)	$ 672
8)	Enter the amount from Form 1040, line 43	$1,431
9)	Enter any amount from Form 1040, line 44	–0–
10)	Subtract line 9 from line 8	$1,431
11)	**Credit** (Enter the smaller of line 7 or line 10)	$672

Form **2441**

Department of the Treasury
Internal Revenue Service

Child and Dependent Care Expenses

▶ **Attach to Form 1040.**

▶ **See separate instructions.**

OMB No. 1545-0068

2003

Attachment Sequence No. **21**

Name(s) shown on Form 1040	Your social security number
Joan Thomas	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 59.

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.

(a) Qualifying person's name First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2003 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 $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 26	**3**	2,400
4	Enter your **earned income**	**4**	29,000
5	If married filing jointly, 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**	2,400
7	Enter the amount from Form 1040, line 35 — **7** 29,000		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	**8**	× .28
9	Multiply line 6 by the decimal amount on line 8. If you paid 2002 expenses in 2003, see the instructions	**9**	672
10	Enter the amount from Form 1040, line 43, minus any amount on Form 1040, line 44	**10**	1,431
11	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040, line 45	**11**	672

If line 7 is: Over — But not over	Decimal amount is	If line 7 is: Over — But not over	Decimal amount is
$0—15,000	.35	$29,000—31,000	.27
15,000—17,000	.34	31,000—33,000	.26
17,000—19,000	.33	33,000—35,000	.25
19,000—21,000	.32	35,000—37,000	.24
21,000—23,000	.31	37,000—39,000	.23
23,000—25,000	.30	39,000—41,000	.22
25,000—27,000	.29	41,000—43,000	.21
27,000—29,000	.28	43,000—No limit	.20

For Paperwork Reduction Act Notice, see page 3 of the instructions.

Cat. No. 11862M Form **2441** (2003)

Part III Dependent Care Benefits

12	Enter the total amount of **dependent care benefits** you received for 2003. 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			12	3,000
13	Enter the amount forfeited, if any (see the instructions)			13	-0-
14	Subtract line 13 from line 12			14	3,000
15	Enter the total amount of **qualified expenses** incurred in 2003 for the care of the **qualifying person(s)**	15	5,400		
16	Enter the **smaller** of line 14 or 15	16	3,000		
17	Enter your **earned income**	17	29,000		
18	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 17.	18	29,000		
19	Enter the **smallest** of line 16, 17, or 18	19	3,000		
20	**Excluded benefits.** Enter here the **smaller** of the following: • The amount from line 19 or • $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 18).			20	3,000
21	**Taxable benefits.** Subtract line 20 from line 14. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB".			21	-0-

To claim the child and dependent care credit, complete lines 22–26 below.

22	Enter $3,000 ($6,000 if two or more qualifying persons)	22	6,000
23	Enter the amount from line 20	23	3,000
24	Subtract line 23 from line 22. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2002 expenses in 2003, see the instructions for line 9	24	3,000
25	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 20 above. Then, add the amounts in column (c) and enter the total here	25	2,400
26	Enter the **smaller** of line 24 or 25. Also, enter this amount on line 3 on the front of this form and complete lines 4–11	26	2,400

Form **2441** (2003)

35.

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.

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 35–A* and *Figure 35–B* as guides to see if you qualify.

Use *Figure 35–A* first to see if you are a qualified individual. If you are, go to *Figure 35–B* to make sure your income is not too high to take the credit.

TIP *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 2003.
2) You were under age 65 at the end of 2003 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 2003.
   c) On January 1, 2003, 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 at the end of 2003, 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).

Table 35–1. **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 a qualifying widow(er) with dependent child and, by the end of 2003, 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 2003	
• 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 and you did not live with your spouse at any time during the year and, by the end of 2003, you were	
• 65 or older	$3,750
• under 65 and retired on permanent and total disability[1]	$3,750

[1]Amount cannot be more than the taxable disability income.
[2]Amount cannot be more than your combined taxable disability income.
[3]Amount is $5,000 plus the taxable disability income of the spouse under age 65, but not more than $7,500.

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.

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 2003, you may not need to get another physician's statement for 2003. 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 35–B,* later.

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 18–24 of Schedule R or lines 18–22 of Schedule 3).

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 35–1.*

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 you received during the year. (See *Nontaxable payments,* later.)

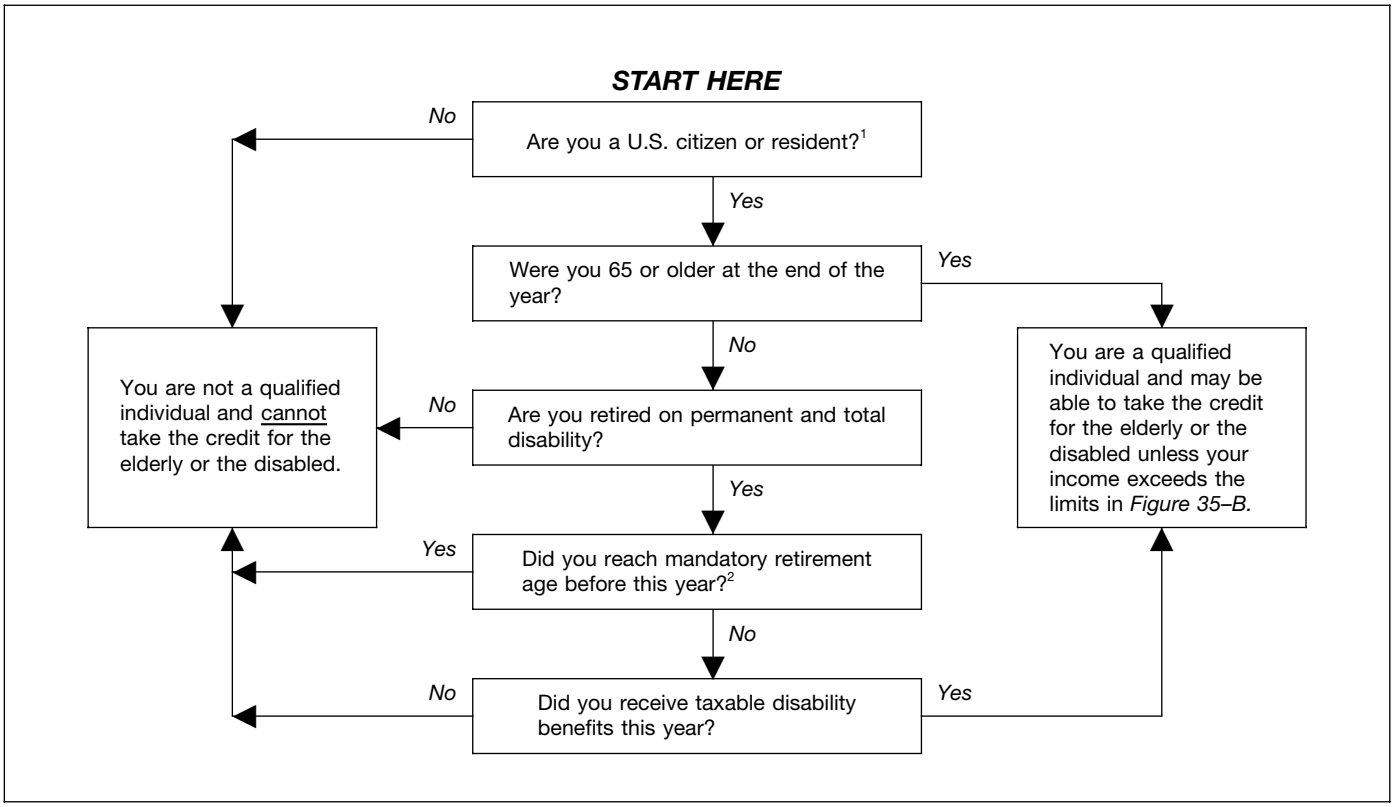
Enter these nontaxable payments on lines 13a or 13b, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

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.*

Nontaxable payments. 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 bene-

Figure 35–A. **Are You a Qualified Individual?**



[1]If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see *U.S. Citizen or Resident* under *Qualified Individual.* If you and your spouse choose to treat you as a U.S. resident, answer "yes" to this question.
[2]Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 35–B. **Income Limits**

	THEN even if you qualify (see *Figure 35–A*), you CANNOT take the credit if ...	
IF your filing status ...	**Your adjusted gross income (AGI)* is equal to or more than ...**	**OR the total of 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 *Figure 35–A*	$25,000	$7,500
married filing a joint return ***and*** only one spouse qualifies in *Figure 35–A*	$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 22, or Form 1040, line 35.

fits, 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.

CAUTION *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 35 of Form 1040 or line 22 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 [($14,630 – $10,000) ÷ 2]	2,315	
c) Total		5,515
3) Balance (Not less than –0–)		–0–
4) **Credit**		–0–

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 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 28.
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 43 (regular tax plus any alternative minimum tax), minus any foreign tax credit on Form 1040, line 44.
3) You are claiming the credit for child and dependent care expenses on:

   a) Form 1040A, line 29, or

   b) Form 1040, line 45.

Figure any limit on your credit on lines 21–24 of Schedule R or lines 21–22 of Schedule 3.

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 32.

Form 1040. If you want the IRS to figure your credit, see *Form 1040 Line Entries* under *Tax Figured by IRS* in chapter 32.

Form 1040A. If you want the IRS to figure your credit, see *Form 1040A Line Entries* under *Tax Figured by IRS* in chapter 32.

Examples

The following examples illustrate the credit for the elderly or the disabled. The initial amounts are taken from *Table 35–1,* 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 2003.

He received the following income for the year:

Nontaxable social security	$1,500
Interest (taxable)	100
Taxable disability pension	11,400

James' adjusted gross income is $11,500 ($11,400 + $100). He figures the credit on Schedule 3 as follows:

1) Initial amount		$5,000
2) Taxable disability pension		11,400
3) Smaller of (1) or (2)		5,000
4) Subtract the total of lines 2a and 2b:		
a) Nontaxable disability benefits (social security)	$1,500	
b) Excess adjusted gross income [($11,500 – $7,500) ÷ 2]	2,000	
c) Total		3,500
5) Balance (Not less than 0)		1,500
6) Multiply line 5 by 15%(.15)		225
7) Enter the amount from Form 1040A, line 28.		373
8) Enter any amounts from Form 1040A, line 29.		0
9) Subtract line 8 from line 7		373
10) **Credit** (Enter the smaller of line 6 or line 9)		$225

His credit is $225. He enters $225 on line 30 of Form 1040A. The Schedule 3 for James Davis is not shown.

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 tax-

able 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 $61 credit for the elderly or the disabled. They attach Schedule R to their joint return and enter $61 on line 46 of Form 1040. See their filled-in Schedule R and Helen's filled-in physician's statement on this page and the next two pages.

Instructions for Physician's Statement

Taxpayer

If you retired after 1976, enter the date you retired in the space provided on the statement below.

Physician

A person is permanently and totally disabled if **both** of the following apply:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

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, 2003

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 2/7/04
Physician's signature Date

Physician's name	Physician's address
Juanita D. Doctor	1900 Green St., Hometown, MD 20000

Schedule R (Form 1040)

Department of the Treasury
Internal Revenue Service

Credit for the Elderly or the Disabled

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule R (Form 1040).**

OMB No. 1545-0074

2003

Attachment Sequence No. **16**

Name(s) shown on Form 1040: William M. White and Helen A. White

Your social security number: 220 00 3333

You may be able to take this credit and reduce your tax if by the end of 2003:

- 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.

TIP 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 2003:		Check only one box:
Single, Head of household, or Qualifying widow(er)	1 You were 65 or older	1	☐
	2 You were under 65 and you retired on permanent and total disability	2	☐
Married filing jointly	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 separately	8 You were 65 or older and you lived apart from your spouse for all of 2003	8	☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2003	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 2003, check this box ▶ ☑

- If you checked this box, you do not have to get another statement for 2003.
- 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) 2003**

Part III **Figure Your Credit**

10 **If you checked (in Part I):** **Enter:**
Box 1, 2, 4, or 7 . . . . . $5,000
Box 3, 5, or 6 . . . . . $7,500
Box 8 or 9 . . . . . $3,750
. . . . . **10** 7,500

Did you check box 2, 4, 5, 6, or 9 in Part I?
Yes → You **must** complete line 11.
No → Enter the amount from line 10 on line 12 and go to line 13.

11 **If you checked (in Part I):**
- Box 6, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total.
- Box 2, 4, or 9, enter your taxable disability income.
- Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total.

. . . . . **11** 7,000

TIP For more details on what to include on line 11, see page R-3.

12 If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10 . . . . . **12** 7,000

13 Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2003.

a Nontaxable part of social security benefits and Nontaxable part of railroad retirement benefits treated as social security (see page R-3). . . . **13a** 3,000

b Nontaxable veterans' pensions and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see page R-3). . . . **13b**

c Add lines 13a and 13b. (Even though these income items are not taxable, they **must** be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c **13c** 3,000

14 Enter the amount from Form 1040, line 35 . . . . . **14** 16,200

15 **If you checked (in Part I):** **Enter:**
Box 1 or 2 . . . . . $7,500
Box 3, 4, 5, 6, or 7 . . . $10,000
Box 8 or 9 . . . . . $5,000
15 10,000

16 Subtract line 15 from line 14. If zero or less, enter -0- **16** 6,200

17 Enter one-half of line 16 . . . . . **17** 3,100

18 Add lines 13c and 17 . . . . . **18** 6,100

19 Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20 . . . . . **19** 900

20 Multiply line 19 by 15% (.15) **20** 135

21 Enter the amount from Form 1040, line 43 . . . . . **21** 61

22 Add the amounts from Form 1040, lines 44 and 45, and enter the total . . . . . **22** -0-

23 Subtract line 22 from line 21 . . . . . **23** 61

24 **Credit for the elderly or the disabled.** Enter the **smaller** of line 20 or line 23 here and on Form 1040, line 46 . . . . . **24** 61

Schedule R (Form 1040) 2003

36.

Child Tax Credit

Important Changes

Child tax credit increased. For 2003, the maximum child tax credit is increased to $1,000 for each qualifying child. But you must reduce your credit by any advance payment you received in 2003.

Advance payment of child tax credit. Advance payments of the increase in the child tax credit were made to some individuals in 2003. If you received an advance payment, you will need to reduce the credit you can claim on your return by the advance payment you already received. (See the filled-in *Child Tax Credit Worksheet* shown later.) The amount of your advance payment (before offset) is shown on Notice 1319. This notice was mailed to you in 2003 if you received an advance payment.

Introduction

The ***child tax credit*** is a credit that you may be able to take on your tax return. It may reduce your tax by as much as $1,000 for each of your qualifying children.

The ***additional child tax credit*** is a credit you may be able to take if you are not able to claim the full amount of the child tax credit.

This chapter explains:

- Who is a qualifying child.
- How much is the credit.
- How to claim the credit.
- Why you should check your tax withholding.

CAUTION *The child tax credit and the additional child tax credit should not be confused with the* child and dependent care credit *discussed in chapter 34.*

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 43 (Form 1040) or line 28 (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 65 (Form 1040) or line 42 (Form 1040A).

Useful Items

You may want to see:

Publication

❑ **972** Child Tax Credit

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 2003.
2) A citizen or resident of the United States.
3) Claimed as your dependent.
4) Your:
   a) Son, daughter, adopted child, stepchild, or a descendent of any of them (for example, your grandchild),
   b) Brother, sister, stepbrother, stepsister, or a descendent of any of them (for example, your niece or nephew) if you care for the individual as you would your own child, or
   c) Eligible foster child.

Example. Your son turned 17 on December 30, 2003. 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 2003.

Adopted child. An adopted child is always treated as your own 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.

Eligible foster child. For the child tax credit, a person is your eligible foster child if both of the following are true.

1) The child is placed with you by an authorized placement agency.
2) You cared for that child as you would your own child.

Kidnapped child. A kidnapped child is treated as a qualifying child for the child tax credit if both of the following statements are true.

1) 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.
2) The child qualified as your dependent for the part of the year before the kidnapping.

This treatment applies for all years until the child is returned. However, the last year this treatment can apply is the earlier of:

1) The year there is a determination that the child is dead, or
2) The year the child would have reached age 16.

Amount of Credit

The maximum credit you can claim is $1,000 for each qualifying child. But you must reduce your credit by any advance payment you received in 2003.

Limits on the Credit

You must reduce your child tax credit if either (1) or (2) applies.

1) The amount on line 43 (Form 1040) or line 28 (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 line 43 or line 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 35 (Form 1040) or line 22 (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 49 (Form 1040) or line 33 (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. 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. Amy chooses to itemize her deductions and files Form 1040. Her AGI, shown on line 35 of her Form 1040, is $23,500. This is her taxable earned income.

Amy received an advance payment of the child tax credit in 2003. The amount was $800. She also received Notice 1319 indicating $800 as the amount of the payment.

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 43 of her Form 1040, is $703. She claims a $437 credit for child and dependent care expenses on line 45. She claims a $2,141 earned income credit on line 63. She has no other credits.

After answering the *Questions* in the Form 1040 instructions for line 49, 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.

Filled-in Questions for Amy Brown (Page references are to the Form 1040 instructions.)

Questions **Who Must Use Pub. 972**

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.** STOP You must use Pub. 972 to figure your credit.

2. Is the amount on Form 1040, line 35, 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.** STOP 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 50, on page 42)
- Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 51, on page 42)
- District of Columbia first-time homebuyer credit, Form 8859

☑ **No.** Use the worksheet on page 41 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.

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 whether you can take the additional child tax credit if you answered "Yes" on
   a) Line 6 or line 7 of the *Child Tax Credit Worksheet* in the Form 1040 or Form 1040A instructions, or
   b) Line 15 of the *Child Tax Credit Worksheet* in Publication 972.
3) If you have an additional child tax credit on line 13 of Form 8812, carry it to line 65 (Form 1040) or line 42 (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 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 Child Tax Credit Worksheet—Amy Brown

(Page references are to the Form 1040 instructions.)

Child Tax Credit Worksheet—Line 49

Keep for Your Records

Before you begin: √ If you received (before offset) an advance child tax credit payment, see **Advance Child Tax Credit Payment** on page 40.

CAUTION

- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2003 and meet the other requirements listed on page 40.
- **Do not** use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 40. Instead, use Pub. 972.

1. Number of qualifying children: 2 × $1,000. Enter the result. — **1** 2,000

2. Enter the amount, if any, of your advance child tax credit payment (before offset). For details, see page 40. — **2** 800

3. Is line 1 less than or equal to line 2?

☐ **Yes.** STOP
You cannot take this credit. If line 2 is more than line 1, you do not have to pay back the difference.

☑ **No.** Subtract line 2 from line 1. — **3** 1,200

4. Enter the amount from Form 1040, line 43. — **4** 703

5. Enter the total of the amounts from Form 1040, lines 44 through 48. — **5** 437

6. Are the amounts on lines 4 and 5 the same?

☐ **Yes.** STOP
You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit.** See the **TIP** below.

☑ **No.** Subtract line 5 from line 4. — **6** 266

7. Is the amount on line 3 more than the amount on line 6?

☑ **Yes.** Enter the amount from line 6. Also, you may be able to take the **additional child tax credit.** See the **TIP** below.

☐ **No.** Enter the amount from line 3.

This is your child tax credit. — **7** 266

Enter this amount on Form 1040, line 49.

1040

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 65, if you answered "Yes" on line 6 **or** line 7 above.

- First, complete your Form 1040 through line 64.
- Then, use Form 8812 to figure any additional child tax credit.

Form **8812**

Department of the Treasury
Internal Revenue Service

Additional Child Tax Credit

Complete and attach to Form 1040 or Form 1040A.

OMB No. 1545-1620

2003

Attachment Sequence No. **47**

Name(s) shown on return: Amy Brown

Your social security number: 012 00 5678

Part I All Filers

1	Enter the amount from line 3 of your Child Tax Credit Worksheet on page 41 of the Form 1040 instructions or page 38 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 10 of the worksheet on page 4 of the publication			1	1,200
2	Enter the amount from Form 1040, line 49, or Form 1040A, line 33			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 $10,500? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☑ **Yes.** Subtract $10,500 from the amount on line 4. Enter the result	5	13,000		
6	Multiply the amount on line 5 by 10% (.10) and enter the result			6	1,300

Next. Do you have three or more qualifying children?

☑ **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.

☐ **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.

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 28 and 56, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 60. **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 63 and 64. **1040A filers:** Enter the total of the amount from Form 1040A, line 41, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (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

Enter this amount on Form 1040, line 65, or Form 1040A, line 42.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10644E Form **8812** (2003)

37.

Education Credits

Important Changes for 2003

Hope and lifetime learning credits. If you are married and filing a joint return, the amount of your Hope or lifetime learning credit for 2003 is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between $83,000 and $103,000. You cannot claim a credit if your MAGI is $103,000 or more. This is an increase from the 2002 limits of $82,000 and $102,000. There was no change in the limits for any other filing status. For more information see *Effect of the Amount of Your Income on the Amount of Your Credit,* later.

Lifetime learning credit. Beginning in 2003, the amount of qualified education expenses you can take into account in figuring your lifetime learning credit increases from $5,000 to $10,000. The credit will equal 20% of these qualified expenses, with the maximum credit being $2,000. See *Lifetime Learning Credit,* later, for more information.

Introduction

This chapter discusses two tax credits (referred to here as education credits) available to persons who pay expenses for higher education.

- The Hope credit.
- The lifetime learning credit.

The chapter 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.

Can you claim both education credits this year. For each student, you can elect for any year only ***one*** of the credits. For example, if you elect to take the Hope credit for a child on your 2003 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2003.

If you are eligible to claim the Hope credit and you are also eligible to claim the lifetime learning credit for the same student in the same year, you can choose to claim either credit, but not both. For 2003, if the total qualified education expenses for a student are less than $7,500, it will generally be to your benefit to claim the Hope credit.

If you pay qualified education 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 year.

Differences between the Hope and lifetime learning credits. There are several differences between the Hope credit and the lifetime learning credit. For example, you can claim the Hope credit based on the same student's expenses for no more than 2 years. However, there is no limit on the number of years for which you can claim a lifetime learning credit based on the same student's expenses. The differences between the two credits are summarized in Table 37–1.

Useful Items

You may want to see:

Publication

❑ **970** Tax Benefits for Education

Form (and Instructions)

❑ **8863** Education Credits (Hope and Lifetime Learning Credits)

Can You Claim the Credit

The following rules will help you determine if you are eligible to claim an education credit on your tax return.

Who Can Claim the Credit

Generally, you can claim an education credit if ***all three*** of the following requirements are met.

1) You pay ***qualified education expenses*** of higher education.
2) You pay the tuition and related expenses for an ***eligible student***.
3) The eligible student is either yourself, your spouse, or a ***dependent for whom you claim an exemption*** on your tax return.

Qualified education expenses are defined later under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*. A dependent for whom you claim an exemption is defined later under *Who Can Claim a Dependent's Expenses*.

Who Cannot Claim the Credit

You cannot claim an education credit for 2003 if ***any*** of the following apply.

- Your filing status is married filing separately.
- You are listed as a dependent in the *Exemptions* section on another person's tax return (such as your parents'). See *Who Can Claim a Dependent's Expenses*, later.
- Your modified adjusted gross income is $51,000 or more ($103,000 or more in the case of a joint return). Modified adjusted gross income is explained later under *Effect of the Amount of Your Income on the Amount of Your Credit*.
- You (or your spouse) were a nonresident alien for any part of 2003 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.

Table 37–1. **Comparison of Education Credits**

Hope Credit	Lifetime Learning Credit
Up to $1,500 credit per **eligible student**	Up to $2,000 credit per **return**
Available **ONLY** until the first 2 years of postsecondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available **ONLY** for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate 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 beginning during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction rule does not apply

What Expenses Qualify

The education credits are based on qualified education expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally, a credit is allowed for qualified education expenses paid in 2003 for an ***academic period*** beginning in 2003 or in the first 3 months of 2004.

For example, if you paid $1,500 in December 2003 for qualified tuition for the Spring 2004 semester beginning in January 2004, you may be able to use that $1,500 in figuring your 2003 credit.

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. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Paid with borrowed funds. You can claim an education credit for qualified education expenses paid with the proceeds of a loan. You use the expenses to figure the education credit for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Qualified Education Expenses

For purposes of an education credit, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an ***eligible educational institution***.

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.

Related expenses. Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses ***only*** if the fees and expenses must be paid ***to the institution*** as a condition of enrollment or attendance.

In the following examples, assume that each student is an eligible student at an eligible educational institution.

Example 1. Jackson is a sophomore in University V's degree program in dentistry. This year, in addition to tuition, he is required to pay a fee to the university for the rental of the dental equipment he will use in this program. Because the equipment rental fee must be paid to University V for enrollment and attendance, Jackson's equipment rental fee is a qualified expense.

Example 2. Donna and Charles, both first-year students at College W, are required to have certain books and other reading materials to use in their mandatory first-year classes. The college has no policy about how students should obtain these materials, but any student who purchases them from College W's bookstore will receive a bill directly from the college. Charles bought his books from a friend, so what he paid for them is not a qualified education expense. Donna bought hers at College W's bookstore. Although Donna paid College W directly for her first-year books and materials, her payment is not a qualified expense because the books and materials are not required to be purchased from College W for enrollment or attendance at the institution.

Example 3. When Marci enrolled at College X for her freshman year, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students, and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Marci's enrollment and attendance at College X. Therefore, it is a qualified expense.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim an education credit based on those same expenses.
- Claim an education credit in the same year that you are claiming a tuition and fees deduction for the same student.
- Claim a Hope credit and a lifetime learning credit based on the same qualified education expenses.
- Claim an education credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
- Claim a credit based on qualified education expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Education Expenses*, next.

Adjustments to Qualified Education Expenses

If you pay qualified education expenses with certain tax-free funds, you cannot claim a credit for those amounts. You must reduce the qualified education expenses by the amount of any ***tax-free educational assistance*** and refund(s) you received.

Tax-free educational assistance. This includes:

- Tax-free part of scholarships and fellowships (see chapter 13 and chapter 1 of Publication 970,
- Pell grants (see chapter 1 of Publication 970),
- Employer-provided educational assistance (see chapter 11 of Publication 970),
- Veterans' educational assistance (see chapter 1 of Publication 970), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund. For more information, see *Refunds* in Publication 970.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

Example 1. In 2003, Jackie paid $3,000 for tuition and $5,000 for room and board at University X. The university did not require her to pay any fees in addition to her tuition in order to enroll in or attend classes. To help pay these costs, she was awarded a $2,000 scholarship and a $4,000 student loan.

The terms of the scholarship state that it may be used to pay any of Jackie's college expenses. Because she applied it toward her tuition, the scholarship is tax free. Therefore, for purposes of figuring an education credit (either Hope or lifetime learning), she must first use the $2,000 scholarship to reduce her tuition (her only qualified education expense). The student loan is not tax-free educational assistance, so she does not use it to reduce her qualified expenses. Jackie is treated as having paid $1,000 in qualified education expenses ($3,000 tuition – $2,000 scholarship) in 2003.

Example 2. The facts are the same as in *Example 1*, except that Jackie uses the $2,000 scholarship to pay room and board, and, therefore, reports her entire scholarship as income on her tax return. In this case, the scholarship is allocated to expenses other than qualified education expenses. Jackie is treated as paying the entire $3,000 tuition with other funds and can figure her education credit on the entire $3,000.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Sports, games, hobbies, and noncredit courses. Qualified education expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on **Form 1098–T**, *Tuition Statement*. See *Figuring the Credit*, later, for more information about Form 1098–T.

Who Can Claim a Dependent's Expenses

If there are qualified education expenses for your dependent for a year, either you or your dependent, but not both of you, can claim an education credit for your dependent's expenses for that year.

For you to claim an education credit for your dependent's expenses, you must also claim an exemption for your dependent. You do this by listing your dependent's name and other required information on line 6c, Form 1040 (or Form 1040A).

IF you...	THEN only...
claim an exemption on your tax return for a dependent who is an eligible student	you can claim a credit based on that dependent's expenses. The dependent cannot claim a credit.
do **not** claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption)	the dependent can claim a credit. You cannot claim a credit based on this dependent's expenses.

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 (or deemed paid) by your dependent as if you had paid them. Include these expenses when figuring the amount of your education credit.

TIP *Qualified education 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 you. If you claim an exemption for a dependent who is an eligible student, only you can include any expenses you paid when figuring the amount of an education credit. If neither you nor anyone else claims an exemption for the dependent, only the dependent can include any expenses you paid when figuring an education credit.

Expenses paid by others. Someone other than you, your spouse, or your dependent (such as a relative or former spouse) may make a payment directly to an eligible educational institution to pay for an eligible student's qualified education expenses. In this case, the student is treated as receiving the payment from the other person and, in turn, paying the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. In 2003, Ms. Allen makes a payment directly to an eligible educational institution for her grandson Todd's qualified education expenses. For purposes of claiming an education credit, Todd is treated as receiving the money as a gift from his grandmother and, in turn, paying his qualified education expenses himself.

Unless an exemption for Todd is claimed on someone else's return, only Todd can use the payment to claim an education credit.

If anyone, such as Todd's parents, claims an exemption for Todd on his or her tax return, whoever claims the exemption may be able to use the expenses to claim an education credit. If anyone else claims an exemption for Todd, Todd cannot claim an education credit.

Tuition reduction. When an eligible educational institution provides a reduction in tuition to an employee of the institution (or spouse or dependent child of an employee), the amount of the reduction may or may not be taxable. If it is taxable, the employee is treated as receiving a payment of that amount and, in turn, paying it to the educational institution on behalf of the student. For more information on tuition reductions, see *Qualified Tuition Reduction* in chapter 1 of Publication 970.

Effect of the Amount of Your Income on the Amount of Your Credit

The amount of your education credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $41,000 and $51,000 ($83,000 and $103,000 if you file a joint return). You cannot claim an education credit if your MAGI is $51,000 or more ($103,000 or more if you file a joint return).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 21 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 34 of that form, modified by adding back any:

1) Foreign earned income exclusion,
2) Foreign housing exclusion,
3) Exclusion of income for bona fide residents of American Samoa, and
4) Exclusion of income from Puerto Rico.

For more information about the phaseout of an education credit, see Form 8863.

Hope Credit

You may be able to claim a Hope credit of up to $1,500 for qualified education expenses paid for ***each*** eligible student.

Who Is an Eligible Student

To claim the Hope credit, the student for whom you pay qualified education expenses must be an ***eligible*** student. This 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 tax years.
2) Had not ***completed the first 2 years*** of postsecondary education (generally, the freshman and sophomore years of college) before 2003.
3) For at least one ***academic period*** beginning in 2003, was ***enrolled at least half-time*** in a program leading to a degree, certificate, or other recognized educational credential.

4) Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2003.

Completion of first 2 years. A student who was awarded 2 years of academic credit for postsecondary work completed before 2003 has completed the first 2 years of postsecondary education. This student generally would not be an eligible student for purposes of the Hope credit.

Exception. 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.

Example 1. Marty graduated from high school in June 2002. In September, he enrolled in an undergraduate degree program at College U, and attended full time for both the 2002 Fall and 2003 Spring semesters. For the 2003 Fall semester, Marty was enrolled less than half-time. Because Marty was enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that began during 2002 and at least one academic period that began during 2003, he is an eligible student for tax years 2002 and 2003 (including the 2003 Fall semester when he enrolled at College U on less than a half-time basis).

Example 2. After taking classes at College V on a half-time basis for the 2002 Spring and Fall semesters, Sharon became a full-time student for the 2003 Spring semester. College V classified Sharon as a second-semester sophomore for the 2003 Spring semester and as a first-semester junior for the 2003 Fall semester. Because College V did not classify Sharon as having completed the first two years of postsecondary education as of the beginning of 2003, Sharon is an eligible student for tax year 2003. Therefore, the qualified education expenses paid for the 2003 Spring semester and the 2003 Fall semester are taken into account in calculating any Hope credit for 2003.

Example 3. During the 2002 Fall semester, Luis was a high school student who took classes on a half-time basis at College X. Luis was not enrolled as part of a degree program at College X because College X only admits students to a degree program if they have a high school diploma or equivalent. Because Luis was not enrolled in a degree program at College X during 2002, Luis was **not** an eligible student for tax year 2002.

Example 4. The facts are the same as in *Example 3*. During the 2003 Spring semester, Luis again attended College X but not as part of a degree program. Luis graduated from high school in June 2003. For the 2003 Fall semester, Luis enrolled as a full-time student in College X as part of a degree program, and College X awarded Luis credit for his prior coursework at College X. Because Luis was enrolled in a degree program at College X for the 2003 Fall term on at least a half-time basis, Luis is an eligible student for all of tax year 2003. Therefore, the qualified education expenses paid for classes taken at College X during both the 2003 Spring semester (during which Luis was not enrolled in a degree program) and the 2003 Fall semester are taken into account in computing any Hope credit.

Example 5. Diana graduated from high school in June 2001. In January 2002, Diana enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a travel agent. Diana completed the program in December 2002, and was awarded a certificate. In January 2003, she enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a computer programmer. Diana is an eligible student for both tax years 2002 and 2003 because she meets the degree requirement, the work load requirement, and the year of study requirement for those years.

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 standard may not be lower than any of those established by the Department of Education under the Higher Education Act of 1965.

Figuring the Credit

The amount of the Hope credit (per eligible student) is the sum of:

1) 100% of the first $1,000 of qualified education expenses you paid for the eligible student, ***and***

2) 50% of the next $1,000 of qualified education expenses you paid for that student.

The maximum amount of Hope credit you can claim in 2003 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 education expenses. However, the credit may be reduced based on your modified adjusted gross income (MAGI). See *Effect of the Amount of Your Income on the Amount of Your Credit*, earlier.

Example. Jon and Karen Frost are married and file a joint tax return. For 2003, they claim an exemption for their dependent daughter on their tax return. Their MAGI is $70,000. Their daughter is in her sophomore (second) year of studies at the local university. Jon and Karen paid qualified education expenses of $4,300 in 2003.

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 2003. This is 100% of the first $1,000 of qualified education expenses, plus 50% of the next $1,000.

Form 1098–T. To help you figure your Hope credit, you should receive **Form 1098–T**. Generally, an eligible educational institution (such as a college or university) must issue Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004.

Claiming the Credit

You claim the Hope credit by completing Parts I and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 47, or on Form 1040A, line 31. An illustrated example using Form 8863 appears at the end of this chapter.

Lifetime Learning Credit

You may be able to claim a lifetime learning credit of up to $2,000 for qualified education expenses paid for ***all*** students enrolled in eligible educational institutions.

Who Is an Eligible Student

For purposes of the lifetime learning credit, an eligible student is a student who is enrolled in one or more courses at an eligible educational institution.

Figuring the Credit

The amount of the lifetime learning credit is 20% of the first $10,000 of qualified education expenses you paid for all eligible students. The maximum amount of lifetime learning credit you can claim for 2003 is $2,000 (20% × $10,000). However, that amount may be reduced based on your modified adjusted gross income (MAGI). See *Effect of the Amount of Your Income on the Amount of Your Credit*, earlier.

Example. Bruce and Toni are married and file a joint tax return. For 2003, their MAGI is $75,000. Toni is attending a local college (an eligible educational institution) to earn credits toward a degree in nursing. She already has a bachelor's degree in history and wants to become a nurse. In August 2003, Toni paid $6,000 of qualified education expenses for her Fall 2003 semester. Bruce and Toni can claim a $1,200 (20% × $6,000) lifetime learning credit on their 2003 joint tax return.

Form 1098–T. To help you figure your lifetime learning credit, you should receive Form 1098–T. Generally, an eligible educational institution (such as a college or university) must issue Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004.

Claiming the Credit

You claim the lifetime learning credit by completing Parts II and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 47, or Form 1040A, line 31. An illustrated example using Form 8863 is shown at the end of this chapter.

When Must the Credit Be Repaid (Recaptured)

If, after you file your 2003 tax return, you or someone else receives tax-free educational assistance for, or a refund of, an expense you used to figure an education credit on that return, you may have to repay all or part of the credit. You must refigure your education credit(s) for 2003 as if the assistance or refund was received in 2003. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. You add the repayment (recapture) to your tax liability for the year in which you receive the assistance or refund (see the instructions for your tax return for that year). Your original 2003 tax return does not change.

Illustrated Example

Dave and Valerie Jones are married and file a joint tax return. For 2003, they claim exemptions for their two dependent children on their tax return. Their modified adjusted gross income is $86,000. Their tax, before credits, is $9,701. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2004. Their daughter, Corey, enrolled full-time at that same college in August 2002, to begin working on her bachelor's degree in physical education. In July 2003, Dave and Valerie paid $2,200 in tuition costs for each child for the Fall 2003 semester. In December 2003, they also paid $2,600 of tuition for each child for the Spring 2004 semester that begins in January.

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 2003 for academic periods beginning in 2003 and the first 3 months of 2004 qualify for the lifetime learning credit. Corey is in her first two (freshman and sophomore) years of postsecondary education, and expenses paid for her in 2003, for academic periods beginning in 2003 and January 2004, qualify for the Hope credit.

Dave and Valerie figure their tentative education credits for 2003, $2,460, as shown in the completed Form 8863. They cannot claim the full amount because their modified adjusted gross income is more than $83,000. They carry the amount from line 18 of Form 8863, $2,091, to line 47 of Form 1040, and they attach the Form 8863 to their return.

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2003

Attachment Sequence No. **50**

Name(s) shown on return: Dave and Valerie Jones

Your social security number: 987 00 6543

Caution: *You **cannot** take both an education credit and the tuition and fees deduction (Form 1040, line 26, or Form 1040A, line 19) for the **same student** in the same year.*

Part I **Hope Credit. Caution:** *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1

(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $2,000 for each student.	(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	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). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶	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** in the same year.*

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(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	4,800

5	Add the amounts on line 4, column (c), and enter the total	5	4,800
6	Enter the **smaller** of line 5 or $10,000	6	4,800
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III ▶	7	960

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7			8	2,460
9	Enter: $103,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	103,000		
10	Enter the amount from Form 1040, line 35*, or Form 1040A, line 22	10	86,000		
11	Subtract line 10 from line 9. If zero or less, **stop;** you cannot take any education credits	11	17,000		
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	× .850
14	Multiply line 8 by line 13 ▶			14	2,091
15	Enter the amount from Form 1040, line 43, or Form 1040A, line 28			15	9,201
16	Enter the total, if any, of your credits from Form 1040, lines 44 through 46, or Form 1040A, lines 29 and 30			16	-0-
17	Subtract line 16 from line 15. If zero or less, **stop;** you cannot take any education credits ▶			17	9,201
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 47, or Form 1040A, line 31 ▶			18	2,091

*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.

For Paperwork Reduction Act Notice, see page 3. Cat. No. 25379M Form **8863** (2003)

38.

Earned Income Credit

Important Changes

Form 8836. If you received Form 8836, *Qualifying Children Residency Statement*, you have been selected to participate in the EIC certification pilot program. File the form with the IRS, following the form instructions, to show that you and your child met the residency test described in *Rule 8* in this chapter. If you did not receive the form, you do not need to get it or file it. You have to file Form 8836 only if it was mailed to you.

Earned income amount is more. The amount you can earn and still get the credit has increased for 2003. The amount you earn must be less than:

- $29,666 ($30,666 for married filing jointly) with one qualifying child,
- $33,692 ($34,692 for married filing jointly) with more than one qualifying child, or
- $11,230 ($12,230 for married filing jointly) 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 to $2,600. See *Rule 6*.

Important Reminders

Increased EIC on certain joint returns. A married person filing a joint return may get more EIC than someone with the same income but a different filing status. As a result, the EIC table has different columns for married persons filing jointly than for everyone else. When you look up your EIC in the EIC Table, be sure to use the correct column for your filing status and the number of children you have.

Advance payment of the earned income credit in your paycheck. If you expect to qualify for the earned income credit in 2004, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit,* later, for more information.

EIC questioned by IRS. The IRS may ask you to provide documents to prove you are entitled to claim the EIC. We will tell you what documents to send us. These may include: birth certificates, school records, medical records, etc. We will also send you a letter with the name, address and telephone number of the IRS employee assigned to your case. The process of establishing your eligibility will delay your refund.

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.

- Medicaid and supplemental security income (SSI).
- Food stamps.
- Low-income housing.

Temporary assistance for needy families (TANF) benefits may be affected. Please check with your state.

Introduction

The earned income credit (EIC) is a tax credit for certain people who work and have earned income under $34,692. 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:

- The 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.

Useful Items

You may want to see:

Publication

❑ **596** Earned Income Credit (EIC)

Form (and Instructions)

❑ **Schedule EIC** Earned Income Credit (Qualifying Child Information)

❑ **W–5** Earned Income Credit Advance Payment Certificate

❑ **8862** Information To Claim Earned Income Credit After Disallowance

Do You Qualify for the Credit?

To qualify to 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 is one final rule 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.

- If you have a qualifying child, the rules in *Parts A, B,* and *D* apply to you.
- If you do not have a qualifying child, the rules in *Parts A, C,* and *D* apply to you.

Table 38–1, Earned Income Credit in a Nutshell. Use *Table 38–1* as a guide to *Parts A, B, C,* and *D*. The table is a summary of all the rules in each part.

Do you have a qualifying child? You have a qualifying child only if you have a child who meets the three tests described in *Rule 8* and illustrated in *Figure 38–1*.

If Improper Claim Made in Prior Year

If your EIC for any year after 1996 was denied or reduced for any reason other than a math or clerical error, you must attach a completed Form 8862 to your next tax return if you wish to claim the EIC.

However, if your EIC was denied or reduced as a result of a math or clerical error, do not attach Form 8862 to your next tax return. For example, if your arithmetic is incorrect, the IRS can correct it. If you do not provide a correct social security number, the IRS can deny the EIC. These kinds of errors are called math or clerical errors.

If your EIC for any year after 1996 was denied and it was determined that your error was due to reckless or intentional disregard of the EIC rules, then you cannot claim the EIC for the next 2 years. If your error was due to fraud, then you cannot claim the EIC for the next 10 years.

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 *7*. You must meet all seven rules to qualify for the earned income credit. If you do not meet all seven rules, you cannot get the credit and you do not need to read the rest of the chapter.

If you meet all seven rules in this part, then read either *Part B* or *Part C* (whichever applies) for more rules you must meet.

Table 38-1. **Earned Income Credit in a Nutshell**

First, you must meet all the rules in this column.		Second, you must meet all the rules in *one* of these columns, whichever applies.		Third, you must meet the rule in this column.
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**	**Part D.** **Figuring and Claiming the EIC**
1. Your adjusted gross income (AGI) must be less than: •$33,692 ($34,692 for married filing jointly) if you have more than one qualifying child, •$29,666 ($30,666 for married filing jointly) if you have one qualifying child, or •$11,230 ($12,230 for married filing jointly) if you do not have a qualifying child.	**2.** You must have a valid social security number. **3.** Your filing status cannot be "Married filing separately." **4.** You must be a U.S. citizen or resident alien all year. **5.** You cannot file Form 2555 or Form 2555–EZ (relating to foreign earned income). **6.** Your investment income must be $2,600 or less. **7.** You must have earned income.	**8.** Your child must meet the relationship, age, and residency tests. **9.** Your qualifying child cannot be used by more than one person to claim the EIC. **10.** You cannot be a qualifying child of another person.	**11.** You must be at least age 25 but under age 65. **12.** You cannot be the dependent of another person. **13.** You cannot be a qualifying child of another person. **14.** You must have lived in the United States more than half of the year.	**15.** Your earned income must be less than: •$33,692 ($34,692 for married filing jointly) if you have more than one qualifying child, •$29,666 ($30,666 for married filing jointly) if you have one qualifying child, or •$11,230 ($12,230 for married filing jointly) if you do not have a qualifying child.

Rule 1. Your AGI Must Be Less Than:

- $33,692 ($34,692 for married filing jointly) if you have more than one qualifying child,
- $29,666 ($30,666 for married filing jointly) if you have one qualifying child, or
- $11,230 ($12,230 for married filing jointly) if you do not have a qualifying child.

Adjusted gross income (AGI). AGI is the amount on line 34 (Form 1040), line 21 (Form 1040A), or line 4 (Form 1040EZ). If your AGI is equal to or more than the applicable limit listed above, you cannot claim the EIC.

Example. Your AGI is $30,000, you are single, and you have one qualifying child. You cannot claim the EIC because your AGI is not less than $29,666. However, if your filing status was married filing jointly, you might be able to claim the EIC because your AGI is less than $30,666.

Community property. If you are married, but qualify to file as head of household under special rules for married taxpayers living apart (see *Rule 3*), and live in a state that has community property laws, your AGI includes that portion of both your and your spouse's wages that you are required to include in gross income. This is different from the community property rules that apply under *Rule 7*.

Rule 2. 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 issued by the Social Security Administration (SSA). Any qualifying child listed on Schedule EIC must also have a valid SSN. (See *Rule 8* if you have a qualifying child.)

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.

Valid for work only with INS authorization. If your social security card reads "Valid for work only with INS authorization," 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 63 (Form 1040) or line 41 (Form 1040A), or on line 8 (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.* 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 3. 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 4. 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 2003 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 5. 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 6. Your Investment Income Must Be $2,600 or Less

You cannot claim the earned income credit unless your investment income is $2,600 or less. If your investment income is more than $2,600, 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 9a of Form 1040 or 1040A).
- Capital gain net income (line 13a of Form 1040, if more than zero, or line 10a of Form 1040A).

If you file Form 1040EZ, your investment income is the total of the amount of line 2 and the amount of any tax-exempt interest you wrote to the right of the words "Form 1040EZ" on line 2.

However, if you are reporting income or loss from the rental of personal property on Form 1040, line 21, or are filing Schedule E (Form 1040), Form 8814, or Form 4797, see *Rule 6* in chapter 1 of Publication 596 for more information.

Rule 7. 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. If you are an employee, earned income includes all the taxable income you get from your employer. If you are self-employed or a statutory employee, you will figure your earned income on EIC Worksheet B in the instructions for Form 1040.

Earned Income

Earned income includes:

1) Wages, salaries, and tips,
2) Net earnings from self-employment, and
3) Gross income received as a statutory employee.

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).

Self-employed persons and statutory employees. If you are self-employed or received income as a statutory employee, you must use the Form 1040 instructions to see if you qualify to get 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 discussed 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 taxable employee compensation. 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 taxable 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

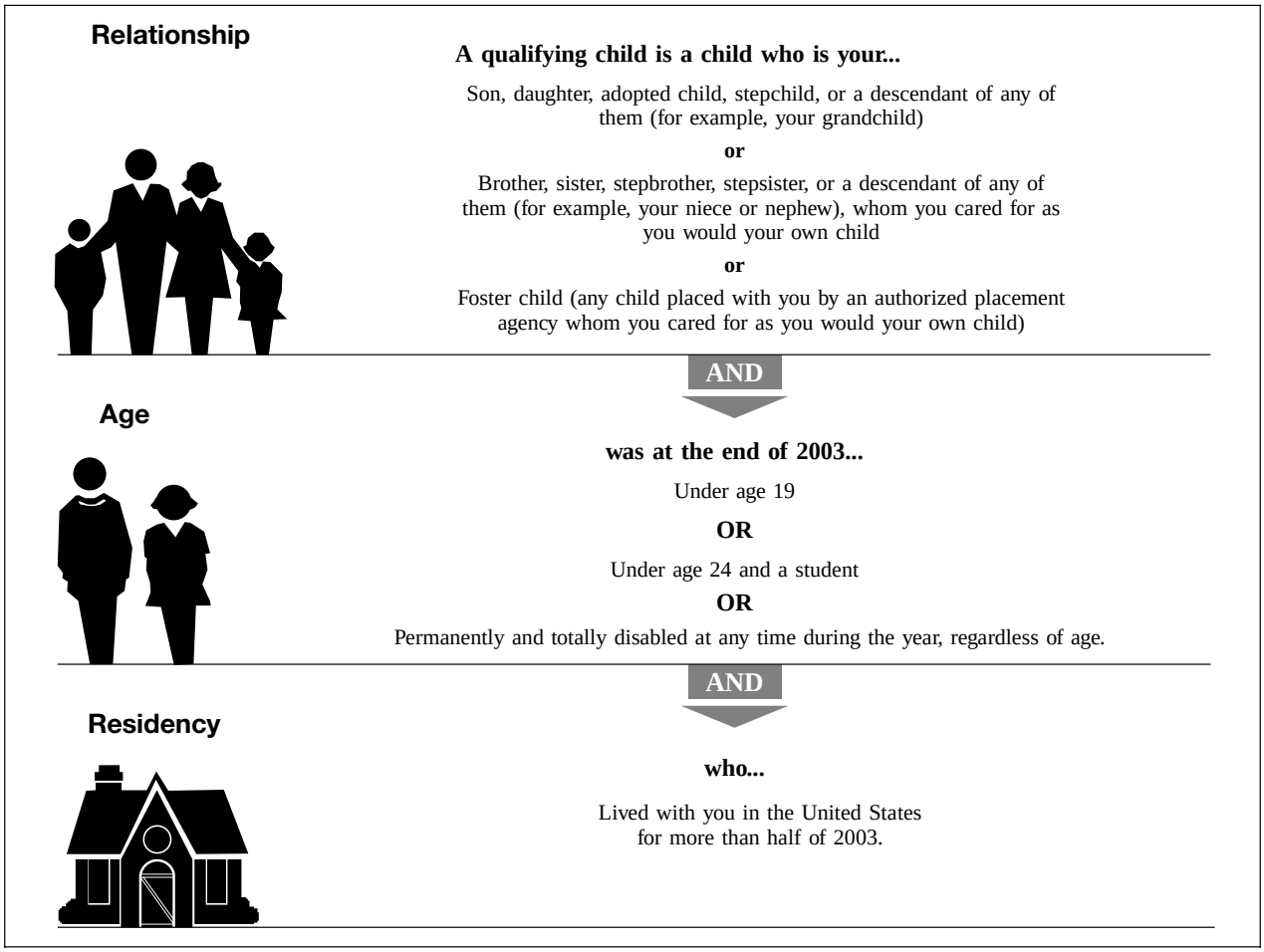
Examples of items that are ***NOT*** earned income include interest and dividends, pensions and annuities, social security and railroad retirement benefits (including disability benefits), alimony and child support, welfare benefits, workers' compensation benefits, unemployment compensation (insurance), nontaxable foster care payments, and veterans' benefits, including VA rehabilitation payments. Do ***NOT*** include any of these items in your 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.

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 3)*, 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.

Figure 38–1. **Tests for Qualifying Child**



Part B. Rules If You Have a Qualifying Child

If you have met all of the rules in *Part A*, read *Part B* to see if you have a qualifying child.

Part B discusses *Rules 8* through *10*. 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.

CAUTION *If you do not meet* Rule 8*, 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.*

Rule 8. 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 38–1.* The paragraphs that follow contain more information about each test.

Relationship Test

To be your qualifying child, a child must be your:

- Son, daughter, adopted child, stepchild, or a descendant (for example, your grandchild) of any of them, or
- Brother, sister, stepbrother, stepsister, or a descendant (for example, your niece or nephew) of any of them whom you cared for as you would your own child, or
- Eligible foster child.

The following definitions clarify the relationship test.

Adopted child. An adopted child is always treated as your own 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 or court authorized by state law to place children for legal adoption.

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 both of the following are true.

1) The child is placed with you by an authorized placement agency. An authorized placement agency includes a state or local government agency or court. It also includes a tax-exempt organization licensed by a state. In addition, it includes an Indian tribal government or an organization authorized by an Indian tribal government to place Indian children.
2) You cared for that child as you would your own child.

Example. Debbie, who is 12 years old, was placed in your care 2 years ago by an authorized

agency responsible for placing children in foster homes. You care for her as you would your own child. Debbie is your eligible foster child.

Age Test

Your child must be:

1) Under age 19 at the end of 2003,
2) A full-time student under age 24 at the end of 2003, or
3) Permanently and totally disabled at any time during 2003, 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 2003. The following definitions clarify the residency test.

United States. This means the 50 states and the District of Columbia. It does not include U.S. possessions, such as Guam and Puerto Rico.

Homeless shelter. Your home can be any location where you regularly live. 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 2003 is treated as having lived with you for all of 2003 if your home was the child's home the entire time he or she was alive in 2003.

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 until the child is returned. However, the last year this treatment can apply is the earlier of:

1) The year there is a determination that the child is 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 5 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 2003. 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 2*.

Rule 9. Your Qualifying Child Cannot Be Used By More Than One Person To Claim the EIC

Sometimes a child meets the rules to be a qualifying child of more than one person. However, only one person can treat that child as a qualifying child and 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.

You can choose which person will claim the EIC. If you and someone else have the same qualifying child, you and the other person(s) can decide who will claim the credit using that qualifying child. But if you and the other person(s) cannot agree and more than one person claims the credit using the same child, the tie-breaker rule (explained in Table 38–2, on the next page) applies. If the other person is your spouse and you file a joint return, this rule does not apply.

If another person claims the EIC using this child. If your qualifying child is treated under this rule as the qualifying child of another person for 2003, you cannot take the EIC using this qualifying child. You may be able to take the EIC using a different qualifying child, but you cannot take the EIC for people who do not have a qualifying child. If you do not have another qualifying child, you cannot take the EIC. Put "No" beside line 63 (Form 1040) or line 41 (Form 1040A).

Example 1– child lived with parent and grandparent. You and your 2-year-old son lived with your mother all year. You are 25 years old. Your only income was $9,000 from a part-time job. Your mother's only income was $20,000 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, only one of you can use him to claim the EIC. You

and your mother may choose which of you will treat the child as a qualifying child to claim the EIC. However, if you and she disagree and both use him to claim the EIC, you as the child's parent will be the only one allowed to claim the credit using this child.

Example 2 – three children lived with parent and grandparent. The facts are the same as in *Example 1,* except that you also have two other young children who lived with you and your mother and are qualifying children of both you and your mother. Only one of you can use each child to claim the EIC. However, you and your mother can split the three qualifying children between you. For example, you can use one child to claim the EIC and your mother can use the other two.

Example 3 – parent is qualifying child of grandparent. The facts are the same as in *Example 1,* except that you are only 18 years old. This means you are a qualifying child of your mother. Because of *Rule 10,* you cannot claim the EIC. Only your mother may be able to treat your son as a qualifying child to claim the EIC.

Example 4 – divorced parents. You, your husband, and your 10-year-old son lived together until July 1, 2003, when your husband moved out of the household. In July and August, your son lived with your husband. In September and October, the boy lived with you. On November 1, 2003, you and your husband were divorced. For the rest of the year, your son lived with your ex-husband, who was given custody. Your son is a qualifying child of both you and your ex-husband 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. You earned $11,000 during the year and your ex-husband earned $25,000. Neither of you had any other income.

You and your ex-husband may choose which of you will treat the child as a qualifying child to claim the EIC. However, if you and he are unable to agree and both use the child to claim the EIC, only your ex-husband will be allowed to claim the credit using this child. This is because, during 2003, the child lived with him longer than with you. You cannot claim the EIC for persons either with or without a qualifying child.

Example 5 – unmarried parents. You, your 5-year-old son, and your son's father lived together all year. You and your son's father are not married. Your son is a qualifying child of both you and his father because he meets the relationship, age, and residency tests for both you and his father. You earned $8,000 and your son's father earned $18,000. Neither of you had any other income. You and your son's father may choose which of you will treat the child as a qualifying child to claim the EIC. However, if you and he are unable to agree and both use the child to claim the EIC, only the father will be allowed to claim the credit using this child. This is because his AGI ($18,000) was more than your AGI ($8,000). You cannot claim the EIC for persons either with or without a qualifying child.

Example 6 – child did not live with a parent. You and your 7-year-old niece lived with your mother all year. You care for your niece as you would your own child. You are 25 years old, and your only income was $9,300 from a part-time job. Your mother's only income was $15,000 from her job. Your niece is a qualifying child of both you and your mother because she meets the relationship, age, and residency tests for both you and your mother. However, only one of you can treat her as a qualifying child to claim the EIC. You and your mother may choose which of you will use the child to claim the EIC. However, if you and she are unable to agree and both use the child to claim the EIC, only your mother will be allowed to claim the credit using this child. This is because her AGI ($15,000) is higher than your AGI ($9,300).

Rule 10. 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. Or, you are that person's brother, sister, stepbrother, or stepsister (or the child or grandchild of that person's brother, sister, stepbrother, or stepsister) for whom that person cares as his or her own child.
- At the end of the year you were under age 19, or 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.

For more details about the tests to be a qualifying child, see *Rule 8*.

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 63 (Form 1040) or line 41 (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

Read this part if you:

1) Do not have a qualifying child, and
2) Have met all the rules in *Part A.*

Part C discusses *Rules 11* through *14.* 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.

CAUTION *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 8 *to find out if you have a qualifying child.*

Rule 11. 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 2003. 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 2003. 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 63 (Form 1040) or line 41 (Form 1040A), or on line 8 (Form 1040EZ).

Table 38–2. **When More Than One Person Claims EIC Using Same Child (Tie-Breaker Rule).**

IF more than one person claims the EIC using the same child and . . .	**THEN . . .**
Only one of the persons is the child's parent,	Only the parent can treat the child as a qualifying child.
Two of the persons are the child's parent, and they do not file a joint return together,	Only the parent with whom the child lived the longest during the year can treat the child as a qualifying child.
Two of the persons are the child's parent, the child lived with each parent the same amount of time during the year, and the parents do not file a joint return together,	Only the parent with the highest adjusted gross income (AGI) can treat the child as a qualifying child.
None of the persons are the child's parent,	Only the person with the highest AGI can treat the child as a qualifying child.

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 12. 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 2003, 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 13. 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. Or, you are that person's brother, sister, stepbrother, or stepsister (or the child or grandchild of that person's brother, sister, stepbrother, or stepsister) for whom that person cares as his or her own child.
- At the end of the year you were under age 19, or 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.

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" directly to the right of line 63 (Form 1040), line 41 (Form 1040A), or on line 8 (Form 1040EZ).

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 14. 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 it was not, put "No" directly to the right of line 63 (Form 1040) or line 41 (Form 1040A), or on line 8 (Form 1040EZ).

United States. This means the 50 states and the District of Columbia. It does not include U.S. possessions, such as Guam and Puerto Rico.

Homeless shelter. Your home can be any location where you regularly live. 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 8*) are considered to live in the United States during that duty period for the EIC.

Part D. Figuring and Claiming the EIC

Read this part if you have met all the rules in *Parts A* and *B,* or all the rules in *Parts A* and *C.*

Part D discusses *Rule 15.* You must meet this rule, 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 15. Your Earned Income Must Be Less Than:

- $33,692 ($34,692 for married filing jointly) if you have more than one qualifying child,
- $29,666 ($30,666 for married filing jointly) if you have one qualifying child, or
- $11,230 ($12,230 for married filing jointly) if you do not have a qualifying child.

Earned income generally means wages, salaries, tips, other taxable employee compensation, and net earnings from self-employment. Earned income is explained in detail in *Rule 7*.

Figuring earned income. If you are self-employed, a statutory employee, or a member of the clergy or church employee who files Schedule SE (Form 1040), you will figure your earned income when you fill out Part 4 of EIC Worksheet B in the Form 1040 instructions.

Otherwise, figure your earned income by using the worksheet in *Step 5* of the Form 1040 instructions for line 63 or the Form 1040A instructions for line 41, or the worksheet in *Step 2* of the Form 1040EZ instructions for line 8.

When using one of those worksheets to figure your earned income, you will start with the amount on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ). You will then reduce that amount by any amount included on that line and described in the following list.

- **Scholarship or fellowship grants not reported on a Form W-2.** A scholarship or fellowship grant that was not reported to you on a Form W-2 is not considered earned income for the earned income credit.
- **Inmates.** Amounts received for work performed while an inmate in a penal institution are not earned income for the earned income credit. This includes amounts received through a work release program or while in a halfway house. If you received any amount for work done while an inmate in a penal institution and that amount is included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ), put "PRI" and the amount 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 left of line 1 (Form 1040EZ).
- **Deferred compensation plans.** A pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan is not considered earned income for the earned income credit. If you received such an amount and it was included in the total on line 7 (Form 1040 or Form 1040A) or line 1 (Form 1040EZ), put "DFC" and the amount on the dotted line next to line 7 (Form 1040), in the space to the left of the entry space for line 7 (Form 1040A), or in the space to the left of line 1 (Form

1040EZ). 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 received as a pension or annuity.

Clergy. If you are a member of the clergy who files Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on line 7 (Form 1040), subtract that amount from the amount on line 7 (Form 1040) and enter the result in the first space of the worksheet in *Step 5* of the Form 1040 instructions for line 63. Print "Clergy" on the dotted line next to line 63 (Form 1040).

Church employees. A church employee 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. If you received wages as a church employee and included any amount on both line 5a of Schedule SE and line 7 (Form 1040), subtract that amount from the amount on line 7 (Form 1040) and enter the result in the first space of the worksheet in *Step 5*of the Form 1040 instructions for line 63.

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.

CAUTION *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.*

TIP *If you want the IRS to also figure the amount of your income tax, see chapter 32.*

Form 1040

If you file Form 1040 and want the IRS to figure your credit for you, follow these steps.

1) Print ***EIC*** on the dotted line next to line 63. Then, if you have any of the types of income described earlier under *Inmates*, *Deferred compensation plans*, or *Clergy*, follow the instructions given there.
2) Complete all other parts of your return that apply to you (including line 58), but do not fill in lines 68, 69, 70a, and 72. 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 2a 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*** to the left of the entry space for line 41. Then, if you have any of the types of income described earlier under *Inmates* or *Deferred compensation plans*, follow the instructions given there.
2) Complete all other parts of your return that apply to you (including line 37), but do not fill in lines 43, 44, 45a, and 47. 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 2a 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*** in the space to the left of line 8. Then if you have the type of income described earlier under *Inmates*, follow the instructions given there.
2) Complete all other parts of your return that apply to you, but do not fill in lines 9, 11a, or 12.

How To Figure the EIC Yourself

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.

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 ***Line 63*** and look for ***Worksheet A*** or ***Worksheet B.***
2) Complete the EIC Worksheet that applies to your situation according to its instructions. Complete Worksheet B if you were self-employed, a member of the clergy or a church employee who files Schedule SE, or a statutory employee filing Schedule C or C-EZ. 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 63.
4) 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.
5) 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 2a 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 ***Line 41*** 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 41.
4) 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.
5) 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 2a 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 ***Line 8*** 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 8.
4) 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.

1) John and Janet Smith, a married couple 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 2003. John worked and earned $9,500. Janet worked part of the year and earned $1,500. Their earned income and AGI are $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 then fill out *Qualifying Child Information* (lines 1–5).

Line 1. The Smiths enter Amy's first name and last name in the column "Child 1."

Line 2a. They enter Amy's SSN.

Line 2b. They enter Amy's year of birth (2000).

Lines 3a and 3b. The Smiths skip lines 3a and 3b because Amy was not born before 1985.

Line 4. The Smiths enter "Daughter." This column shows Amy's relationship to John and Janet.

Line 5. The Smiths enter "12." This is how many months Amy lived with them in 2003.

Completing the EIC Worksheet

Next, the Smiths will complete the EIC Worksheet to figure their earned income credit.

Line 1. The Smiths enter $11,000 (their 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 $11,000 to $11,050. They follow this line across to the column that describes their filing status and number of children, and find $2,547 and enter it on line 2.

Line 3. The Smiths enter their 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 ($2,547) on line 6.

Line 6. The Smiths' EIC is $2,547.

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 2003. She had a part-time job and earned $6,240. 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 $6,240 (her earned income).

Line 2. Kelly goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her earned income of $6,240 in the range of $6,200 to $6,250. Kelly follows this line across to the column that describes her filing status and number of children and finds $382. She enters $382 on line 2.

Line 3. Kelly enters $6,260 (her AGI).

Line 4. Kelly checks the "No" box because lines 1 and 3 are not the same.

Line 5. Kelly checks the "No" box because the amount on line 3 ($6,260) is not less than $6,250. She goes to the *Earned Income Credit Table* in the forms instruction booklet. She finds her adjusted gross income of $6,260 in the range of $6,250 to $6,300. Kelly follows this line across to the column that describes her filing status and number of children and finds $379. She enters $379 on line 5. She looks at the amounts on lines 5 and 2. $379 is the smaller amount.

Line 6. She enters $379 here and on Form 1040EZ, line 8. Kelly's earned income credit is $379.

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 2004, you can choose to get part of the credit in advance. Give your employer a 2004 **Form W–5,** *Earned Income Credit Advance Payment Certificate,* and your employer will include part of the credit regularly in your pay.

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 AGI will each be less than a certain amount. The amount in 2003 was $29,666 ($30,666 if you expected to file married filing jointly). The amount for 2004 will be higher. (See the 2004 Form W–5 for the 2004 amount.)
2) You must expect to 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 2004

To get part of the credit in advance, you must fill out a 2004 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.

CAUTION *If you receive advance earned income credit payments in 2004, you must file Form 1040 or Form 1040A for 2004. 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 2004 Form W–5 you give to your employer is valid until December 31, 2004. If you expect to qualify for the earned income credit in 2005 and you want to receive advance payments, you must give your employer a ***new*** Form W–5 in 2005. 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 3.

Advance Payments Received in 2003

If you received advance payments of the earned income credit in 2003, you must file a tax return to report the payments. Report the amount on line 58 (Form 1040) or line 37 (Form 1040A). Your Form W–2, box 9, will show the amount you received.

CAUTION *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. Is your AGI less than: • $11,230 ($12,230 if married filing jointly) if you do not have a qualifying child, • $29,666 ($30,666 if married filing jointly) if you have one qualifying child, or • $33,692 ($34,692 if married filing jointly) if you have more than one qualifying child? (See *Rule 1*.)	❑	❑
2. Do you, your spouse, and your qualifying child each have a valid SSN? (See *Rule 2*.)	❑	❑
3. Is your filing status married filing jointly, head of household, qualifying widow(er), or single? (See *Rule 3*.) **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 4*.)	❑	❑
4. Answer **YES** if you are not filing Form 2555 or Form 2555–EZ. Otherwise, answer **NO**. (See *Rule 5*.)	❑	❑
5. Is your investment income $2,600 or less? (See *Rule 6*.)	❑	❑
6. Is your total earned income at least $1 but less than: • $11,230 ($12,230 if married filing jointly) if you do not have a qualifying child, • $29,666 ($30,666 if married filing jointly) if you have one qualifying child, or • $33,692 ($34,692 if married filing jointly) if you have more than one qualifying child? (See *Rules 7* and *15*.)	❑	❑
7. Answer **YES** if you (and your spouse if filing a joint return) are not a qualifying child of another person. Otherwise, answer **NO**. (See *Rules 10* and *13*.) **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 questions 8 and 9 and answer 10–12.***	❑	❑
8. Does your child meet the age, residency, and relationship tests for a qualifying child? (See *Rule 8*.)	❑	❑
9. Is your child a qualifying child only for you? Answer **YES** if your qualifying child also meets the tests to be a qualifying child of another person, but either (a) the other person is not claiming the EIC using that child, or (b) if both you and the other person claim the EIC using that child, *Rule 9* will allow only you to treat the child as a qualifying child. (See *Rule 9*.)	❑	❑
10. Were you (or your spouse if filing a joint return) at least age 25 but under 65 at the end of 2003? (See *Rule 11*.)	❑	❑
11. 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 (or your spouse if filing a joint return) can be claimed as a dependent on someone else's return. (See *Rule 12*.)	❑	❑
12. 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 14*.)	❑	❑

* **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.

PERSONS WITHOUT A QUALIFYING CHILD: If you answered **YES** to questions 1 through 7, and 10 through 12, you can claim the EIC.

If you answered NO to any question that applies to you: You cannot claim the EIC.

Filled-in Schedule EIC — John and Janet Smith

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service

Earned Income Credit

Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

OMB No. 1545-0074

2003

Attachment Sequence No. **43**

Name(s) shown on return		Your social security number
John and Janet	Smith	222 00 2222

Before you begin: See the instructions for Form 1040A, line 41, or Form 1040, line 63, to make sure that **(a)** you can take the EIC and **(b)** you have a qualifying child.

CAUTION

- 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 2a 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 If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name: Amy; Last name: Smith	First name: ; Last name:
2a Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 47 of the Form 1040 instructions unless the child was born and died in 2003. If your child was born and died in 2003 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	000 00 2224	
b Child's year of birth	Year 2000 *If born after 1984, skip lines 3a and 3b; go to line 4.*	Year ____ *If born after 1984, skip lines 3a and 3b; go to line 4.*
3 If the child was born before 1985— **a** Was the child under age 24 at the end of 2003 and a student?	☐ **Yes.** *Go to line 4.* ☐ **No.** *Continue*	☐ **Yes.** *Go to line 4.* ☐ **No.** *Continue*
b Was the child permanently and totally disabled during any part of 2003?	☐ **Yes.** *Continue* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue* ☐ **No.** The child is not a qualifying child.
4 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	Daughter	
5 Number of months child lived with you in the United States during 2003 • If the child lived with you for more than half of 2003 but less than 7 months, enter "7". • If the child was born or died in 2003 and your home was the child's home for the entire time he or she was alive during 2003, enter "12".	12 months *Do not enter more than 12 months.*	____ months *Do not enter more than 12 months.*

TIP

You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2003, **(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 42 of Form 1040A or line 65 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2003**

Filled-in EIC Worksheet—John and Janet Smith (Page references are to the Form 1040A Instructions.)

Earned Income Credit (EIC) Worksheet—Line 41

Keep for Your Records

Part 1

All Filers

1. Enter your earned income from Step 5 on page 42. | **1** | 11,000 |

2. Look up the amount on line 1 above in the EIC Table on pages 45–49 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. | **2** | 2,547 |

If line 2 is zero, STOP You cannot take the credit.
Put "No" to the left of the entry space for line 41.

3. Enter the amount from Form 1040A, line 22. | **3** | 11,000 |

AGI

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. If you have:

- No qualifying children, is the amount on line 3 less than $6,250 ($7,250 if married filing jointly)?
- 1 or more qualifying children, is the amount on line 3 less than $13,750 ($14,750 if married filing jointly)?

☐ **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 45–49 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. | **5** | ——— |

Look at the amounts on lines 5 and 2.
*Then, enter the **smaller** amount on line 6.*

Part 3

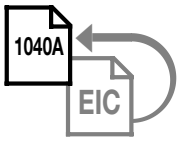
Your Earned Income Credit

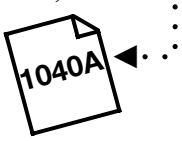
6. This is your earned income credit. | **6** | 2,547 |

Enter this amount on Form 1040A, line 41.

Reminder—

√ If you have a qualifying child, complete and attach Schedule EIC.





CAUTION

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 2003.

Filled-in EIC Worksheet—Kelly Green (Page references are to the Form 1040EZ Instructions)

Earned Income Credit (EIC) Worksheet—Line 8

Keep for Your Records

Part 1

All Filers

1. Enter your earned income from Step 2 on page 16. | **1** | 6,240 |

2. Look up the amount on line 1 above in the EIC Table on page 18 to find the credit. Be sure you use the correct column for your filing status. Enter the credit here. | **2** | 382 |

If line 2 is zero, STOP You cannot take the credit.
Enter "No" in the space to the left of line 8.

3. Enter the amount from Form 1040EZ, line 4. | **3** | 6,260 |

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 $6,250 ($7,250 if married filing jointly)?

☐ **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 18 to find the credit. Be sure you use the correct column for your filing status. Enter the credit here. | **5** | 379 |

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** | 379 |

Enter this amount on Form 1040EZ, line 8.

1040EZ

CAUTION

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 2003.

39.

Other Credits

Important Changes for 2003

Adoption credit. Beginning in 2003, the maximum adoption credit increases to $10,160. This amount may be allowed for the adoption of a child with special needs regardless of whether you have qualifying expenses. See *Adoption Credit,* later for more information.

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 $87,000 in 2003. If you had two or more employers and they withheld too much social security or RRTA tax during 2003, 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.

Health coverage tax credit. There is a new credit for health insurance premiums paid by certain workers who are displaced by foreign trade or who are receiving a pension from the Pension Benefit Guaranty Corporation. This credit is available to eligible individuals for qualifying payments made for each month in 2003. For more information, see *Health Coverage Tax Credit* near the end of this chapter.

Introduction

This chapter discusses the following credits.

- Adoption credit.
- Foreign tax credit.
- Mortgage interest credit.
- Retirement savings contributions 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.
- Health coverage tax credit.

Several other credits are discussed in other chapters in this publication.

- Child and dependent care credit (chapter 34).
- Credit for the elderly or the disabled (chapter 35).
- Child tax credit (chapter 36).
- Education credits (chapter 37).
- Earned income credit (chapter 38).

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 three 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 payments you made. If this total is more than your total tax, the excess will be refunded to you.

Useful Items

You may want to see:

Publication

- ❑ **502** Medical and Dental Expenses
- ❑ **514** Foreign Tax Credit for Individuals
- ❑ **530** Tax Information for First-Time Homeowners
- ❑ **535** Business Expenses
- ❑ **590** Individual Retirement Arrangements (IRAs)
- ❑ **968** Tax Benefits for Adoption

Form (and Instructions)

- ❑ **1116** Foreign Tax Credit (Individual, Estate, or Trust)
- ❑ **2439** Notice to Shareholder of Undistributed Long-Term Capital Gains
- ❑ **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
- ❑ **8880** Credit for Qualified Retirement Savings Contributions
- ❑ **8885** Health Coverage Tax Credit

Nonrefundable Credits

The following credits are discussed in this part.

- Adoption credit.
- Foreign tax credit.
- Mortgage interest credit.
- Retirement savings contributions credit.
- Credit for prior year minimum tax.
- Credit for electric vehicles.

Adoption Credit

You may be able to take a tax credit of up to $10,160 for qualifying expenses paid to adopt an eligible child. A credit of up to $10,160 may be allowed for the adoption of a child with special needs even if you do not have any qualifying expenses.

If your modified adjusted gross income (AGI) is more than $152,390, your credit is reduced. If your modified AGI is $192,389 or more, you cannot claim the credit.

CAUTION *The amount of expenses paid or incurred before 2002 that can be taken into account is limited to the pre-2002 dollar limits. The limit on these expenses is $5,000 ($6,000 in the case of a child with special needs, defined later).*

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 U.S. possessions) and
2) A state (including the District of Columbia) 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

Table 39–1. **Applicable Percentage for Retirement Savings Contributions Credit**

IF your filing status is ...	AND your AGI is ...	THEN your applicable percentage is ...
married filing jointly	Not over $30,000	50%
	Over $30,000, but not over $32,500	20%
	Over $32,500, but not over $50,000	10%
	Over $50,000	0%
head of household	Not over $22,500	50%
	Over $22,500, but not over $24,375	20%
	Over $24,375, but not over $37,500	10%
	Over $37,500	0%
single, qualifying widow(er), or married filing separately	Not over $15,000	50%
	Over $15,000, but not over $16,250	20%
	Over $16,250, but not over $25,000	10%
	Over $25,000	0%

- Whether the child has a medical condition or physical, mental, or emotional handicap.

Foreign child. If the child is not a U.S. citizen or resident, you cannot take the credit unless the adoption becomes final.

When to claim the credit. Generally, for any year before the adoption becomes final, you take the credit in the year after your qualified expenses are paid or incurred. See Publication 968 for more specific information on when to claim the credit.

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 50, Form 1040, or line 34, 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 you exclude from U.S. tax under any of the following.

1) Foreign earned income exclusion.
2) Foreign housing exclusion.
3) Possession exclusion.
4) Extraterritorial income exclusion.

Limit on the credit. Your foreign tax credit cannot be more than your U.S. tax liability (line 41, 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 44, 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 44, Form 1040.

CAUTION *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

The mortgage interest credit is intended to help lower-income individuals afford home ownership. If you qualify, you can claim the credit each year for part of the home mortgage interest you pay.

Who qualifies. You may be eligible for the credit if you were issued a ***mortgage credit certificate (MCC)*** from your state or local government. Generally, an MCC is issued only in connection with a new mortgage for the purchase of 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 two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person. See Publication 530 for further information.

CAUTION *If the certificate credit rate is higher than 20%, the credit you are allowed cannot be more than $2,000.*

Carryforward. If your allowable credit is reduced because of the limit based on your tax, you can carry forward the unused portion of the credit to the next 3 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%, you cannot carry forward any amount more than $2,000 (or your share of the $2,000 if you must divide the credit).

How to claim the credit. Figure your 2003 credit and any carryforward to 2004 on Form 8396, and attach it to your Form 1040. Be sure to include any credit carryforward from 2000, 2001, and 2002.

Include the credit in your total for line 51, Form 1040, and check box a.

Reduced home mortgage interest deduction. If you itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction by the amount of the mortgage interest credit shown on line 3 of Form 8396. You must do this even if part of that amount is to be carried forward to 2004. For more information about the home mortgage interest deduction, see chapter 25.

Recapture of federal mortgage subsidy. If you received an MCC with your mortgage loan, you may have to recapture (pay back) all or part of the benefit you received from that program. The recapture may be required if you sell or dispose of your home at a gain during the first 9 years after the date you closed your mortgage loan. See Publication 523, *Selling Your Home,* for more information.

Retirement Savings Contributions Credit

You may be able to take a tax credit of up to $1,000 ($2,000 if married filing jointly) for making eligible contributions to an employer-sponsored retirement plan or to an individual retirement arrangement (IRA). The credit is a percentage of the qualifying contributions, with the highest rate for taxpayers with the least income.

You **cannot** claim this credit if any of the following apply.

1) The amount of your 2003 adjusted gross income (discussed next) is more than $25,000 ($37,500 if head of household, $50,000 if married filing jointly).
2) You were born after January 1, 1986.

3) You are claimed as a dependent on another person's 2003 tax return.

4) You were a full-time student in 2003.

The amount of credit you can take depends on your filing status, your adjusted gross income (AGI), and your eligible contributions.

Adjusted gross income (AGI). This is generally the amount on Form 1040, line 35, or Form 1040A, line 22. However, you must add to that amount any exclusion or deduction claimed for the year for:

- Foreign earned income,
- Foreign housing costs,
- Income for residents of American Samoa, and
- Income from Puerto Rico.

You can use *Table 39–1* to find the percentage of your eligible contributions you qualify to use. For example, if you are single with an AGI of $15,000, you may be entitled to a credit equal to 50% of your eligible contributions (defined next).

Eligible contributions. These include contributions to a traditional or Roth IRA and salary reduction contributions (elective deferrals) to most employer-sponsored retirement plans. They also include certain voluntary after-tax employee contributions.

Contributions reduced. Your eligible contributions must be reduced by certain taxable and nontaxable distributions made after 2000 and before the due date (including extensions) of your 2003 tax return.

See Publication 590, chapter 4, for more specific information on eligible contributions and the reductions you must make.

Limit on the credit. After your contributions are reduced, the maximum annual contributions on which you can base the credit is $2,000 per person. This makes the maximum possible credit $1,000 per return ($2,000 if married filing jointly).

Example. During 2003, you contributed $3,000 to your 401(k) plan and made a $500 IRA withdrawal. You also took a $900 IRA withdrawal in 2002. Neither of your withdrawals was rolled over. The amount of your 2003 plan contributions eligible for the credit is $1,600 ($3,000 – $500 – $900). If you are single and your AGI is $24,500, your applicable percentage from *Table 39–1* is 10%. Therefore, your retirement savings contributions credit is $160 ($1,600 × 10%).

How to claim the credit. To claim the credit, complete Form 8880 and attach it to your Form 1040 or 1040A. Enter the credit on line 48, Form 1040, or line 32, Form 1040A.

The credit you compute on Form 8880 will take into account any nonrefundable credits that have already reduced your tax (such as the credit for child and dependent care expenses). If your tax liability is reduced to zero because of other nonrefundable credits, you will not be entitled to the credit for retirement savings contributions.

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 2002,

2) Had an unused minimum tax credit that you are carrying forward from 2002 to 2003, or

3) Had unallowed qualified electric vehicle credits in 2002.

How to claim the credit. Figure your 2003 credit and any carryforward to 2004 on Form 8801, and attach it to your Form 1040. Include the credit in your total for line 52, Form 1040, and check box b. 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 drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current,

3) Is originally used by you,

4) Is acquired for your own use, not for resale,

5) Has never been used as a nonelectric vehicle, and

6) Is used predominately in the United States.

Amount of credit. If you placed a qualified electric vehicle in service during 2003, the credit is generally 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost of the vehicle by any section 179 deduction before figuring the credit. See 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 2003.

Recapture. 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 (or its use is modified) so that it is no longer eligible for the credit. You recapture the credit by adding part or all of it to your income tax for the year in which the recapture event occurs. See chapter 12 of Publication 535 for more information.

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 52, Form 1040. Check box c, and print "8834" on the line next to box c.

CAUTION *Do not confuse this credit with the deduction for clean-fuel vehicles that is reported on Form 1040, line 33.*

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.
- Health coverage tax credit.

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 2003, you may have had too much social security or RRTA tax withheld from your pay. You can claim the excess social security or RRTA tier 1 tax 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 2003.

Type of tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social security or RRTA tier 1	$87,000	$5,394.00
RRTA tier 2	$64,500	$3,160.50

CAUTION *All wages are subject to Medicare tax withholding.*

TIP *Use Form 843,* Claim for Refund and Request for Abatement*, to claim a refund of excess RRTA tier 2 tax. See Publication 505,* Tax Withholding and Estimated Tax*, for details.*

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 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 64. If you file Form 1040A, include the credit in the total on line 43 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 2003, figure the credit as follows:

1. Add all social security tax withheld (but not more than $5,394.00 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 60	
3. Add lines 1 and 2. If $5,394.00 or less, stop here. You cannot claim the credit	
4. Social security tax limit	5,394.00
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 64 (or Form 1040A, line 43)	

Example. You are married and file a joint return with your spouse who had no gross income in 2003. During 2003, you worked for the Brown Shoe Company and earned $52,000 in wages. Social security tax of $3,224 was withheld. You also worked for another employer in 2003 and earned $40,200 in wages. $2,492.40 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than $87,000, you can claim a credit of $322.40 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than $5,394.00 for each employer). Enter the total here	$5,716.40
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 60	–0–
3. Add lines 1 and 2. If $5,394.00 or less, stop here. You cannot claim the credit	5,716.40
4. Social security tax limit	5,394.00
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 64 (or Form 1040A, line 43)	$ 322.40

How to figure the credit if you worked for a railroad. If you were a railroad employee during 2003, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than $5,394.00 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 60	
3. Add lines 1 and 2. If $5,394.00 or less, stop here. You cannot claim the credit	
4. Social security and tier 1 RRTA tax limit	5,394.00
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 64 (or Form 1040A, line 43)	

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 67, 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.

Health Coverage Tax Credit

There is a health coverage tax credit available to certain individuals who receive a pension benefit from the Pension Benefit Guaranty Corporation (PBGC) or are eligible to receive certain Trade Adjustment Assistance (TAA) or who are eligible for the Alternate Trade Adjustment Assistance (ATAA) program. You qualify for this credit if you:

1) Are an ***eligible individual***,
2) Pay for ***qualified health insurance*** covering an ***eligible coverage month*** for yourself or for yourself and ***qualifying family members***,
3) Do not have ***other specified coverage***, and
4) Are not in prison.

You qualify for this credit on a month-by-month basis. If you qualify, you can claim a credit equal to 65% of the premiums you pay for qualified health insurance.

You can either take this credit on your tax return or have it paid on your behalf in advance to your insurance company. Your payments and any payments paid on your behalf in advance are treated as having been made on the first day of the month for which they are made. If the credit is paid on your behalf in advance, that amount will reduce the amount of the credit you can claim on your tax return. If you received National Emergency Grant (NEG) payments during 2003 for qualified health insurance, that amount will also reduce the amount of the credit you can claim.

CAUTION *You are not entitled to the credit for a month, if on the first day of that month, you are either:*

- *Covered by Medicare, or*
- *Covered by a group health plan available through your or your spouse's employer if the employer contributes 50% or more of the premium.*

For a definition of an ***eligible individual***, see the following discussion. For definitions of the terms in (2) and (3) earlier, including ***qualified health insurance*** and ***other specified coverage***, see Publication 502.

Eligible Individual

You are an eligible individual for any month during which one of the following is true.

1) You receive a TAA for individuals under the Trade Act of 1974 for at least one day in the month.
2) You would receive a TAA but do not because you have not yet exhausted your unemployment benefits, and are covered under a TAA certification.
3) You are a worker receiving a supplemental wage allowance under section 246 of the Trade Act of 1974 for such month.
4) You are at least 55 years old as of the first day of the month and are receiving pension benefits from the PBGC.

Once you qualify under (1) or (2) above, you remain eligible for the first month that you otherwise cease to be eligible.

Example. You receive a TAA for individuals during May, but do not receive another for the rest of the year. You are eligible for the health coverage tax credit for both May and June.

You are not an eligible individual if an exemption can be claimed for you on another person's tax return.

ATAA workers. Beginning in August, 2003, if you are eligible for the Alternative Trade Adjustment Assistance (ATAA) program, you are eligible for this credit for a period not to exceed two years if you:

1) Are covered by a qualifying certification,
2) Are reemployed not more than 26 weeks after the date of separation from the adversely-affected employment,
3) Are at least 50 years of age,
4) Do not earn more than $50,000 a year in wages from reemployment,
5) Are employed on a full-time basis, and
6) Do not return to the employment from which you were separated.

How To Claim the Credit

To claim the credit, complete Form 8885 and attach it to your Form 1040. Include your credit in the total for line 67, Form 1040, and check box c. You cannot claim the credit on Form 1040A or Form 1040EZ.

You must attach invoices and proof of payment for any amounts you include on line 2 of Form 8885 for which you did not receive an advance payment. For details, see Publication 502 or Form 8885.

2003 Tax Table

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 40 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 $3,099. This is the tax amount they should enter on line 41 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**	3,434	3,084	3,434	3,284
25,250	**25,300**	3,441	3,091	3,441	3,291
25,300	**25,350**	3,449	3,099	3,449	3,299
25,350	**25,400**	3,456	3,106	3,456	3,306

If line 40 (taxable income) is—		And you are—			
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
5	**15**	1	1	1	1
15	**25**	2	2	2	2
25	**50**	4	4	4	4
50	**75**	6	6	6	6
75	**100**	9	9	9	9
100	**125**	11	11	11	11
125	**150**	14	14	14	14
150	**175**	16	16	16	16
175	**200**	19	19	19	19
200	**225**	21	21	21	21
225	**250**	24	24	24	24
250	**275**	26	26	26	26
275	**300**	29	29	29	29
300	**325**	31	31	31	31
325	**350**	34	34	34	34
350	**375**	36	36	36	36
375	**400**	39	39	39	39
400	**425**	41	41	41	41
425	**450**	44	44	44	44
450	**475**	46	46	46	46
475	**500**	49	49	49	49
500	**525**	51	51	51	51
525	**550**	54	54	54	54
550	**575**	56	56	56	56
575	**600**	59	59	59	59
600	**625**	61	61	61	61
625	**650**	64	64	64	64
650	**675**	66	66	66	66
675	**700**	69	69	69	69
700	**725**	71	71	71	71
725	**750**	74	74	74	74
750	**775**	76	76	76	76
775	**800**	79	79	79	79
800	**825**	81	81	81	81
825	**850**	84	84	84	84
850	**875**	86	86	86	86
875	**900**	89	89	89	89
900	**925**	91	91	91	91
925	**950**	94	94	94	94
950	**975**	96	96	96	96
975	**1,000**	99	99	99	99
1,000					
1,000	**1,025**	101	101	101	101
1,025	**1,050**	104	104	104	104
1,050	**1,075**	106	106	106	106
1,075	**1,100**	109	109	109	109
1,100	**1,125**	111	111	111	111
1,125	**1,150**	114	114	114	114
1,150	**1,175**	116	116	116	116
1,175	**1,200**	119	119	119	119
1,200	**1,225**	121	121	121	121
1,225	**1,250**	124	124	124	124
1,250	**1,275**	126	126	126	126
1,275	**1,300**	129	129	129	129

If line 40 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
1,300	**1,325**	131	131	131	131
1,325	**1,350**	134	134	134	134
1,350	**1,375**	136	136	136	136
1,375	**1,400**	139	139	139	139
1,400	**1,425**	141	141	141	141
1,425	**1,450**	144	144	144	144
1,450	**1,475**	146	146	146	146
1,475	**1,500**	149	149	149	149
1,500	**1,525**	151	151	151	151
1,525	**1,550**	154	154	154	154
1,550	**1,575**	156	156	156	156
1,575	**1,600**	159	159	159	159
1,600	**1,625**	161	161	161	161
1,625	**1,650**	164	164	164	164
1,650	**1,675**	166	166	166	166
1,675	**1,700**	169	169	169	169
1,700	**1,725**	171	171	171	171
1,725	**1,750**	174	174	174	174
1,750	**1,775**	176	176	176	176
1,775	**1,800**	179	179	179	179
1,800	**1,825**	181	181	181	181
1,825	**1,850**	184	184	184	184
1,850	**1,875**	186	186	186	186
1,875	**1,900**	189	189	189	189
1,900	**1,925**	191	191	191	191
1,925	**1,950**	194	194	194	194
1,950	**1,975**	196	196	196	196
1,975	**2,000**	199	199	199	199
2,000					
2,000	**2,025**	201	201	201	201
2,025	**2,050**	204	204	204	204
2,050	**2,075**	206	206	206	206
2,075	**2,100**	209	209	209	209
2,100	**2,125**	211	211	211	211
2,125	**2,150**	214	214	214	214
2,150	**2,175**	216	216	216	216
2,175	**2,200**	219	219	219	219
2,200	**2,225**	221	221	221	221
2,225	**2,250**	224	224	224	224
2,250	**2,275**	226	226	226	226
2,275	**2,300**	229	229	229	229
2,300	**2,325**	231	231	231	231
2,325	**2,350**	234	234	234	234
2,350	**2,375**	236	236	236	236
2,375	**2,400**	239	239	239	239
2,400	**2,425**	241	241	241	241
2,425	**2,450**	244	244	244	244
2,450	**2,475**	246	246	246	246
2,475	**2,500**	249	249	249	249
2,500	**2,525**	251	251	251	251
2,525	**2,550**	254	254	254	254
2,550	**2,575**	256	256	256	256
2,575	**2,600**	259	259	259	259
2,600	**2,625**	261	261	261	261
2,625	**2,650**	264	264	264	264
2,650	**2,675**	266	266	266	266
2,675	**2,700**	269	269	269	269

If line 40 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
2,700	**2,725**	271	271	271	271
2,725	**2,750**	274	274	274	274
2,750	**2,775**	276	276	276	276
2,775	**2,800**	279	279	279	279
2,800	**2,825**	281	281	281	281
2,825	**2,850**	284	284	284	284
2,850	**2,875**	286	286	286	286
2,875	**2,900**	289	289	289	289
2,900	**2,925**	291	291	291	291
2,925	**2,950**	294	294	294	294
2,950	**2,975**	296	296	296	296
2,975	**3,000**	299	299	299	299
3,000					
3,000	**3,050**	303	303	303	303
3,050	**3,100**	308	308	308	308
3,100	**3,150**	313	313	313	313
3,150	**3,200**	318	318	318	318
3,200	**3,250**	323	323	323	323
3,250	**3,300**	328	328	328	328
3,300	**3,350**	333	333	333	333
3,350	**3,400**	338	338	338	338
3,400	**3,450**	343	343	343	343
3,450	**3,500**	348	348	348	348
3,500	**3,550**	353	353	353	353
3,550	**3,600**	358	358	358	358
3,600	**3,650**	363	363	363	363
3,650	**3,700**	368	368	368	368
3,700	**3,750**	373	373	373	373
3,750	**3,800**	378	378	378	378
3,800	**3,850**	383	383	383	383
3,850	**3,900**	388	388	388	388
3,900	**3,950**	393	393	393	393
3,950	**4,000**	398	398	398	398
4,000					
4,000	**4,050**	403	403	403	403
4,050	**4,100**	408	408	408	408
4,100	**4,150**	413	413	413	413
4,150	**4,200**	418	418	418	418
4,200	**4,250**	423	423	423	423
4,250	**4,300**	428	428	428	428
4,300	**4,350**	433	433	433	433
4,350	**4,400**	438	438	438	438
4,400	**4,450**	443	443	443	443
4,450	**4,500**	448	448	448	448
4,500	**4,550**	453	453	453	453
4,550	**4,600**	458	458	458	458
4,600	**4,650**	463	463	463	463
4,650	**4,700**	468	468	468	468
4,700	**4,750**	473	473	473	473
4,750	**4,800**	478	478	478	478
4,800	**4,850**	483	483	483	483
4,850	**4,900**	488	488	488	488
4,900	**4,950**	493	493	493	493
4,950	**5,000**	498	498	498	498

(Continued on page 63)

* This column must also be used by a qualifying widow(er).

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	503	503	503	503	**8,000**	**8,050**	854	803	854	803	**11,000**	**11,050**	1,304	1,103	1,304	1,154
5,050	**5,100**	508	508	508	508	**8,050**	**8,100**	861	808	861	808	**11,050**	**11,100**	1,311	1,108	1,311	1,161
5,100	**5,150**	513	513	513	513	**8,100**	**8,150**	869	813	869	813	**11,100**	**11,150**	1,319	1,113	1,319	1,169
5,150	**5,200**	518	518	518	518	**8,150**	**8,200**	876	818	876	818	**11,150**	**11,200**	1,326	1,118	1,326	1,176
5,200	**5,250**	523	523	523	523	**8,200**	**8,250**	884	823	884	823	**11,200**	**11,250**	1,334	1,123	1,334	1,184
5,250	**5,300**	528	528	528	528	**8,250**	**8,300**	891	828	891	828	**11,250**	**11,300**	1,341	1,128	1,341	1,191
5,300	**5,350**	533	533	533	533	**8,300**	**8,350**	899	833	899	833	**11,300**	**11,350**	1,349	1,133	1,349	1,199
5,350	**5,400**	538	538	538	538	**8,350**	**8,400**	906	838	906	838	**11,350**	**11,400**	1,356	1,138	1,356	1,206
5,400	**5,450**	543	543	543	543	**8,400**	**8,450**	914	843	914	843	**11,400**	**11,450**	1,364	1,143	1,364	1,214
5,450	**5,500**	548	548	548	548	**8,450**	**8,500**	921	848	921	848	**11,450**	**11,500**	1,371	1,148	1,371	1,221
5,500	**5,550**	553	553	553	553	**8,500**	**8,550**	929	853	929	853	**11,500**	**11,550**	1,379	1,153	1,379	1,229
5,550	**5,600**	558	558	558	558	**8,550**	**8,600**	936	858	936	858	**11,550**	**11,600**	1,386	1,158	1,386	1,236
5,600	**5,650**	563	563	563	563	**8,600**	**8,650**	944	863	944	863	**11,600**	**11,650**	1,394	1,163	1,394	1,244
5,650	**5,700**	568	568	568	568	**8,650**	**8,700**	951	868	951	868	**11,650**	**11,700**	1,401	1,168	1,401	1,251
5,700	**5,750**	573	573	573	573	**8,700**	**8,750**	959	873	959	873	**11,700**	**11,750**	1,409	1,173	1,409	1,259
5,750	**5,800**	578	578	578	578	**8,750**	**8,800**	966	878	966	878	**11,750**	**11,800**	1,416	1,178	1,416	1,266
5,800	**5,850**	583	583	583	583	**8,800**	**8,850**	974	883	974	883	**11,800**	**11,850**	1,424	1,183	1,424	1,274
5,850	**5,900**	588	588	588	588	**8,850**	**8,900**	981	888	981	888	**11,850**	**11,900**	1,431	1,188	1,431	1,281
5,900	**5,950**	593	593	593	593	**8,900**	**8,950**	989	893	989	893	**11,900**	**11,950**	1,439	1,193	1,439	1,289
5,950	**6,000**	598	598	598	598	**8,950**	**9,000**	996	898	996	898	**11,950**	**12,000**	1,446	1,198	1,446	1,296
6,000						**9,000**						**12,000**					
6,000	**6,050**	603	603	603	603	**9,000**	**9,050**	1,004	903	1,004	903	**12,000**	**12,050**	1,454	1,203	1,454	1,304
6,050	**6,100**	608	608	608	608	**9,050**	**9,100**	1,011	908	1,011	908	**12,050**	**12,100**	1,461	1,208	1,461	1,311
6,100	**6,150**	613	613	613	613	**9,100**	**9,150**	1,019	913	1,019	913	**12,100**	**12,150**	1,469	1,213	1,469	1,319
6,150	**6,200**	618	618	618	618	**9,150**	**9,200**	1,026	918	1,026	918	**12,150**	**12,200**	1,476	1,218	1,476	1,326
6,200	**6,250**	623	623	623	623	**9,200**	**9,250**	1,034	923	1,034	923	**12,200**	**12,250**	1,484	1,223	1,484	1,334
6,250	**6,300**	628	628	628	628	**9,250**	**9,300**	1,041	928	1,041	928	**12,250**	**12,300**	1,491	1,228	1,491	1,341
6,300	**6,350**	633	633	633	633	**9,300**	**9,350**	1,049	933	1,049	933	**12,300**	**12,350**	1,499	1,233	1,499	1,349
6,350	**6,400**	638	638	638	638	**9,350**	**9,400**	1,056	938	1,056	938	**12,350**	**12,400**	1,506	1,238	1,506	1,356
6,400	**6,450**	643	643	643	643	**9,400**	**9,450**	1,064	943	1,064	943	**12,400**	**12,450**	1,514	1,243	1,514	1,364
6,450	**6,500**	648	648	648	648	**9,450**	**9,500**	1,071	948	1,071	948	**12,450**	**12,500**	1,521	1,248	1,521	1,371
6,500	**6,550**	653	653	653	653	**9,500**	**9,550**	1,079	953	1,079	953	**12,500**	**12,550**	1,529	1,253	1,529	1,379
6,550	**6,600**	658	658	658	658	**9,550**	**9,600**	1,086	958	1,086	958	**12,550**	**12,600**	1,536	1,258	1,536	1,386
6,600	**6,650**	663	663	663	663	**9,600**	**9,650**	1,094	963	1,094	963	**12,600**	**12,650**	1,544	1,263	1,544	1,394
6,650	**6,700**	668	668	668	668	**9,650**	**9,700**	1,101	968	1,101	968	**12,650**	**12,700**	1,551	1,268	1,551	1,401
6,700	**6,750**	673	673	673	673	**9,700**	**9,750**	1,109	973	1,109	973	**12,700**	**12,750**	1,559	1,273	1,559	1,409
6,750	**6,800**	678	678	678	678	**9,750**	**9,800**	1,116	978	1,116	978	**12,750**	**12,800**	1,566	1,278	1,566	1,416
6,800	**6,850**	683	683	683	683	**9,800**	**9,850**	1,124	983	1,124	983	**12,800**	**12,850**	1,574	1,283	1,574	1,424
6,850	**6,900**	688	688	688	688	**9,850**	**9,900**	1,131	988	1,131	988	**12,850**	**12,900**	1,581	1,288	1,581	1,431
6,900	**6,950**	693	693	693	693	**9,900**	**9,950**	1,139	993	1,139	993	**12,900**	**12,950**	1,589	1,293	1,589	1,439
6,950	**7,000**	698	698	698	698	**9,950**	**10,000**	1,146	998	1,146	998	**12,950**	**13,000**	1,596	1,298	1,596	1,446
7,000						**10,000**						**13,000**					
7,000	**7,050**	704	703	704	703	**10,000**	**10,050**	1,154	1,003	1,154	1,004	**13,000**	**13,050**	1,604	1,303	1,604	1,454
7,050	**7,100**	711	708	711	708	**10,050**	**10,100**	1,161	1,008	1,161	1,011	**13,050**	**13,100**	1,611	1,308	1,611	1,461
7,100	**7,150**	719	713	719	713	**10,100**	**10,150**	1,169	1,013	1,169	1,019	**13,100**	**13,150**	1,619	1,313	1,619	1,469
7,150	**7,200**	726	718	726	718	**10,150**	**10,200**	1,176	1,018	1,176	1,026	**13,150**	**13,200**	1,626	1,318	1,626	1,476
7,200	**7,250**	734	723	734	723	**10,200**	**10,250**	1,184	1,023	1,184	1,034	**13,200**	**13,250**	1,634	1,323	1,634	1,484
7,250	**7,300**	741	728	741	728	**10,250**	**10,300**	1,191	1,028	1,191	1,041	**13,250**	**13,300**	1,641	1,328	1,641	1,491
7,300	**7,350**	749	733	749	733	**10,300**	**10,350**	1,199	1,033	1,199	1,049	**13,300**	**13,350**	1,649	1,333	1,649	1,499
7,350	**7,400**	756	738	756	738	**10,350**	**10,400**	1,206	1,038	1,206	1,056	**13,350**	**13,400**	1,656	1,338	1,656	1,506
7,400	**7,450**	764	743	764	743	**10,400**	**10,450**	1,214	1,043	1,214	1,064	**13,400**	**13,450**	1,664	1,343	1,664	1,514
7,450	**7,500**	771	748	771	748	**10,450**	**10,500**	1,221	1,048	1,221	1,071	**13,450**	**13,500**	1,671	1,348	1,671	1,521
7,500	**7,550**	779	753	779	753	**10,500**	**10,550**	1,229	1,053	1,229	1,079	**13,500**	**13,550**	1,679	1,353	1,679	1,529
7,550	**7,600**	786	758	786	758	**10,550**	**10,600**	1,236	1,058	1,236	1,086	**13,550**	**13,600**	1,686	1,358	1,686	1,536
7,600	**7,650**	794	763	794	763	**10,600**	**10,650**	1,244	1,063	1,244	1,094	**13,600**	**13,650**	1,694	1,363	1,694	1,544
7,650	**7,700**	801	768	801	768	**10,650**	**10,700**	1,251	1,068	1,251	1,101	**13,650**	**13,700**	1,701	1,368	1,701	1,551
7,700	**7,750**	809	773	809	773	**10,700**	**10,750**	1,259	1,073	1,259	1,109	**13,700**	**13,750**	1,709	1,373	1,709	1,559
7,750	**7,800**	816	778	816	778	**10,750**	**10,800**	1,266	1,078	1,266	1,116	**13,750**	**13,800**	1,716	1,378	1,716	1,566
7,800	**7,850**	824	783	824	783	**10,800**	**10,850**	1,274	1,083	1,274	1,124	**13,800**	**13,850**	1,724	1,383	1,724	1,574
7,850	**7,900**	831	788	831	788	**10,850**	**10,900**	1,281	1,088	1,281	1,131	**13,850**	**13,900**	1,731	1,388	1,731	1,581
7,900	**7,950**	839	793	839	793	**10,900**	**10,950**	1,289	1,093	1,289	1,139	**13,900**	**13,950**	1,739	1,393	1,739	1,589
7,950	**8,000**	846	798	846	798	**10,950**	**11,000**	1,296	1,098	1,296	1,146	**13,950**	**14,000**	1,746	1,398	1,746	1,596

* This column must also be used by a qualifying widow(er).

(Continued on page 64)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	1,754	1,404	1,754	1,604	**17,000**	**17,050**	2,204	1,854	2,204	2,054	**20,000**	**20,050**	2,654	2,304	2,654	2,504
14,050	**14,100**	1,761	1,411	1,761	1,611	**17,050**	**17,100**	2,211	1,861	2,211	2,061	**20,050**	**20,100**	2,661	2,311	2,661	2,511
14,100	**14,150**	1,769	1,419	1,769	1,619	**17,100**	**17,150**	2,219	1,869	2,219	2,069	**20,100**	**20,150**	2,669	2,319	2,669	2,519
14,150	**14,200**	1,776	1,426	1,776	1,626	**17,150**	**17,200**	2,226	1,876	2,226	2,076	**20,150**	**20,200**	2,676	2,326	2,676	2,526
14,200	**14,250**	1,784	1,434	1,784	1,634	**17,200**	**17,250**	2,234	1,884	2,234	2,084	**20,200**	**20,250**	2,684	2,334	2,684	2,534
14,250	**14,300**	1,791	1,441	1,791	1,641	**17,250**	**17,300**	2,241	1,891	2,241	2,091	**20,250**	**20,300**	2,691	2,341	2,691	2,541
14,300	**14,350**	1,799	1,449	1,799	1,649	**17,300**	**17,350**	2,249	1,899	2,249	2,099	**20,300**	**20,350**	2,699	2,349	2,699	2,549
14,350	**14,400**	1,806	1,456	1,806	1,656	**17,350**	**17,400**	2,256	1,906	2,256	2,106	**20,350**	**20,400**	2,706	2,356	2,706	2,556
14,400	**14,450**	1,814	1,464	1,814	1,664	**17,400**	**17,450**	2,264	1,914	2,264	2,114	**20,400**	**20,450**	2,714	2,364	2,714	2,564
14,450	**14,500**	1,821	1,471	1,821	1,671	**17,450**	**17,500**	2,271	1,921	2,271	2,121	**20,450**	**20,500**	2,721	2,371	2,721	2,571
14,500	**14,550**	1,829	1,479	1,829	1,679	**17,500**	**17,550**	2,279	1,929	2,279	2,129	**20,500**	**20,550**	2,729	2,379	2,729	2,579
14,550	**14,600**	1,836	1,486	1,836	1,686	**17,550**	**17,600**	2,286	1,936	2,286	2,136	**20,550**	**20,600**	2,736	2,386	2,736	2,586
14,600	**14,650**	1,844	1,494	1,844	1,694	**17,600**	**17,650**	2,294	1,944	2,294	2,144	**20,600**	**20,650**	2,744	2,394	2,744	2,594
14,650	**14,700**	1,851	1,501	1,851	1,701	**17,650**	**17,700**	2,301	1,951	2,301	2,151	**20,650**	**20,700**	2,751	2,401	2,751	2,601
14,700	**14,750**	1,859	1,509	1,859	1,709	**17,700**	**17,750**	2,309	1,959	2,309	2,159	**20,700**	**20,750**	2,759	2,409	2,759	2,609
14,750	**14,800**	1,866	1,516	1,866	1,716	**17,750**	**17,800**	2,316	1,966	2,316	2,166	**20,750**	**20,800**	2,766	2,416	2,766	2,616
14,800	**14,850**	1,874	1,524	1,874	1,724	**17,800**	**17,850**	2,324	1,974	2,324	2,174	**20,800**	**20,850**	2,774	2,424	2,774	2,624
14,850	**14,900**	1,881	1,531	1,881	1,731	**17,850**	**17,900**	2,331	1,981	2,331	2,181	**20,850**	**20,900**	2,781	2,431	2,781	2,631
14,900	**14,950**	1,889	1,539	1,889	1,739	**17,900**	**17,950**	2,339	1,989	2,339	2,189	**20,900**	**20,950**	2,789	2,439	2,789	2,639
14,950	**15,000**	1,896	1,546	1,896	1,746	**17,950**	**18,000**	2,346	1,996	2,346	2,196	**20,950**	**21,000**	2,796	2,446	2,796	2,646
15,000						**18,000**						**21,000**					
15,000	**15,050**	1,904	1,554	1,904	1,754	**18,000**	**18,050**	2,354	2,004	2,354	2,204	**21,000**	**21,050**	2,804	2,454	2,804	2,654
15,050	**15,100**	1,911	1,561	1,911	1,761	**18,050**	**18,100**	2,361	2,011	2,361	2,211	**21,050**	**21,100**	2,811	2,461	2,811	2,661
15,100	**15,150**	1,919	1,569	1,919	1,769	**18,100**	**18,150**	2,369	2,019	2,369	2,219	**21,100**	**21,150**	2,819	2,469	2,819	2,669
15,150	**15,200**	1,926	1,576	1,926	1,776	**18,150**	**18,200**	2,376	2,026	2,376	2,226	**21,150**	**21,200**	2,826	2,476	2,826	2,676
15,200	**15,250**	1,934	1,584	1,934	1,784	**18,200**	**18,250**	2,384	2,034	2,384	2,234	**21,200**	**21,250**	2,834	2,484	2,834	2,684
15,250	**15,300**	1,941	1,591	1,941	1,791	**18,250**	**18,300**	2,391	2,041	2,391	2,241	**21,250**	**21,300**	2,841	2,491	2,841	2,691
15,300	**15,350**	1,949	1,599	1,949	1,799	**18,300**	**18,350**	2,399	2,049	2,399	2,249	**21,300**	**21,350**	2,849	2,499	2,849	2,699
15,350	**15,400**	1,956	1,606	1,956	1,806	**18,350**	**18,400**	2,406	2,056	2,406	2,256	**21,350**	**21,400**	2,856	2,506	2,856	2,706
15,400	**15,450**	1,964	1,614	1,964	1,814	**18,400**	**18,450**	2,414	2,064	2,414	2,264	**21,400**	**21,450**	2,864	2,514	2,864	2,714
15,450	**15,500**	1,971	1,621	1,971	1,821	**18,450**	**18,500**	2,421	2,071	2,421	2,271	**21,450**	**21,500**	2,871	2,521	2,871	2,721
15,500	**15,550**	1,979	1,629	1,979	1,829	**18,500**	**18,550**	2,429	2,079	2,429	2,279	**21,500**	**21,550**	2,879	2,529	2,879	2,729
15,550	**15,600**	1,986	1,636	1,986	1,836	**18,550**	**18,600**	2,436	2,086	2,436	2,286	**21,550**	**21,600**	2,886	2,536	2,886	2,736
15,600	**15,650**	1,994	1,644	1,994	1,844	**18,600**	**18,650**	2,444	2,094	2,444	2,294	**21,600**	**21,650**	2,894	2,544	2,894	2,744
15,650	**15,700**	2,001	1,651	2,001	1,851	**18,650**	**18,700**	2,451	2,101	2,451	2,301	**21,650**	**21,700**	2,901	2,551	2,901	2,751
15,700	**15,750**	2,009	1,659	2,009	1,859	**18,700**	**18,750**	2,459	2,109	2,459	2,309	**21,700**	**21,750**	2,909	2,559	2,909	2,759
15,750	**15,800**	2,016	1,666	2,016	1,866	**18,750**	**18,800**	2,466	2,116	2,466	2,316	**21,750**	**21,800**	2,916	2,566	2,916	2,766
15,800	**15,850**	2,024	1,674	2,024	1,874	**18,800**	**18,850**	2,474	2,124	2,474	2,324	**21,800**	**21,850**	2,924	2,574	2,924	2,774
15,850	**15,900**	2,031	1,681	2,031	1,881	**18,850**	**18,900**	2,481	2,131	2,481	2,331	**21,850**	**21,900**	2,931	2,581	2,931	2,781
15,900	**15,950**	2,039	1,689	2,039	1,889	**18,900**	**18,950**	2,489	2,139	2,489	2,339	**21,900**	**21,950**	2,939	2,589	2,939	2,789
15,950	**16,000**	2,046	1,696	2,046	1,896	**18,950**	**19,000**	2,496	2,146	2,496	2,346	**21,950**	**22,000**	2,946	2,596	2,946	2,796
16,000						**19,000**						**22,000**					
16,000	**16,050**	2,054	1,704	2,054	1,904	**19,000**	**19,050**	2,504	2,154	2,504	2,354	**22,000**	**22,050**	2,954	2,604	2,954	2,804
16,050	**16,100**	2,061	1,711	2,061	1,911	**19,050**	**19,100**	2,511	2,161	2,511	2,361	**22,050**	**22,100**	2,961	2,611	2,961	2,811
16,100	**16,150**	2,069	1,719	2,069	1,919	**19,100**	**19,150**	2,519	2,169	2,519	2,369	**22,100**	**22,150**	2,969	2,619	2,969	2,819
16,150	**16,200**	2,076	1,726	2,076	1,926	**19,150**	**19,200**	2,526	2,176	2,526	2,376	**22,150**	**22,200**	2,976	2,626	2,976	2,826
16,200	**16,250**	2,084	1,734	2,084	1,934	**19,200**	**19,250**	2,534	2,184	2,534	2,384	**22,200**	**22,250**	2,984	2,634	2,984	2,834
16,250	**16,300**	2,091	1,741	2,091	1,941	**19,250**	**19,300**	2,541	2,191	2,541	2,391	**22,250**	**22,300**	2,991	2,641	2,991	2,841
16,300	**16,350**	2,099	1,749	2,099	1,949	**19,300**	**19,350**	2,549	2,199	2,549	2,399	**22,300**	**22,350**	2,999	2,649	2,999	2,849
16,350	**16,400**	2,106	1,756	2,106	1,956	**19,350**	**19,400**	2,556	2,206	2,556	2,406	**22,350**	**22,400**	3,006	2,656	3,006	2,856
16,400	**16,450**	2,114	1,764	2,114	1,964	**19,400**	**19,450**	2,564	2,214	2,564	2,414	**22,400**	**22,450**	3,014	2,664	3,014	2,864
16,450	**16,500**	2,121	1,771	2,121	1,971	**19,450**	**19,500**	2,571	2,221	2,571	2,421	**22,450**	**22,500**	3,021	2,671	3,021	2,871
16,500	**16,550**	2,129	1,779	2,129	1,979	**19,500**	**19,550**	2,579	2,229	2,579	2,429	**22,500**	**22,550**	3,029	2,679	3,029	2,879
16,550	**16,600**	2,136	1,786	2,136	1,986	**19,550**	**19,600**	2,586	2,236	2,586	2,436	**22,550**	**22,600**	3,036	2,686	3,036	2,886
16,600	**16,650**	2,144	1,794	2,144	1,994	**19,600**	**19,650**	2,594	2,244	2,594	2,444	**22,600**	**22,650**	3,044	2,694	3,044	2,894
16,650	**16,700**	2,151	1,801	2,151	2,001	**19,650**	**19,700**	2,601	2,251	2,601	2,451	**22,650**	**22,700**	3,051	2,701	3,051	2,901
16,700	**16,750**	2,159	1,809	2,159	2,009	**19,700**	**19,750**	2,609	2,259	2,609	2,459	**22,700**	**22,750**	3,059	2,709	3,059	2,909
16,750	**16,800**	2,166	1,816	2,166	2,016	**19,750**	**19,800**	2,616	2,266	2,616	2,466	**22,750**	**22,800**	3,066	2,716	3,066	2,916
16,800	**16,850**	2,174	1,824	2,174	2,024	**19,800**	**19,850**	2,624	2,274	2,624	2,474	**22,800**	**22,850**	3,074	2,724	3,074	2,924
16,850	**16,900**	2,181	1,831	2,181	2,031	**19,850**	**19,900**	2,631	2,281	2,631	2,481	**22,850**	**22,900**	3,081	2,731	3,081	2,931
16,900	**16,950**	2,189	1,839	2,189	2,039	**19,900**	**19,950**	2,639	2,289	2,639	2,489	**22,900**	**22,950**	3,089	2,739	3,089	2,939
16,950	**17,000**	2,196	1,846	2,196	2,046	**19,950**	**20,000**	2,646	2,296	2,646	2,496	**22,950**	**23,000**	3,096	2,746	3,096	2,946

* This column must also be used by a qualifying widow(er).

(Continued on page 65)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	3,104	2,754	3,104	2,954	**26,000**	**26,050**	3,554	3,204	3,554	3,404	**29,000**	**29,050**	4,066	3,654	4,066	3,854
23,050	**23,100**	3,111	2,761	3,111	2,961	**26,050**	**26,100**	3,561	3,211	3,561	3,411	**29,050**	**29,100**	4,079	3,661	4,079	3,861
23,100	**23,150**	3,119	2,769	3,119	2,969	**26,100**	**26,150**	3,569	3,219	3,569	3,419	**29,100**	**29,150**	4,091	3,669	4,091	3,869
23,150	**23,200**	3,126	2,776	3,126	2,976	**26,150**	**26,200**	3,576	3,226	3,576	3,426	**29,150**	**29,200**	4,104	3,676	4,104	3,876
23,200	**23,250**	3,134	2,784	3,134	2,984	**26,200**	**26,250**	3,584	3,234	3,584	3,434	**29,200**	**29,250**	4,116	3,684	4,116	3,884
23,250	**23,300**	3,141	2,791	3,141	2,991	**26,250**	**26,300**	3,591	3,241	3,591	3,441	**29,250**	**29,300**	4,129	3,691	4,129	3,891
23,300	**23,350**	3,149	2,799	3,149	2,999	**26,300**	**26,350**	3,599	3,249	3,599	3,449	**29,300**	**29,350**	4,141	3,699	4,141	3,899
23,350	**23,400**	3,156	2,806	3,156	3,006	**26,350**	**26,400**	3,606	3,256	3,606	3,456	**29,350**	**29,400**	4,154	3,706	4,154	3,906
23,400	**23,450**	3,164	2,814	3,164	3,014	**26,400**	**26,450**	3,614	3,264	3,614	3,464	**29,400**	**29,450**	4,166	3,714	4,166	3,914
23,450	**23,500**	3,171	2,821	3,171	3,021	**26,450**	**26,500**	3,621	3,271	3,621	3,471	**29,450**	**29,500**	4,179	3,721	4,179	3,921
23,500	**23,550**	3,179	2,829	3,179	3,029	**26,500**	**26,550**	3,629	3,279	3,629	3,479	**29,500**	**29,550**	4,191	3,729	4,191	3,929
23,550	**23,600**	3,186	2,836	3,186	3,036	**26,550**	**26,600**	3,636	3,286	3,636	3,486	**29,550**	**29,600**	4,204	3,736	4,204	3,936
23,600	**23,650**	3,194	2,844	3,194	3,044	**26,600**	**26,650**	3,644	3,294	3,644	3,494	**29,600**	**29,650**	4,216	3,744	4,216	3,944
23,650	**23,700**	3,201	2,851	3,201	3,051	**26,650**	**26,700**	3,651	3,301	3,651	3,501	**29,650**	**29,700**	4,229	3,751	4,229	3,951
23,700	**23,750**	3,209	2,859	3,209	3,059	**26,700**	**26,750**	3,659	3,309	3,659	3,509	**29,700**	**29,750**	4,241	3,759	4,241	3,959
23,750	**23,800**	3,216	2,866	3,216	3,066	**26,750**	**26,800**	3,666	3,316	3,666	3,516	**29,750**	**29,800**	4,254	3,766	4,254	3,966
23,800	**23,850**	3,224	2,874	3,224	3,074	**26,800**	**26,850**	3,674	3,324	3,674	3,524	**29,800**	**29,850**	4,266	3,774	4,266	3,974
23,850	**23,900**	3,231	2,881	3,231	3,081	**26,850**	**26,900**	3,681	3,331	3,681	3,531	**29,850**	**29,900**	4,279	3,781	4,279	3,981
23,900	**23,950**	3,239	2,889	3,239	3,089	**26,900**	**26,950**	3,689	3,339	3,689	3,539	**29,900**	**29,950**	4,291	3,789	4,291	3,989
23,950	**24,000**	3,246	2,896	3,246	3,096	**26,950**	**27,000**	3,696	3,346	3,696	3,546	**29,950**	**30,000**	4,304	3,796	4,304	3,996
24,000						**27,000**						**30,000**					
24,000	**24,050**	3,254	2,904	3,254	3,104	**27,000**	**27,050**	3,704	3,354	3,704	3,554	**30,000**	**30,050**	4,316	3,804	4,316	4,004
24,050	**24,100**	3,261	2,911	3,261	3,111	**27,050**	**27,100**	3,711	3,361	3,711	3,561	**30,050**	**30,100**	4,329	3,811	4,329	4,011
24,100	**24,150**	3,269	2,919	3,269	3,119	**27,100**	**27,150**	3,719	3,369	3,719	3,569	**30,100**	**30,150**	4,341	3,819	4,341	4,019
24,150	**24,200**	3,276	2,926	3,276	3,126	**27,150**	**27,200**	3,726	3,376	3,726	3,576	**30,150**	**30,200**	4,354	3,826	4,354	4,026
24,200	**24,250**	3,284	2,934	3,284	3,134	**27,200**	**27,250**	3,734	3,384	3,734	3,584	**30,200**	**30,250**	4,366	3,834	4,366	4,034
24,250	**24,300**	3,291	2,941	3,291	3,141	**27,250**	**27,300**	3,741	3,391	3,741	3,591	**30,250**	**30,300**	4,379	3,841	4,379	4,041
24,300	**24,350**	3,299	2,949	3,299	3,149	**27,300**	**27,350**	3,749	3,399	3,749	3,599	**30,300**	**30,350**	4,391	3,849	4,391	4,049
24,350	**24,400**	3,306	2,956	3,306	3,156	**27,350**	**27,400**	3,756	3,406	3,756	3,606	**30,350**	**30,400**	4,404	3,856	4,404	4,056
24,400	**24,450**	3,314	2,964	3,314	3,164	**27,400**	**27,450**	3,764	3,414	3,764	3,614	**30,400**	**30,450**	4,416	3,864	4,416	4,064
24,450	**24,500**	3,321	2,971	3,321	3,171	**27,450**	**27,500**	3,771	3,421	3,771	3,621	**30,450**	**30,500**	4,429	3,871	4,429	4,071
24,500	**24,550**	3,329	2,979	3,329	3,179	**27,500**	**27,550**	3,779	3,429	3,779	3,629	**30,500**	**30,550**	4,441	3,879	4,441	4,079
24,550	**24,600**	3,336	2,986	3,336	3,186	**27,550**	**27,600**	3,786	3,436	3,786	3,636	**30,550**	**30,600**	4,454	3,886	4,454	4,086
24,600	**24,650**	3,344	2,994	3,344	3,194	**27,600**	**27,650**	3,794	3,444	3,794	3,644	**30,600**	**30,650**	4,466	3,894	4,466	4,094
24,650	**24,700**	3,351	3,001	3,351	3,201	**27,650**	**27,700**	3,801	3,451	3,801	3,651	**30,650**	**30,700**	4,479	3,901	4,479	4,101
24,700	**24,750**	3,359	3,009	3,359	3,209	**27,700**	**27,750**	3,809	3,459	3,809	3,659	**30,700**	**30,750**	4,491	3,909	4,491	4,109
24,750	**24,800**	3,366	3,016	3,366	3,216	**27,750**	**27,800**	3,816	3,466	3,816	3,666	**30,750**	**30,800**	4,504	3,916	4,504	4,116
24,800	**24,850**	3,374	3,024	3,374	3,224	**27,800**	**27,850**	3,824	3,474	3,824	3,674	**30,800**	**30,850**	4,516	3,924	4,516	4,124
24,850	**24,900**	3,381	3,031	3,381	3,231	**27,850**	**27,900**	3,831	3,481	3,831	3,681	**30,850**	**30,900**	4,529	3,931	4,529	4,131
24,900	**24,950**	3,389	3,039	3,389	3,239	**27,900**	**27,950**	3,839	3,489	3,839	3,689	**30,900**	**30,950**	4,541	3,939	4,541	4,139
24,950	**25,000**	3,396	3,046	3,396	3,246	**27,950**	**28,000**	3,846	3,496	3,846	3,696	**30,950**	**31,000**	4,554	3,946	4,554	4,146
25,000						**28,000**						**31,000**					
25,000	**25,050**	3,404	3,054	3,404	3,254	**28,000**	**28,050**	3,854	3,504	3,854	3,704	**31,000**	**31,050**	4,566	3,954	4,566	4,154
25,050	**25,100**	3,411	3,061	3,411	3,261	**28,050**	**28,100**	3,861	3,511	3,861	3,711	**31,050**	**31,100**	4,579	3,961	4,579	4,161
25,100	**25,150**	3,419	3,069	3,419	3,269	**28,100**	**28,150**	3,869	3,519	3,869	3,719	**31,100**	**31,150**	4,591	3,969	4,591	4,169
25,150	**25,200**	3,426	3,076	3,426	3,276	**28,150**	**28,200**	3,876	3,526	3,876	3,726	**31,150**	**31,200**	4,604	3,976	4,604	4,176
25,200	**25,250**	3,434	3,084	3,434	3,284	**28,200**	**28,250**	3,884	3,534	3,884	3,734	**31,200**	**31,250**	4,616	3,984	4,616	4,184
25,250	**25,300**	3,441	3,091	3,441	3,291	**28,250**	**28,300**	3,891	3,541	3,891	3,741	**31,250**	**31,300**	4,629	3,991	4,629	4,191
25,300	**25,350**	3,449	3,099	3,449	3,299	**28,300**	**28,350**	3,899	3,549	3,899	3,749	**31,300**	**31,350**	4,641	3,999	4,641	4,199
25,350	**25,400**	3,456	3,106	3,456	3,306	**28,350**	**28,400**	3,906	3,556	3,906	3,756	**31,350**	**31,400**	4,654	4,006	4,654	4,206
25,400	**25,450**	3,464	3,114	3,464	3,314	**28,400**	**28,450**	3,916	3,564	3,916	3,764	**31,400**	**31,450**	4,666	4,014	4,666	4,214
25,450	**25,500**	3,471	3,121	3,471	3,321	**28,450**	**28,500**	3,929	3,571	3,929	3,771	**31,450**	**31,500**	4,679	4,021	4,679	4,221
25,500	**25,550**	3,479	3,129	3,479	3,329	**28,500**	**28,550**	3,941	3,579	3,941	3,779	**31,500**	**31,550**	4,691	4,029	4,691	4,229
25,550	**25,600**	3,486	3,136	3,486	3,336	**28,550**	**28,600**	3,954	3,586	3,954	3,786	**31,550**	**31,600**	4,704	4,036	4,704	4,236
25,600	**25,650**	3,494	3,144	3,494	3,344	**28,600**	**28,650**	3,966	3,594	3,966	3,794	**31,600**	**31,650**	4,716	4,044	4,716	4,244
25,650	**25,700**	3,501	3,151	3,501	3,351	**28,650**	**28,700**	3,979	3,601	3,979	3,801	**31,650**	**31,700**	4,729	4,051	4,729	4,251
25,700	**25,750**	3,509	3,159	3,509	3,359	**28,700**	**28,750**	3,991	3,609	3,991	3,809	**31,700**	**31,750**	4,741	4,059	4,741	4,259
25,750	**25,800**	3,516	3,166	3,516	3,366	**28,750**	**28,800**	4,004	3,616	4,004	3,816	**31,750**	**31,800**	4,754	4,066	4,754	4,266
25,800	**25,850**	3,524	3,174	3,524	3,374	**28,800**	**28,850**	4,016	3,624	4,016	3,824	**31,800**	**31,850**	4,766	4,074	4,766	4,274
25,850	**25,900**	3,531	3,181	3,531	3,381	**28,850**	**28,900**	4,029	3,631	4,029	3,831	**31,850**	**31,900**	4,779	4,081	4,779	4,281
25,900	**25,950**	3,539	3,189	3,539	3,389	**28,900**	**28,950**	4,041	3,639	4,041	3,839	**31,900**	**31,950**	4,791	4,089	4,791	4,289
25,950	**26,000**	3,546	3,196	3,546	3,396	**28,950**	**29,000**	4,054	3,646	4,054	3,846	**31,950**	**32,000**	4,804	4,096	4,804	4,296

* This column must also be used by a qualifying widow(er).

(Continued on page 66)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	4,816	4,104	4,816	4,304	**35,000**	**35,050**	5,566	4,554	5,566	4,754	**38,000**	**38,050**	6,316	5,004	6,316	5,204
32,050	**32,100**	4,829	4,111	4,829	4,311	**35,050**	**35,100**	5,579	4,561	5,579	4,761	**38,050**	**38,100**	6,329	5,011	6,329	5,214
32,100	**32,150**	4,841	4,119	4,841	4,319	**35,100**	**35,150**	5,591	4,569	5,591	4,769	**38,100**	**38,150**	6,341	5,019	6,341	5,226
32,150	**32,200**	4,854	4,126	4,854	4,326	**35,150**	**35,200**	5,604	4,576	5,604	4,776	**38,150**	**38,200**	6,354	5,026	6,354	5,239
32,200	**32,250**	4,866	4,134	4,866	4,334	**35,200**	**35,250**	5,616	4,584	5,616	4,784	**38,200**	**38,250**	6,366	5,034	6,366	5,251
32,250	**32,300**	4,879	4,141	4,879	4,341	**35,250**	**35,300**	5,629	4,591	5,629	4,791	**38,250**	**38,300**	6,379	5,041	6,379	5,264
32,300	**32,350**	4,891	4,149	4,891	4,349	**35,300**	**35,350**	5,641	4,599	5,641	4,799	**38,300**	**38,350**	6,391	5,049	6,391	5,276
32,350	**32,400**	4,904	4,156	4,904	4,356	**35,350**	**35,400**	5,654	4,606	5,654	4,806	**38,350**	**38,400**	6,404	5,056	6,404	5,289
32,400	**32,450**	4,916	4,164	4,916	4,364	**35,400**	**35,450**	5,666	4,614	5,666	4,814	**38,400**	**38,450**	6,416	5,064	6,416	5,301
32,450	**32,500**	4,929	4,171	4,929	4,371	**35,450**	**35,500**	5,679	4,621	5,679	4,821	**38,450**	**38,500**	6,429	5,071	6,429	5,314
32,500	**32,550**	4,941	4,179	4,941	4,379	**35,500**	**35,550**	5,691	4,629	5,691	4,829	**38,500**	**38,550**	6,441	5,079	6,441	5,326
32,550	**32,600**	4,954	4,186	4,954	4,386	**35,550**	**35,600**	5,704	4,636	5,704	4,836	**38,550**	**38,600**	6,454	5,086	6,454	5,339
32,600	**32,650**	4,966	4,194	4,966	4,394	**35,600**	**35,650**	5,716	4,644	5,716	4,844	**38,600**	**38,650**	6,466	5,094	6,466	5,351
32,650	**32,700**	4,979	4,201	4,979	4,401	**35,650**	**35,700**	5,729	4,651	5,729	4,851	**38,650**	**38,700**	6,479	5,101	6,479	5,364
32,700	**32,750**	4,991	4,209	4,991	4,409	**35,700**	**35,750**	5,741	4,659	5,741	4,859	**38,700**	**38,750**	6,491	5,109	6,491	5,376
32,750	**32,800**	5,004	4,216	5,004	4,416	**35,750**	**35,800**	5,754	4,666	5,754	4,866	**38,750**	**38,800**	6,504	5,116	6,504	5,389
32,800	**32,850**	5,016	4,224	5,016	4,424	**35,800**	**35,850**	5,766	4,674	5,766	4,874	**38,800**	**38,850**	6,516	5,124	6,516	5,401
32,850	**32,900**	5,029	4,231	5,029	4,431	**35,850**	**35,900**	5,779	4,681	5,779	4,881	**38,850**	**38,900**	6,529	5,131	6,529	5,414
32,900	**32,950**	5,041	4,239	5,041	4,439	**35,900**	**35,950**	5,791	4,689	5,791	4,889	**38,900**	**38,950**	6,541	5,139	6,541	5,426
32,950	**33,000**	5,054	4,246	5,054	4,446	**35,950**	**36,000**	5,804	4,696	5,804	4,896	**38,950**	**39,000**	6,554	5,146	6,554	5,439
33,000						**36,000**						**39,000**					
33,000	**33,050**	5,066	4,254	5,066	4,454	**36,000**	**36,050**	5,816	4,704	5,816	4,904	**39,000**	**39,050**	6,566	5,154	6,566	5,451
33,050	**33,100**	5,079	4,261	5,079	4,461	**36,050**	**36,100**	5,829	4,711	5,829	4,911	**39,050**	**39,100**	6,579	5,161	6,579	5,464
33,100	**33,150**	5,091	4,269	5,091	4,469	**36,100**	**36,150**	5,841	4,719	5,841	4,919	**39,100**	**39,150**	6,591	5,169	6,591	5,476
33,150	**33,200**	5,104	4,276	5,104	4,476	**36,150**	**36,200**	5,854	4,726	5,854	4,926	**39,150**	**39,200**	6,604	5,176	6,604	5,489
33,200	**33,250**	5,116	4,284	5,116	4,484	**36,200**	**36,250**	5,866	4,734	5,866	4,934	**39,200**	**39,250**	6,616	5,184	6,616	5,501
33,250	**33,300**	5,129	4,291	5,129	4,491	**36,250**	**36,300**	5,879	4,741	5,879	4,941	**39,250**	**39,300**	6,629	5,191	6,629	5,514
33,300	**33,350**	5,141	4,299	5,141	4,499	**36,300**	**36,350**	5,891	4,749	5,891	4,949	**39,300**	**39,350**	6,641	5,199	6,641	5,526
33,350	**33,400**	5,154	4,306	5,154	4,506	**36,350**	**36,400**	5,904	4,756	5,904	4,956	**39,350**	**39,400**	6,654	5,206	6,654	5,539
33,400	**33,450**	5,166	4,314	5,166	4,514	**36,400**	**36,450**	5,916	4,764	5,916	4,964	**39,400**	**39,450**	6,666	5,214	6,666	5,551
33,450	**33,500**	5,179	4,321	5,179	4,521	**36,450**	**36,500**	5,929	4,771	5,929	4,971	**39,450**	**39,500**	6,679	5,221	6,679	5,564
33,500	**33,550**	5,191	4,329	5,191	4,529	**36,500**	**36,550**	5,941	4,779	5,941	4,979	**39,500**	**39,550**	6,691	5,229	6,691	5,576
33,550	**33,600**	5,204	4,336	5,204	4,536	**36,550**	**36,600**	5,954	4,786	5,954	4,986	**39,550**	**39,600**	6,704	5,236	6,704	5,589
33,600	**33,650**	5,216	4,344	5,216	4,544	**36,600**	**36,650**	5,966	4,794	5,966	4,994	**39,600**	**39,650**	6,716	5,244	6,716	5,601
33,650	**33,700**	5,229	4,351	5,229	4,551	**36,650**	**36,700**	5,979	4,801	5,979	5,001	**39,650**	**39,700**	6,729	5,251	6,729	5,614
33,700	**33,750**	5,241	4,359	5,241	4,559	**36,700**	**36,750**	5,991	4,809	5,991	5,009	**39,700**	**39,750**	6,741	5,259	6,741	5,626
33,750	**33,800**	5,254	4,366	5,254	4,566	**36,750**	**36,800**	6,004	4,816	6,004	5,016	**39,750**	**39,800**	6,754	5,266	6,754	5,639
33,800	**33,850**	5,266	4,374	5,266	4,574	**36,800**	**36,850**	6,016	4,824	6,016	5,024	**39,800**	**39,850**	6,766	5,274	6,766	5,651
33,850	**33,900**	5,279	4,381	5,279	4,581	**36,850**	**36,900**	6,029	4,831	6,029	5,031	**39,850**	**39,900**	6,779	5,281	6,779	5,664
33,900	**33,950**	5,291	4,389	5,291	4,589	**36,900**	**36,950**	6,041	4,839	6,041	5,039	**39,900**	**39,950**	6,791	5,289	6,791	5,676
33,950	**34,000**	5,304	4,396	5,304	4,596	**36,950**	**37,000**	6,054	4,846	6,054	5,046	**39,950**	**40,000**	6,804	5,296	6,804	5,689
34,000						**37,000**						**40,000**					
34,000	**34,050**	5,316	4,404	5,316	4,604	**37,000**	**37,050**	6,066	4,854	6,066	5,054	**40,000**	**40,050**	6,816	5,304	6,816	5,701
34,050	**34,100**	5,329	4,411	5,329	4,611	**37,050**	**37,100**	6,079	4,861	6,079	5,061	**40,050**	**40,100**	6,829	5,311	6,829	5,714
34,100	**34,150**	5,341	4,419	5,341	4,619	**37,100**	**37,150**	6,091	4,869	6,091	5,069	**40,100**	**40,150**	6,841	5,319	6,841	5,726
34,150	**34,200**	5,354	4,426	5,354	4,626	**37,150**	**37,200**	6,104	4,876	6,104	5,076	**40,150**	**40,200**	6,854	5,326	6,854	5,739
34,200	**34,250**	5,366	4,434	5,366	4,634	**37,200**	**37,250**	6,116	4,884	6,116	5,084	**40,200**	**40,250**	6,866	5,334	6,866	5,751
34,250	**34,300**	5,379	4,441	5,379	4,641	**37,250**	**37,300**	6,129	4,891	6,129	5,091	**40,250**	**40,300**	6,879	5,341	6,879	5,764
34,300	**34,350**	5,391	4,449	5,391	4,649	**37,300**	**37,350**	6,141	4,899	6,141	5,099	**40,300**	**40,350**	6,891	5,349	6,891	5,776
34,350	**34,400**	5,404	4,456	5,404	4,656	**37,350**	**37,400**	6,154	4,906	6,154	5,106	**40,350**	**40,400**	6,904	5,356	6,904	5,789
34,400	**34,450**	5,416	4,464	5,416	4,664	**37,400**	**37,450**	6,166	4,914	6,166	5,114	**40,400**	**40,450**	6,916	5,364	6,916	5,801
34,450	**34,500**	5,429	4,471	5,429	4,671	**37,450**	**37,500**	6,179	4,921	6,179	5,121	**40,450**	**40,500**	6,929	5,371	6,929	5,814
34,500	**34,550**	5,441	4,479	5,441	4,679	**37,500**	**37,550**	6,191	4,929	6,191	5,129	**40,500**	**40,550**	6,941	5,379	6,941	5,826
34,550	**34,600**	5,454	4,486	5,454	4,686	**37,550**	**37,600**	6,204	4,936	6,204	5,136	**40,550**	**40,600**	6,954	5,386	6,954	5,839
34,600	**34,650**	5,466	4,494	5,466	4,694	**37,600**	**37,650**	6,216	4,944	6,216	5,144	**40,600**	**40,650**	6,966	5,394	6,966	5,851
34,650	**34,700**	5,479	4,501	5,479	4,701	**37,650**	**37,700**	6,229	4,951	6,229	5,151	**40,650**	**40,700**	6,979	5,401	6,979	5,864
34,700	**34,750**	5,491	4,509	5,491	4,709	**37,700**	**37,750**	6,241	4,959	6,241	5,159	**40,700**	**40,750**	6,991	5,409	6,991	5,876
34,750	**34,800**	5,504	4,516	5,504	4,716	**37,750**	**37,800**	6,254	4,966	6,254	5,166	**40,750**	**40,800**	7,004	5,416	7,004	5,889
34,800	**34,850**	5,516	4,524	5,516	4,724	**37,800**	**37,850**	6,266	4,974	6,266	5,174	**40,800**	**40,850**	7,016	5,424	7,016	5,901
34,850	**34,900**	5,529	4,531	5,529	4,731	**37,850**	**37,900**	6,279	4,981	6,279	5,181	**40,850**	**40,900**	7,029	5,431	7,029	5,914
34,900	**34,950**	5,541	4,539	5,541	4,739	**37,900**	**37,950**	6,291	4,989	6,291	5,189	**40,900**	**40,950**	7,041	5,439	7,041	5,926
34,950	**35,000**	5,554	4,546	5,554	4,746	**37,950**	**38,000**	6,304	4,996	6,304	5,196	**40,950**	**41,000**	7,054	5,446	7,054	5,939

* This column must also be used by a qualifying widow(er).

(Continued on page 67)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	7,066	5,454	7,066	5,951	**44,000**	**44,050**	7,816	5,904	7,816	6,701	**47,000**	**47,050**	8,566	6,354	8,566	7,451
41,050	**41,100**	7,079	5,461	7,079	5,964	**44,050**	**44,100**	7,829	5,911	7,829	6,714	**47,050**	**47,100**	8,579	6,361	8,579	7,464
41,100	**41,150**	7,091	5,469	7,091	5,976	**44,100**	**44,150**	7,841	5,919	7,841	6,726	**47,100**	**47,150**	8,591	6,369	8,591	7,476
41,150	**41,200**	7,104	5,476	7,104	5,989	**44,150**	**44,200**	7,854	5,926	7,854	6,739	**47,150**	**47,200**	8,604	6,376	8,604	7,489
41,200	**41,250**	7,116	5,484	7,116	6,001	**44,200**	**44,250**	7,866	5,934	7,866	6,751	**47,200**	**47,250**	8,616	6,384	8,616	7,501
41,250	**41,300**	7,129	5,491	7,129	6,014	**44,250**	**44,300**	7,879	5,941	7,879	6,764	**47,250**	**47,300**	8,629	6,391	8,629	7,514
41,300	**41,350**	7,141	5,499	7,141	6,026	**44,300**	**44,350**	7,891	5,949	7,891	6,776	**47,300**	**47,350**	8,641	6,399	8,641	7,526
41,350	**41,400**	7,154	5,506	7,154	6,039	**44,350**	**44,400**	7,904	5,956	7,904	6,789	**47,350**	**47,400**	8,654	6,406	8,654	7,539
41,400	**41,450**	7,166	5,514	7,166	6,051	**44,400**	**44,450**	7,916	5,964	7,916	6,801	**47,400**	**47,450**	8,666	6,414	8,666	7,551
41,450	**41,500**	7,179	5,521	7,179	6,064	**44,450**	**44,500**	7,929	5,971	7,929	6,814	**47,450**	**47,500**	8,679	6,421	8,679	7,564
41,500	**41,550**	7,191	5,529	7,191	6,076	**44,500**	**44,550**	7,941	5,979	7,941	6,826	**47,500**	**47,550**	8,691	6,429	8,691	7,576
41,550	**41,600**	7,204	5,536	7,204	6,089	**44,550**	**44,600**	7,954	5,986	7,954	6,839	**47,550**	**47,600**	8,704	6,436	8,704	7,589
41,600	**41,650**	7,216	5,544	7,216	6,101	**44,600**	**44,650**	7,966	5,994	7,966	6,851	**47,600**	**47,650**	8,716	6,444	8,716	7,601
41,650	**41,700**	7,229	5,551	7,229	6,114	**44,650**	**44,700**	7,979	6,001	7,979	6,864	**47,650**	**47,700**	8,729	6,451	8,729	7,614
41,700	**41,750**	7,241	5,559	7,241	6,126	**44,700**	**44,750**	7,991	6,009	7,991	6,876	**47,700**	**47,750**	8,741	6,459	8,741	7,626
41,750	**41,800**	7,254	5,566	7,254	6,139	**44,750**	**44,800**	8,004	6,016	8,004	6,889	**47,750**	**47,800**	8,754	6,466	8,754	7,639
41,800	**41,850**	7,266	5,574	7,266	6,151	**44,800**	**44,850**	8,016	6,024	8,016	6,901	**47,800**	**47,850**	8,766	6,474	8,766	7,651
41,850	**41,900**	7,279	5,581	7,279	6,164	**44,850**	**44,900**	8,029	6,031	8,029	6,914	**47,850**	**47,900**	8,779	6,481	8,779	7,664
41,900	**41,950**	7,291	5,589	7,291	6,176	**44,900**	**44,950**	8,041	6,039	8,041	6,926	**47,900**	**47,950**	8,791	6,489	8,791	7,676
41,950	**42,000**	7,304	5,596	7,304	6,189	**44,950**	**45,000**	8,054	6,046	8,054	6,939	**47,950**	**48,000**	8,804	6,496	8,804	7,689
42,000						**45,000**						**48,000**					
42,000	**42,050**	7,316	5,604	7,316	6,201	**45,000**	**45,050**	8,066	6,054	8,066	6,951	**48,000**	**48,050**	8,816	6,504	8,816	7,701
42,050	**42,100**	7,329	5,611	7,329	6,214	**45,050**	**45,100**	8,079	6,061	8,079	6,964	**48,050**	**48,100**	8,829	6,511	8,829	7,714
42,100	**42,150**	7,341	5,619	7,341	6,226	**45,100**	**45,150**	8,091	6,069	8,091	6,976	**48,100**	**48,150**	8,841	6,519	8,841	7,726
42,150	**42,200**	7,354	5,626	7,354	6,239	**45,150**	**45,200**	8,104	6,076	8,104	6,989	**48,150**	**48,200**	8,854	6,526	8,854	7,739
42,200	**42,250**	7,366	5,634	7,366	6,251	**45,200**	**45,250**	8,116	6,084	8,116	7,001	**48,200**	**48,250**	8,866	6,534	8,866	7,751
42,250	**42,300**	7,379	5,641	7,379	6,264	**45,250**	**45,300**	8,129	6,091	8,129	7,014	**48,250**	**48,300**	8,879	6,541	8,879	7,764
42,300	**42,350**	7,391	5,649	7,391	6,276	**45,300**	**45,350**	8,141	6,099	8,141	7,026	**48,300**	**48,350**	8,891	6,549	8,891	7,776
42,350	**42,400**	7,404	5,656	7,404	6,289	**45,350**	**45,400**	8,154	6,106	8,154	7,039	**48,350**	**48,400**	8,904	6,556	8,904	7,789
42,400	**42,450**	7,416	5,664	7,416	6,301	**45,400**	**45,450**	8,166	6,114	8,166	7,051	**48,400**	**48,450**	8,916	6,564	8,916	7,801
42,450	**42,500**	7,429	5,671	7,429	6,314	**45,450**	**45,500**	8,179	6,121	8,179	7,064	**48,450**	**48,500**	8,929	6,571	8,929	7,814
42,500	**42,550**	7,441	5,679	7,441	6,326	**45,500**	**45,550**	8,191	6,129	8,191	7,076	**48,500**	**48,550**	8,941	6,579	8,941	7,826
42,550	**42,600**	7,454	5,686	7,454	6,339	**45,550**	**45,600**	8,204	6,136	8,204	7,089	**48,550**	**48,600**	8,954	6,586	8,954	7,839
42,600	**42,650**	7,466	5,694	7,466	6,351	**45,600**	**45,650**	8,216	6,144	8,216	7,101	**48,600**	**48,650**	8,966	6,594	8,966	7,851
42,650	**42,700**	7,479	5,701	7,479	6,364	**45,650**	**45,700**	8,229	6,151	8,229	7,114	**48,650**	**48,700**	8,979	6,601	8,979	7,864
42,700	**42,750**	7,491	5,709	7,491	6,376	**45,700**	**45,750**	8,241	6,159	8,241	7,126	**48,700**	**48,750**	8,991	6,609	8,991	7,876
42,750	**42,800**	7,504	5,716	7,504	6,389	**45,750**	**45,800**	8,254	6,166	8,254	7,139	**48,750**	**48,800**	9,004	6,616	9,004	7,889
42,800	**42,850**	7,516	5,724	7,516	6,401	**45,800**	**45,850**	8,266	6,174	8,266	7,151	**48,800**	**48,850**	9,016	6,624	9,016	7,901
42,850	**42,900**	7,529	5,731	7,529	6,414	**45,850**	**45,900**	8,279	6,181	8,279	7,164	**48,850**	**48,900**	9,029	6,631	9,029	7,914
42,900	**42,950**	7,541	5,739	7,541	6,426	**45,900**	**45,950**	8,291	6,189	8,291	7,176	**48,900**	**48,950**	9,041	6,639	9,041	7,926
42,950	**43,000**	7,554	5,746	7,554	6,439	**45,950**	**46,000**	8,304	6,196	8,304	7,189	**48,950**	**49,000**	9,054	6,646	9,054	7,939
43,000						**46,000**						**49,000**					
43,000	**43,050**	7,566	5,754	7,566	6,451	**46,000**	**46,050**	8,316	6,204	8,316	7,201	**49,000**	**49,050**	9,066	6,654	9,066	7,951
43,050	**43,100**	7,579	5,761	7,579	6,464	**46,050**	**46,100**	8,329	6,211	8,329	7,214	**49,050**	**49,100**	9,079	6,661	9,079	7,964
43,100	**43,150**	7,591	5,769	7,591	6,476	**46,100**	**46,150**	8,341	6,219	8,341	7,226	**49,100**	**49,150**	9,091	6,669	9,091	7,976
43,150	**43,200**	7,604	5,776	7,604	6,489	**46,150**	**46,200**	8,354	6,226	8,354	7,239	**49,150**	**49,200**	9,104	6,676	9,104	7,989
43,200	**43,250**	7,616	5,784	7,616	6,501	**46,200**	**46,250**	8,366	6,234	8,366	7,251	**49,200**	**49,250**	9,116	6,684	9,116	8,001
43,250	**43,300**	7,629	5,791	7,629	6,514	**46,250**	**46,300**	8,379	6,241	8,379	7,264	**49,250**	**49,300**	9,129	6,691	9,129	8,014
43,300	**43,350**	7,641	5,799	7,641	6,526	**46,300**	**46,350**	8,391	6,249	8,391	7,276	**49,300**	**49,350**	9,141	6,699	9,141	8,026
43,350	**43,400**	7,654	5,806	7,654	6,539	**46,350**	**46,400**	8,404	6,256	8,404	7,289	**49,350**	**49,400**	9,154	6,706	9,154	8,039
43,400	**43,450**	7,666	5,814	7,666	6,551	**46,400**	**46,450**	8,416	6,264	8,416	7,301	**49,400**	**49,450**	9,166	6,714	9,166	8,051
43,450	**43,500**	7,679	5,821	7,679	6,564	**46,450**	**46,500**	8,429	6,271	8,429	7,314	**49,450**	**49,500**	9,179	6,721	9,179	8,064
43,500	**43,550**	7,691	5,829	7,691	6,576	**46,500**	**46,550**	8,441	6,279	8,441	7,326	**49,500**	**49,550**	9,191	6,729	9,191	8,076
43,550	**43,600**	7,704	5,836	7,704	6,589	**46,550**	**46,600**	8,454	6,286	8,454	7,339	**49,550**	**49,600**	9,204	6,736	9,204	8,089
43,600	**43,650**	7,716	5,844	7,716	6,601	**46,600**	**46,650**	8,466	6,294	8,466	7,351	**49,600**	**49,650**	9,216	6,744	9,216	8,101
43,650	**43,700**	7,729	5,851	7,729	6,614	**46,650**	**46,700**	8,479	6,301	8,479	7,364	**49,650**	**49,700**	9,229	6,751	9,229	8,114
43,700	**43,750**	7,741	5,859	7,741	6,626	**46,700**	**46,750**	8,491	6,309	8,491	7,376	**49,700**	**49,750**	9,241	6,759	9,241	8,126
43,750	**43,800**	7,754	5,866	7,754	6,639	**46,750**	**46,800**	8,504	6,316	8,504	7,389	**49,750**	**49,800**	9,254	6,766	9,254	8,139
43,800	**43,850**	7,766	5,874	7,766	6,651	**46,800**	**46,850**	8,516	6,324	8,516	7,401	**49,800**	**49,850**	9,266	6,774	9,266	8,151
43,850	**43,900**	7,779	5,881	7,779	6,664	**46,850**	**46,900**	8,529	6,331	8,529	7,414	**49,850**	**49,900**	9,279	6,781	9,279	8,164
43,900	**43,950**	7,791	5,889	7,791	6,676	**46,900**	**46,950**	8,541	6,339	8,541	7,426	**49,900**	**49,950**	9,291	6,789	9,291	8,176
43,950	**44,000**	7,804	5,896	7,804	6,689	**46,950**	**47,000**	8,554	6,346	8,554	7,439	**49,950**	**50,000**	9,304	6,796	9,304	8,189

* This column must also be used by a qualifying widow(er).

(Continued on page 68)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	9,316	6,804	9,316	8,201	**53,000**	**53,050**	10,066	7,254	10,066	8,951	**56,000**	**56,050**	10,816	7,704	10,816	9,701
50,050	**50,100**	9,329	6,811	9,329	8,214	**53,050**	**53,100**	10,079	7,261	10,079	8,964	**56,050**	**56,100**	10,829	7,711	10,829	9,714
50,100	**50,150**	9,341	6,819	9,341	8,226	**53,100**	**53,150**	10,091	7,269	10,091	8,976	**56,100**	**56,150**	10,841	7,719	10,841	9,726
50,150	**50,200**	9,354	6,826	9,354	8,239	**53,150**	**53,200**	10,104	7,276	10,104	8,989	**56,150**	**56,200**	10,854	7,726	10,854	9,739
50,200	**50,250**	9,366	6,834	9,366	8,251	**53,200**	**53,250**	10,116	7,284	10,116	9,001	**56,200**	**56,250**	10,866	7,734	10,866	9,751
50,250	**50,300**	9,379	6,841	9,379	8,264	**53,250**	**53,300**	10,129	7,291	10,129	9,014	**56,250**	**56,300**	10,879	7,741	10,879	9,764
50,300	**50,350**	9,391	6,849	9,391	8,276	**53,300**	**53,350**	10,141	7,299	10,141	9,026	**56,300**	**56,350**	10,891	7,749	10,891	9,776
50,350	**50,400**	9,404	6,856	9,404	8,289	**53,350**	**53,400**	10,154	7,306	10,154	9,039	**56,350**	**56,400**	10,904	7,756	10,904	9,789
50,400	**50,450**	9,416	6,864	9,416	8,301	**53,400**	**53,450**	10,166	7,314	10,166	9,051	**56,400**	**56,450**	10,916	7,764	10,916	9,801
50,450	**50,500**	9,429	6,871	9,429	8,314	**53,450**	**53,500**	10,179	7,321	10,179	9,064	**56,450**	**56,500**	10,929	7,771	10,929	9,814
50,500	**50,550**	9,441	6,879	9,441	8,326	**53,500**	**53,550**	10,191	7,329	10,191	9,076	**56,500**	**56,550**	10,941	7,779	10,941	9,826
50,550	**50,600**	9,454	6,886	9,454	8,339	**53,550**	**53,600**	10,204	7,336	10,204	9,089	**56,550**	**56,600**	10,954	7,786	10,954	9,839
50,600	**50,650**	9,466	6,894	9,466	8,351	**53,600**	**53,650**	10,216	7,344	10,216	9,101	**56,600**	**56,650**	10,966	7,794	10,966	9,851
50,650	**50,700**	9,479	6,901	9,479	8,364	**53,650**	**53,700**	10,229	7,351	10,229	9,114	**56,650**	**56,700**	10,979	7,801	10,979	9,864
50,700	**50,750**	9,491	6,909	9,491	8,376	**53,700**	**53,750**	10,241	7,359	10,241	9,126	**56,700**	**56,750**	10,991	7,809	10,991	9,876
50,750	**50,800**	9,504	6,916	9,504	8,389	**53,750**	**53,800**	10,254	7,366	10,254	9,139	**56,750**	**56,800**	11,004	7,816	11,004	9,889
50,800	**50,850**	9,516	6,924	9,516	8,401	**53,800**	**53,850**	10,266	7,374	10,266	9,151	**56,800**	**56,850**	11,016	7,826	11,016	9,901
50,850	**50,900**	9,529	6,931	9,529	8,414	**53,850**	**53,900**	10,279	7,381	10,279	9,164	**56,850**	**56,900**	11,029	7,839	11,029	9,914
50,900	**50,950**	9,541	6,939	9,541	8,426	**53,900**	**53,950**	10,291	7,389	10,291	9,176	**56,900**	**56,950**	11,041	7,851	11,041	9,926
50,950	**51,000**	9,554	6,946	9,554	8,439	**53,950**	**54,000**	10,304	7,396	10,304	9,189	**56,950**	**57,000**	11,054	7,864	11,054	9,939
51,000						**54,000**						**57,000**					
51,000	**51,050**	9,566	6,954	9,566	8,451	**54,000**	**54,050**	10,316	7,404	10,316	9,201	**57,000**	**57,050**	11,066	7,876	11,066	9,951
51,050	**51,100**	9,579	6,961	9,579	8,464	**54,050**	**54,100**	10,329	7,411	10,329	9,214	**57,050**	**57,100**	11,079	7,889	11,079	9,964
51,100	**51,150**	9,591	6,969	9,591	8,476	**54,100**	**54,150**	10,341	7,419	10,341	9,226	**57,100**	**57,150**	11,091	7,901	11,091	9,976
51,150	**51,200**	9,604	6,976	9,604	8,489	**54,150**	**54,200**	10,354	7,426	10,354	9,239	**57,150**	**57,200**	11,104	7,914	11,104	9,989
51,200	**51,250**	9,616	6,984	9,616	8,501	**54,200**	**54,250**	10,366	7,434	10,366	9,251	**57,200**	**57,250**	11,116	7,926	11,116	10,001
51,250	**51,300**	9,629	6,991	9,629	8,514	**54,250**	**54,300**	10,379	7,441	10,379	9,264	**57,250**	**57,300**	11,129	7,939	11,129	10,014
51,300	**51,350**	9,641	6,999	9,641	8,526	**54,300**	**54,350**	10,391	7,449	10,391	9,276	**57,300**	**57,350**	11,141	7,951	11,141	10,026
51,350	**51,400**	9,654	7,006	9,654	8,539	**54,350**	**54,400**	10,404	7,456	10,404	9,289	**57,350**	**57,400**	11,154	7,964	11,155	10,039
51,400	**51,450**	9,666	7,014	9,666	8,551	**54,400**	**54,450**	10,416	7,464	10,416	9,301	**57,400**	**57,450**	11,166	7,976	11,169	10,051
51,450	**51,500**	9,679	7,021	9,679	8,564	**54,450**	**54,500**	10,429	7,471	10,429	9,314	**57,450**	**57,500**	11,179	7,989	11,183	10,064
51,500	**51,550**	9,691	7,029	9,691	8,576	**54,500**	**54,550**	10,441	7,479	10,441	9,326	**57,500**	**57,550**	11,191	8,001	11,197	10,076
51,550	**51,600**	9,704	7,036	9,704	8,589	**54,550**	**54,600**	10,454	7,486	10,454	9,339	**57,550**	**57,600**	11,204	8,014	11,211	10,089
51,600	**51,650**	9,716	7,044	9,716	8,601	**54,600**	**54,650**	10,466	7,494	10,466	9,351	**57,600**	**57,650**	11,216	8,026	11,225	10,101
51,650	**51,700**	9,729	7,051	9,729	8,614	**54,650**	**54,700**	10,479	7,501	10,479	9,364	**57,650**	**57,700**	11,229	8,039	11,239	10,114
51,700	**51,750**	9,741	7,059	9,741	8,626	**54,700**	**54,750**	10,491	7,509	10,491	9,376	**57,700**	**57,750**	11,241	8,051	11,253	10,126
51,750	**51,800**	9,754	7,066	9,754	8,639	**54,750**	**54,800**	10,504	7,516	10,504	9,389	**57,750**	**57,800**	11,254	8,064	11,267	10,139
51,800	**51,850**	9,766	7,074	9,766	8,651	**54,800**	**54,850**	10,516	7,524	10,516	9,401	**57,800**	**57,850**	11,266	8,076	11,281	10,151
51,850	**51,900**	9,779	7,081	9,779	8,664	**54,850**	**54,900**	10,529	7,531	10,529	9,414	**57,850**	**57,900**	11,279	8,089	11,295	10,164
51,900	**51,950**	9,791	7,089	9,791	8,676	**54,900**	**54,950**	10,541	7,539	10,541	9,426	**57,900**	**57,950**	11,291	8,101	11,309	10,176
51,950	**52,000**	9,804	7,096	9,804	8,689	**54,950**	**55,000**	10,554	7,546	10,554	9,439	**57,950**	**58,000**	11,304	8,114	11,323	10,189
52,000						**55,000**						**58,000**					
52,000	**52,050**	9,816	7,104	9,816	8,701	**55,000**	**55,050**	10,566	7,554	10,566	9,451	**58,000**	**58,050**	11,316	8,126	11,337	10,201
52,050	**52,100**	9,829	7,111	9,829	8,714	**55,050**	**55,100**	10,579	7,561	10,579	9,464	**58,050**	**58,100**	11,329	8,139	11,351	10,214
52,100	**52,150**	9,841	7,119	9,841	8,726	**55,100**	**55,150**	10,591	7,569	10,591	9,476	**58,100**	**58,150**	11,341	8,151	11,365	10,226
52,150	**52,200**	9,854	7,126	9,854	8,739	**55,150**	**55,200**	10,604	7,576	10,604	9,489	**58,150**	**58,200**	11,354	8,164	11,379	10,239
52,200	**52,250**	9,866	7,134	9,866	8,751	**55,200**	**55,250**	10,616	7,584	10,616	9,501	**58,200**	**58,250**	11,366	8,176	11,393	10,251
52,250	**52,300**	9,879	7,141	9,879	8,764	**55,250**	**55,300**	10,629	7,591	10,629	9,514	**58,250**	**58,300**	11,379	8,189	11,407	10,264
52,300	**52,350**	9,891	7,149	9,891	8,776	**55,300**	**55,350**	10,641	7,599	10,641	9,526	**58,300**	**58,350**	11,391	8,201	11,421	10,276
52,350	**52,400**	9,904	7,156	9,904	8,789	**55,350**	**55,400**	10,654	7,606	10,654	9,539	**58,350**	**58,400**	11,404	8,214	11,435	10,289
52,400	**52,450**	9,916	7,164	9,916	8,801	**55,400**	**55,450**	10,666	7,614	10,666	9,551	**58,400**	**58,450**	11,416	8,226	11,449	10,301
52,450	**52,500**	9,929	7,171	9,929	8,814	**55,450**	**55,500**	10,679	7,621	10,679	9,564	**58,450**	**58,500**	11,429	8,239	11,463	10,314
52,500	**52,550**	9,941	7,179	9,941	8,826	**55,500**	**55,550**	10,691	7,629	10,691	9,576	**58,500**	**58,550**	11,441	8,251	11,477	10,326
52,550	**52,600**	9,954	7,186	9,954	8,839	**55,550**	**55,600**	10,704	7,636	10,704	9,589	**58,550**	**58,600**	11,454	8,264	11,491	10,339
52,600	**52,650**	9,966	7,194	9,966	8,851	**55,600**	**55,650**	10,716	7,644	10,716	9,601	**58,600**	**58,650**	11,466	8,276	11,505	10,351
52,650	**52,700**	9,979	7,201	9,979	8,864	**55,650**	**55,700**	10,729	7,651	10,729	9,614	**58,650**	**58,700**	11,479	8,289	11,519	10,364
52,700	**52,750**	9,991	7,209	9,991	8,876	**55,700**	**55,750**	10,741	7,659	10,741	9,626	**58,700**	**58,750**	11,491	8,301	11,533	10,376
52,750	**52,800**	10,004	7,216	10,004	8,889	**55,750**	**55,800**	10,754	7,666	10,754	9,639	**58,750**	**58,800**	11,504	8,314	11,547	10,389
52,800	**52,850**	10,016	7,224	10,016	8,901	**55,800**	**55,850**	10,766	7,674	10,766	9,651	**58,800**	**58,850**	11,516	8,326	11,561	10,401
52,850	**52,900**	10,029	7,231	10,029	8,914	**55,850**	**55,900**	10,779	7,681	10,779	9,664	**58,850**	**58,900**	11,529	8,339	11,575	10,414
52,900	**52,950**	10,041	7,239	10,041	8,926	**55,900**	**55,950**	10,791	7,689	10,791	9,676	**58,900**	**58,950**	11,541	8,351	11,589	10,426
52,950	**53,000**	10,054	7,246	10,054	8,939	**55,950**	**56,000**	10,804	7,696	10,804	9,689	**58,950**	**59,000**	11,554	8,364	11,603	10,439

* This column must also be used by a qualifying widow(er).

(Continued on page 69)

2003 Tax Table—*Continued*

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	11,566	8,376	11,617	10,451	**62,000**	**62,050**	12,316	9,126	12,457	11,201	**65,000**	**65,050**	13,066	9,876	13,297	11,951
59,050	**59,100**	11,579	8,389	11,631	10,464	**62,050**	**62,100**	12,329	9,139	12,471	11,214	**65,050**	**65,100**	13,079	9,889	13,311	11,964
59,100	**59,150**	11,591	8,401	11,645	10,476	**62,100**	**62,150**	12,341	9,151	12,485	11,226	**65,100**	**65,150**	13,091	9,901	13,325	11,976
59,150	**59,200**	11,604	8,414	11,659	10,489	**62,150**	**62,200**	12,354	9,164	12,499	11,239	**65,150**	**65,200**	13,104	9,914	13,339	11,989
59,200	**59,250**	11,616	8,426	11,673	10,501	**62,200**	**62,250**	12,366	9,176	12,513	11,251	**65,200**	**65,250**	13,116	9,926	13,353	12,001
59,250	**59,300**	11,629	8,439	11,687	10,514	**62,250**	**62,300**	12,379	9,189	12,527	11,264	**65,250**	**65,300**	13,129	9,939	13,367	12,014
59,300	**59,350**	11,641	8,451	11,701	10,526	**62,300**	**62,350**	12,391	9,201	12,541	11,276	**65,300**	**65,350**	13,141	9,951	13,381	12,026
59,350	**59,400**	11,654	8,464	11,715	10,539	**62,350**	**62,400**	12,404	9,214	12,555	11,289	**65,350**	**65,400**	13,154	9,964	13,395	12,039
59,400	**59,450**	11,666	8,476	11,729	10,551	**62,400**	**62,450**	12,416	9,226	12,569	11,301	**65,400**	**65,450**	13,166	9,976	13,409	12,051
59,450	**59,500**	11,679	8,489	11,743	10,564	**62,450**	**62,500**	12,429	9,239	12,583	11,314	**65,450**	**65,500**	13,179	9,989	13,423	12,064
59,500	**59,550**	11,691	8,501	11,757	10,576	**62,500**	**62,550**	12,441	9,251	12,597	11,326	**65,500**	**65,550**	13,191	10,001	13,437	12,076
59,550	**59,600**	11,704	8,514	11,771	10,589	**62,550**	**62,600**	12,454	9,264	12,611	11,339	**65,550**	**65,600**	13,204	10,014	13,451	12,089
59,600	**59,650**	11,716	8,526	11,785	10,601	**62,600**	**62,650**	12,466	9,276	12,625	11,351	**65,600**	**65,650**	13,216	10,026	13,465	12,101
59,650	**59,700**	11,729	8,539	11,799	10,614	**62,650**	**62,700**	12,479	9,289	12,639	11,364	**65,650**	**65,700**	13,229	10,039	13,479	12,114
59,700	**59,750**	11,741	8,551	11,813	10,626	**62,700**	**62,750**	12,491	9,301	12,653	11,376	**65,700**	**65,750**	13,241	10,051	13,493	12,126
59,750	**59,800**	11,754	8,564	11,827	10,639	**62,750**	**62,800**	12,504	9,314	12,667	11,389	**65,750**	**65,800**	13,254	10,064	13,507	12,139
59,800	**59,850**	11,766	8,576	11,841	10,651	**62,800**	**62,850**	12,516	9,326	12,681	11,401	**65,800**	**65,850**	13,266	10,076	13,521	12,151
59,850	**59,900**	11,779	8,589	11,855	10,664	**62,850**	**62,900**	12,529	9,339	12,695	11,414	**65,850**	**65,900**	13,279	10,089	13,535	12,164
59,900	**59,950**	11,791	8,601	11,869	10,676	**62,900**	**62,950**	12,541	9,351	12,709	11,426	**65,900**	**65,950**	13,291	10,101	13,549	12,176
59,950	**60,000**	11,804	8,614	11,883	10,689	**62,950**	**63,000**	12,554	9,364	12,723	11,439	**65,950**	**66,000**	13,304	10,114	13,563	12,189
60,000						**63,000**						**66,000**					
60,000	**60,050**	11,816	8,626	11,897	10,701	**63,000**	**63,050**	12,566	9,376	12,737	11,451	**66,000**	**66,050**	13,316	10,126	13,577	12,201
60,050	**60,100**	11,829	8,639	11,911	10,714	**63,050**	**63,100**	12,579	9,389	12,751	11,464	**66,050**	**66,100**	13,329	10,139	13,591	12,214
60,100	**60,150**	11,841	8,651	11,925	10,726	**63,100**	**63,150**	12,591	9,401	12,765	11,476	**66,100**	**66,150**	13,341	10,151	13,605	12,226
60,150	**60,200**	11,854	8,664	11,939	10,739	**63,150**	**63,200**	12,604	9,414	12,779	11,489	**66,150**	**66,200**	13,354	10,164	13,619	12,239
60,200	**60,250**	11,866	8,676	11,953	10,751	**63,200**	**63,250**	12,616	9,426	12,793	11,501	**66,200**	**66,250**	13,366	10,176	13,633	12,251
60,250	**60,300**	11,879	8,689	11,967	10,764	**63,250**	**63,300**	12,629	9,439	12,807	11,514	**66,250**	**66,300**	13,379	10,189	13,647	12,264
60,300	**60,350**	11,891	8,701	11,981	10,776	**63,300**	**63,350**	12,641	9,451	12,821	11,526	**66,300**	**66,350**	13,391	10,201	13,661	12,276
60,350	**60,400**	11,904	8,714	11,995	10,789	**63,350**	**63,400**	12,654	9,464	12,835	11,539	**66,350**	**66,400**	13,404	10,214	13,675	12,289
60,400	**60,450**	11,916	8,726	12,009	10,801	**63,400**	**63,450**	12,666	9,476	12,849	11,551	**66,400**	**66,450**	13,416	10,226	13,689	12,301
60,450	**60,500**	11,929	8,739	12,023	10,814	**63,450**	**63,500**	12,679	9,489	12,863	11,564	**66,450**	**66,500**	13,429	10,239	13,703	12,314
60,500	**60,550**	11,941	8,751	12,037	10,826	**63,500**	**63,550**	12,691	9,501	12,877	11,576	**66,500**	**66,550**	13,441	10,251	13,717	12,326
60,550	**60,600**	11,954	8,764	12,051	10,839	**63,550**	**63,600**	12,704	9,514	12,891	11,589	**66,550**	**66,600**	13,454	10,264	13,731	12,339
60,600	**60,650**	11,966	8,776	12,065	10,851	**63,600**	**63,650**	12,716	9,526	12,905	11,601	**66,600**	**66,650**	13,466	10,276	13,745	12,351
60,650	**60,700**	11,979	8,789	12,079	10,864	**63,650**	**63,700**	12,729	9,539	12,919	11,614	**66,650**	**66,700**	13,479	10,289	13,759	12,364
60,700	**60,750**	11,991	8,801	12,093	10,876	**63,700**	**63,750**	12,741	9,551	12,933	11,626	**66,700**	**66,750**	13,491	10,301	13,773	12,376
60,750	**60,800**	12,004	8,814	12,107	10,889	**63,750**	**63,800**	12,754	9,564	12,947	11,639	**66,750**	**66,800**	13,504	10,314	13,787	12,389
60,800	**60,850**	12,016	8,826	12,121	10,901	**63,800**	**63,850**	12,766	9,576	12,961	11,651	**66,800**	**66,850**	13,516	10,326	13,801	12,401
60,850	**60,900**	12,029	8,839	12,135	10,914	**63,850**	**63,900**	12,779	9,589	12,975	11,664	**66,850**	**66,900**	13,529	10,339	13,815	12,414
60,900	**60,950**	12,041	8,851	12,149	10,926	**63,900**	**63,950**	12,791	9,601	12,989	11,676	**66,900**	**66,950**	13,541	10,351	13,829	12,426
60,950	**61,000**	12,054	8,864	12,163	10,939	**63,950**	**64,000**	12,804	9,614	13,003	11,689	**66,950**	**67,000**	13,554	10,364	13,843	12,439
61,000						**64,000**						**67,000**					
61,000	**61,050**	12,066	8,876	12,177	10,951	**64,000**	**64,050**	12,816	9,626	13,017	11,701	**67,000**	**67,050**	13,566	10,376	13,857	12,451
61,050	**61,100**	12,079	8,889	12,191	10,964	**64,050**	**64,100**	12,829	9,639	13,031	11,714	**67,050**	**67,100**	13,579	10,389	13,871	12,464
61,100	**61,150**	12,091	8,901	12,205	10,976	**64,100**	**64,150**	12,841	9,651	13,045	11,726	**67,100**	**67,150**	13,591	10,401	13,885	12,476
61,150	**61,200**	12,104	8,914	12,219	10,989	**64,150**	**64,200**	12,854	9,664	13,059	11,739	**67,150**	**67,200**	13,604	10,414	13,899	12,489
61,200	**61,250**	12,116	8,926	12,233	11,001	**64,200**	**64,250**	12,866	9,676	13,073	11,751	**67,200**	**67,250**	13,616	10,426	13,913	12,501
61,250	**61,300**	12,129	8,939	12,247	11,014	**64,250**	**64,300**	12,879	9,689	13,087	11,764	**67,250**	**67,300**	13,629	10,439	13,927	12,514
61,300	**61,350**	12,141	8,951	12,261	11,026	**64,300**	**64,350**	12,891	9,701	13,101	11,776	**67,300**	**67,350**	13,641	10,451	13,941	12,526
61,350	**61,400**	12,154	8,964	12,275	11,039	**64,350**	**64,400**	12,904	9,714	13,115	11,789	**67,350**	**67,400**	13,654	10,464	13,955	12,539
61,400	**61,450**	12,166	8,976	12,289	11,051	**64,400**	**64,450**	12,916	9,726	13,129	11,801	**67,400**	**67,450**	13,666	10,476	13,969	12,551
61,450	**61,500**	12,179	8,989	12,303	11,064	**64,450**	**64,500**	12,929	9,739	13,143	11,814	**67,450**	**67,500**	13,679	10,489	13,983	12,564
61,500	**61,550**	12,191	9,001	12,317	11,076	**64,500**	**64,550**	12,941	9,751	13,157	11,826	**67,500**	**67,550**	13,691	10,501	13,997	12,576
61,550	**61,600**	12,204	9,014	12,331	11,089	**64,550**	**64,600**	12,954	9,764	13,171	11,839	**67,550**	**67,600**	13,704	10,514	14,011	12,589
61,600	**61,650**	12,216	9,026	12,345	11,101	**64,600**	**64,650**	12,966	9,776	13,185	11,851	**67,600**	**67,650**	13,716	10,526	14,025	12,601
61,650	**61,700**	12,229	9,039	12,359	11,114	**64,650**	**64,700**	12,979	9,789	13,199	11,864	**67,650**	**67,700**	13,729	10,539	14,039	12,614
61,700	**61,750**	12,241	9,051	12,373	11,126	**64,700**	**64,750**	12,991	9,801	13,213	11,876	**67,700**	**67,750**	13,741	10,551	14,053	12,626
61,750	**61,800**	12,254	9,064	12,387	11,139	**64,750**	**64,800**	13,004	9,814	13,227	11,889	**67,750**	**67,800**	13,754	10,564	14,067	12,639
61,800	**61,850**	12,266	9,076	12,401	11,151	**64,800**	**64,850**	13,016	9,826	13,241	11,901	**67,800**	**67,850**	13,766	10,576	14,081	12,651
61,850	**61,900**	12,279	9,089	12,415	11,164	**64,850**	**64,900**	13,029	9,839	13,255	11,914	**67,850**	**67,900**	13,779	10,589	14,095	12,664
61,900	**61,950**	12,291	9,101	12,429	11,176	**64,900**	**64,950**	13,041	9,851	13,269	11,926	**67,900**	**67,950**	13,791	10,601	14,109	12,676
61,950	**62,000**	12,304	9,114	12,443	11,189	**64,950**	**65,000**	13,054	9,864	13,283	11,939	**67,950**	**68,000**	13,804	10,614	14,123	12,689

* This column must also be used by a qualifying widow(er).

(Continued on page 70)

If line 40 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
68,000					
68,000	**68,050**	13,816	10,626	14,137	12,701
68,050	**68,100**	13,829	10,639	14,151	12,714
68,100	**68,150**	13,841	10,651	14,165	12,726
68,150	**68,200**	13,854	10,664	14,179	12,739
68,200	**68,250**	13,866	10,676	14,193	12,751
68,250	**68,300**	13,879	10,689	14,207	12,764
68,300	**68,350**	13,891	10,701	14,221	12,776
68,350	**68,400**	13,904	10,714	14,235	12,789
68,400	**68,450**	13,916	10,726	14,249	12,801
68,450	**68,500**	13,929	10,739	14,263	12,814
68,500	**68,550**	13,941	10,751	14,277	12,826
68,550	**68,600**	13,954	10,764	14,291	12,839
68,600	**68,650**	13,966	10,776	14,305	12,851
68,650	**68,700**	13,979	10,789	14,319	12,864
68,700	**68,750**	13,991	10,801	14,333	12,876
68,750	**68,800**	14,004	10,814	14,347	12,889
68,800	**68,850**	14,017	10,826	14,361	12,901
68,850	**68,900**	14,031	10,839	14,375	12,914
68,900	**68,950**	14,045	10,851	14,389	12,926
68,950	**69,000**	14,059	10,864	14,403	12,939
69,000					
69,000	**69,050**	14,073	10,876	14,417	12,951
69,050	**69,100**	14,087	10,889	14,431	12,964
69,100	**69,150**	14,101	10,901	14,445	12,976
69,150	**69,200**	14,115	10,914	14,459	12,989
69,200	**69,250**	14,129	10,926	14,473	13,001
69,250	**69,300**	14,143	10,939	14,487	13,014
69,300	**69,350**	14,157	10,951	14,501	13,026
69,350	**69,400**	14,171	10,964	14,515	13,039
69,400	**69,450**	14,185	10,976	14,529	13,051
69,450	**69,500**	14,199	10,989	14,543	13,064
69,500	**69,550**	14,213	11,001	14,557	13,076
69,550	**69,600**	14,227	11,014	14,571	13,089
69,600	**69,650**	14,241	11,026	14,585	13,101
69,650	**69,700**	14,255	11,039	14,599	13,114
69,700	**69,750**	14,269	11,051	14,613	13,126
69,750	**69,800**	14,283	11,064	14,627	13,139
69,800	**69,850**	14,297	11,076	14,641	13,151
69,850	**69,900**	14,311	11,089	14,655	13,164
69,900	**69,950**	14,325	11,101	14,669	13,176
69,950	**70,000**	14,339	11,114	14,683	13,189
70,000					
70,000	**70,050**	14,353	11,126	14,697	13,201
70,050	**70,100**	14,367	11,139	14,711	13,214
70,100	**70,150**	14,381	11,151	14,725	13,226
70,150	**70,200**	14,395	11,164	14,739	13,239
70,200	**70,250**	14,409	11,176	14,753	13,251
70,250	**70,300**	14,423	11,189	14,767	13,264
70,300	**70,350**	14,437	11,201	14,781	13,276
70,350	**70,400**	14,451	11,214	14,795	13,289
70,400	**70,450**	14,465	11,226	14,809	13,301
70,450	**70,500**	14,479	11,239	14,823	13,314
70,500	**70,550**	14,493	11,251	14,837	13,326
70,550	**70,600**	14,507	11,264	14,851	13,339
70,600	**70,650**	14,521	11,276	14,865	13,351
70,650	**70,700**	14,535	11,289	14,879	13,364
70,700	**70,750**	14,549	11,301	14,893	13,376
70,750	**70,800**	14,563	11,314	14,907	13,389
70,800	**70,850**	14,577	11,326	14,921	13,401
70,850	**70,900**	14,591	11,339	14,935	13,414
70,900	**70,950**	14,605	11,351	14,949	13,426
70,950	**71,000**	14,619	11,364	14,963	13,439

If line 40 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
71,000					
71,000	**71,050**	14,633	11,376	14,977	13,451
71,050	**71,100**	14,647	11,389	14,991	13,464
71,100	**71,150**	14,661	11,401	15,005	13,476
71,150	**71,200**	14,675	11,414	15,019	13,489
71,200	**71,250**	14,689	11,426	15,033	13,501
71,250	**71,300**	14,703	11,439	15,047	13,514
71,300	**71,350**	14,717	11,451	15,061	13,526
71,350	**71,400**	14,731	11,464	15,075	13,539
71,400	**71,450**	14,745	11,476	15,089	13,551
71,450	**71,500**	14,759	11,489	15,103	13,564
71,500	**71,550**	14,773	11,501	15,117	13,576
71,550	**71,600**	14,787	11,514	15,131	13,589
71,600	**71,650**	14,801	11,526	15,145	13,601
71,650	**71,700**	14,815	11,539	15,159	13,614
71,700	**71,750**	14,829	11,551	15,173	13,626
71,750	**71,800**	14,843	11,564	15,187	13,639
71,800	**71,850**	14,857	11,576	15,201	13,651
71,850	**71,900**	14,871	11,589	15,215	13,664
71,900	**71,950**	14,885	11,601	15,229	13,676
71,950	**72,000**	14,899	11,614	15,243	13,689
72,000					
72,000	**72,050**	14,913	11,626	15,257	13,701
72,050	**72,100**	14,927	11,639	15,271	13,714
72,100	**72,150**	14,941	11,651	15,285	13,726
72,150	**72,200**	14,955	11,664	15,299	13,739
72,200	**72,250**	14,969	11,676	15,313	13,751
72,250	**72,300**	14,983	11,689	15,327	13,764
72,300	**72,350**	14,997	11,701	15,341	13,776
72,350	**72,400**	15,011	11,714	15,355	13,789
72,400	**72,450**	15,025	11,726	15,369	13,801
72,450	**72,500**	15,039	11,739	15,383	13,814
72,500	**72,550**	15,053	11,751	15,397	13,826
72,550	**72,600**	15,067	11,764	15,411	13,839
72,600	**72,650**	15,081	11,776	15,425	13,851
72,650	**72,700**	15,095	11,789	15,439	13,864
72,700	**72,750**	15,109	11,801	15,453	13,876
72,750	**72,800**	15,123	11,814	15,467	13,889
72,800	**72,850**	15,137	11,826	15,481	13,901
72,850	**72,900**	15,151	11,839	15,495	13,914
72,900	**72,950**	15,165	11,851	15,509	13,926
72,950	**73,000**	15,179	11,864	15,523	13,939
73,000					
73,000	**73,050**	15,193	11,876	15,537	13,951
73,050	**73,100**	15,207	11,889	15,551	13,964
73,100	**73,150**	15,221	11,901	15,565	13,976
73,150	**73,200**	15,235	11,914	15,579	13,989
73,200	**73,250**	15,249	11,926	15,593	14,001
73,250	**73,300**	15,263	11,939	15,607	14,014
73,300	**73,350**	15,277	11,951	15,621	14,026
73,350	**73,400**	15,291	11,964	15,635	14,039
73,400	**73,450**	15,305	11,976	15,649	14,051
73,450	**73,500**	15,319	11,989	15,663	14,064
73,500	**73,550**	15,333	12,001	15,677	14,076
73,550	**73,600**	15,347	12,014	15,691	14,089
73,600	**73,650**	15,361	12,026	15,705	14,101
73,650	**73,700**	15,375	12,039	15,719	14,114
73,700	**73,750**	15,389	12,051	15,733	14,126
73,750	**73,800**	15,403	12,064	15,747	14,139
73,800	**73,850**	15,417	12,076	15,761	14,151
73,850	**73,900**	15,431	12,089	15,775	14,164
73,900	**73,950**	15,445	12,101	15,789	14,176
73,950	**74,000**	15,459	12,114	15,803	14,189

If line 40 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
74,000					
74,000	**74,050**	15,473	12,126	15,817	14,201
74,050	**74,100**	15,487	12,139	15,831	14,214
74,100	**74,150**	15,501	12,151	15,845	14,226
74,150	**74,200**	15,515	12,164	15,859	14,239
74,200	**74,250**	15,529	12,176	15,873	14,251
74,250	**74,300**	15,543	12,189	15,887	14,264
74,300	**74,350**	15,557	12,201	15,901	14,276
74,350	**74,400**	15,571	12,214	15,915	14,289
74,400	**74,450**	15,585	12,226	15,929	14,301
74,450	**74,500**	15,599	12,239	15,943	14,314
74,500	**74,550**	15,613	12,251	15,957	14,326
74,550	**74,600**	15,627	12,264	15,971	14,339
74,600	**74,650**	15,641	12,276	15,985	14,351
74,650	**74,700**	15,655	12,289	15,999	14,364
74,700	**74,750**	15,669	12,301	16,013	14,376
74,750	**74,800**	15,683	12,314	16,027	14,389
74,800	**74,850**	15,697	12,326	16,041	14,401
74,850	**74,900**	15,711	12,339	16,055	14,414
74,900	**74,950**	15,725	12,351	16,069	14,426
74,950	**75,000**	15,739	12,364	16,083	14,439
75,000					
75,000	**75,050**	15,753	12,376	16,097	14,451
75,050	**75,100**	15,767	12,389	16,111	14,464
75,100	**75,150**	15,781	12,401	16,125	14,476
75,150	**75,200**	15,795	12,414	16,139	14,489
75,200	**75,250**	15,809	12,426	16,153	14,501
75,250	**75,300**	15,823	12,439	16,167	14,514
75,300	**75,350**	15,837	12,451	16,181	14,526
75,350	**75,400**	15,851	12,464	16,195	14,539
75,400	**75,450**	15,865	12,476	16,209	14,551
75,450	**75,500**	15,879	12,489	16,223	14,564
75,500	**75,550**	15,893	12,501	16,237	14,576
75,550	**75,600**	15,907	12,514	16,251	14,589
75,600	**75,650**	15,921	12,526	16,265	14,601
75,650	**75,700**	15,935	12,539	16,279	14,614
75,700	**75,750**	15,949	12,551	16,293	14,626
75,750	**75,800**	15,963	12,564	16,307	14,639
75,800	**75,850**	15,977	12,576	16,321	14,651
75,850	**75,900**	15,991	12,589	16,335	14,664
75,900	**75,950**	16,005	12,601	16,349	14,676
75,950	**76,000**	16,019	12,614	16,363	14,689
76,000					
76,000	**76,050**	16,033	12,626	16,377	14,701
76,050	**76,100**	16,047	12,639	16,391	14,714
76,100	**76,150**	16,061	12,651	16,405	14,726
76,150	**76,200**	16,075	12,664	16,419	14,739
76,200	**76,250**	16,089	12,676	16,433	14,751
76,250	**76,300**	16,103	12,689	16,447	14,764
76,300	**76,350**	16,117	12,701	16,461	14,776
76,350	**76,400**	16,131	12,714	16,475	14,789
76,400	**76,450**	16,145	12,726	16,489	14,801
76,450	**76,500**	16,159	12,739	16,503	14,814
76,500	**76,550**	16,173	12,751	16,517	14,826
76,550	**76,600**	16,187	12,764	16,531	14,839
76,600	**76,650**	16,201	12,776	16,545	14,851
76,650	**76,700**	16,215	12,789	16,559	14,864
76,700	**76,750**	16,229	12,801	16,573	14,876
76,750	**76,800**	16,243	12,814	16,587	14,889
76,800	**76,850**	16,257	12,826	16,601	14,901
76,850	**76,900**	16,271	12,839	16,615	14,914
76,900	**76,950**	16,285	12,851	16,629	14,926
76,950	**77,000**	16,299	12,864	16,643	14,939

* This column must also be used by a qualifying widow(er).

(Continued on page 71)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	16,313	12,876	16,657	14,951	**80,000**	**80,050**	17,153	13,626	17,497	15,701	**83,000**	**83,050**	17,993	14,376	18,337	16,451
77,050	**77,100**	16,327	12,889	16,671	14,964	**80,050**	**80,100**	17,167	13,639	17,511	15,714	**83,050**	**83,100**	18,007	14,389	18,351	16,464
77,100	**77,150**	16,341	12,901	16,685	14,976	**80,100**	**80,150**	17,181	13,651	17,525	15,726	**83,100**	**83,150**	18,021	14,401	18,365	16,476
77,150	**77,200**	16,355	12,914	16,699	14,989	**80,150**	**80,200**	17,195	13,664	17,539	15,739	**83,150**	**83,200**	18,035	14,414	18,379	16,489
77,200	**77,250**	16,369	12,926	16,713	15,001	**80,200**	**80,250**	17,209	13,676	17,553	15,751	**83,200**	**83,250**	18,049	14,426	18,393	16,501
77,250	**77,300**	16,383	12,939	16,727	15,014	**80,250**	**80,300**	17,223	13,689	17,567	15,764	**83,250**	**83,300**	18,063	14,439	18,407	16,514
77,300	**77,350**	16,397	12,951	16,741	15,026	**80,300**	**80,350**	17,237	13,701	17,581	15,776	**83,300**	**83,350**	18,077	14,451	18,421	16,526
77,350	**77,400**	16,411	12,964	16,755	15,039	**80,350**	**80,400**	17,251	13,714	17,595	15,789	**83,350**	**83,400**	18,091	14,464	18,435	16,539
77,400	**77,450**	16,425	12,976	16,769	15,051	**80,400**	**80,450**	17,265	13,726	17,609	15,801	**83,400**	**83,450**	18,105	14,476	18,449	16,551
77,450	**77,500**	16,439	12,989	16,783	15,064	**80,450**	**80,500**	17,279	13,739	17,623	15,814	**83,450**	**83,500**	18,119	14,489	18,463	16,564
77,500	**77,550**	16,453	13,001	16,797	15,076	**80,500**	**80,550**	17,293	13,751	17,637	15,826	**83,500**	**83,550**	18,133	14,501	18,477	16,576
77,550	**77,600**	16,467	13,014	16,811	15,089	**80,550**	**80,600**	17,307	13,764	17,651	15,839	**83,550**	**83,600**	18,147	14,514	18,491	16,589
77,600	**77,650**	16,481	13,026	16,825	15,101	**80,600**	**80,650**	17,321	13,776	17,665	15,851	**83,600**	**83,650**	18,161	14,526	18,505	16,601
77,650	**77,700**	16,495	13,039	16,839	15,114	**80,650**	**80,700**	17,335	13,789	17,679	15,864	**83,650**	**83,700**	18,175	14,539	18,519	16,614
77,700	**77,750**	16,509	13,051	16,853	15,126	**80,700**	**80,750**	17,349	13,801	17,693	15,876	**83,700**	**83,750**	18,189	14,551	18,533	16,626
77,750	**77,800**	16,523	13,064	16,867	15,139	**80,750**	**80,800**	17,363	13,814	17,707	15,889	**83,750**	**83,800**	18,203	14,564	18,547	16,639
77,800	**77,850**	16,537	13,076	16,881	15,151	**80,800**	**80,850**	17,377	13,826	17,721	15,901	**83,800**	**83,850**	18,217	14,576	18,561	16,651
77,850	**77,900**	16,551	13,089	16,895	15,164	**80,850**	**80,900**	17,391	13,839	17,735	15,914	**83,850**	**83,900**	18,231	14,589	18,575	16,664
77,900	**77,950**	16,565	13,101	16,909	15,176	**80,900**	**80,950**	17,405	13,851	17,749	15,926	**83,900**	**83,950**	18,245	14,601	18,589	16,676
77,950	**78,000**	16,579	13,114	16,923	15,189	**80,950**	**81,000**	17,419	13,864	17,763	15,939	**83,950**	**84,000**	18,259	14,614	18,603	16,689
78,000						**81,000**						**84,000**					
78,000	**78,050**	16,593	13,126	16,937	15,201	**81,000**	**81,050**	17,433	13,876	17,777	15,951	**84,000**	**84,050**	18,273	14,626	18,617	16,701
78,050	**78,100**	16,607	13,139	16,951	15,214	**81,050**	**81,100**	17,447	13,889	17,791	15,964	**84,050**	**84,100**	18,287	14,639	18,631	16,714
78,100	**78,150**	16,621	13,151	16,965	15,226	**81,100**	**81,150**	17,461	13,901	17,805	15,976	**84,100**	**84,150**	18,301	14,651	18,645	16,726
78,150	**78,200**	16,635	13,164	16,979	15,239	**81,150**	**81,200**	17,475	13,914	17,819	15,989	**84,150**	**84,200**	18,315	14,664	18,659	16,739
78,200	**78,250**	16,649	13,176	16,993	15,251	**81,200**	**81,250**	17,489	13,926	17,833	16,001	**84,200**	**84,250**	18,329	14,676	18,673	16,751
78,250	**78,300**	16,663	13,189	17,007	15,264	**81,250**	**81,300**	17,503	13,939	17,847	16,014	**84,250**	**84,300**	18,343	14,689	18,687	16,764
78,300	**78,350**	16,677	13,201	17,021	15,276	**81,300**	**81,350**	17,517	13,951	17,861	16,026	**84,300**	**84,350**	18,357	14,701	18,701	16,776
78,350	**78,400**	16,691	13,214	17,035	15,289	**81,350**	**81,400**	17,531	13,964	17,875	16,039	**84,350**	**84,400**	18,371	14,714	18,715	16,789
78,400	**78,450**	16,705	13,226	17,049	15,301	**81,400**	**81,450**	17,545	13,976	17,889	16,051	**84,400**	**84,450**	18,385	14,726	18,729	16,801
78,450	**78,500**	16,719	13,239	17,063	15,314	**81,450**	**81,500**	17,559	13,989	17,903	16,064	**84,450**	**84,500**	18,399	14,739	18,743	16,814
78,500	**78,550**	16,733	13,251	17,077	15,326	**81,500**	**81,550**	17,573	14,001	17,917	16,076	**84,500**	**84,550**	18,413	14,751	18,757	16,826
78,550	**78,600**	16,747	13,264	17,091	15,339	**81,550**	**81,600**	17,587	14,014	17,931	16,089	**84,550**	**84,600**	18,427	14,764	18,771	16,839
78,600	**78,650**	16,761	13,276	17,105	15,351	**81,600**	**81,650**	17,601	14,026	17,945	16,101	**84,600**	**84,650**	18,441	14,776	18,785	16,851
78,650	**78,700**	16,775	13,289	17,119	15,364	**81,650**	**81,700**	17,615	14,039	17,959	16,114	**84,650**	**84,700**	18,455	14,789	18,799	16,864
78,700	**78,750**	16,789	13,301	17,133	15,376	**81,700**	**81,750**	17,629	14,051	17,973	16,126	**84,700**	**84,750**	18,469	14,801	18,813	16,876
78,750	**78,800**	16,803	13,314	17,147	15,389	**81,750**	**81,800**	17,643	14,064	17,987	16,139	**84,750**	**84,800**	18,483	14,814	18,827	16,889
78,800	**78,850**	16,817	13,326	17,161	15,401	**81,800**	**81,850**	17,657	14,076	18,001	16,151	**84,800**	**84,850**	18,497	14,826	18,841	16,901
78,850	**78,900**	16,831	13,339	17,175	15,414	**81,850**	**81,900**	17,671	14,089	18,015	16,164	**84,850**	**84,900**	18,511	14,839	18,855	16,914
78,900	**78,950**	16,845	13,351	17,189	15,426	**81,900**	**81,950**	17,685	14,101	18,029	16,176	**84,900**	**84,950**	18,525	14,851	18,869	16,926
78,950	**79,000**	16,859	13,364	17,203	15,439	**81,950**	**82,000**	17,699	14,114	18,043	16,189	**84,950**	**85,000**	18,539	14,864	18,883	16,939
79,000						**82,000**						**85,000**					
79,000	**79,050**	16,873	13,376	17,217	15,451	**82,000**	**82,050**	17,713	14,126	18,057	16,201	**85,000**	**85,050**	18,553	14,876	18,897	16,951
79,050	**79,100**	16,887	13,389	17,231	15,464	**82,050**	**82,100**	17,727	14,139	18,071	16,214	**85,050**	**85,100**	18,567	14,889	18,911	16,964
79,100	**79,150**	16,901	13,401	17,245	15,476	**82,100**	**82,150**	17,741	14,151	18,085	16,226	**85,100**	**85,150**	18,581	14,901	18,925	16,976
79,150	**79,200**	16,915	13,414	17,259	15,489	**82,150**	**82,200**	17,755	14,164	18,099	16,239	**85,150**	**85,200**	18,595	14,914	18,939	16,989
79,200	**79,250**	16,929	13,426	17,273	15,501	**82,200**	**82,250**	17,769	14,176	18,113	16,251	**85,200**	**85,250**	18,609	14,926	18,953	17,001
79,250	**79,300**	16,943	13,439	17,287	15,514	**82,250**	**82,300**	17,783	14,189	18,127	16,264	**85,250**	**85,300**	18,623	14,939	18,967	17,014
79,300	**79,350**	16,957	13,451	17,301	15,526	**82,300**	**82,350**	17,797	14,201	18,141	16,276	**85,300**	**85,350**	18,637	14,951	18,981	17,026
79,350	**79,400**	16,971	13,464	17,315	15,539	**82,350**	**82,400**	17,811	14,214	18,155	16,289	**85,350**	**85,400**	18,651	14,964	18,995	17,039
79,400	**79,450**	16,985	13,476	17,329	15,551	**82,400**	**82,450**	17,825	14,226	18,169	16,301	**85,400**	**85,450**	18,665	14,976	19,009	17,051
79,450	**79,500**	16,999	13,489	17,343	15,564	**82,450**	**82,500**	17,839	14,239	18,183	16,314	**85,450**	**85,500**	18,679	14,989	19,023	17,064
79,500	**79,550**	17,013	13,501	17,357	15,576	**82,500**	**82,550**	17,853	14,251	18,197	16,326	**85,500**	**85,550**	18,693	15,001	19,037	17,076
79,550	**79,600**	17,027	13,514	17,371	15,589	**82,550**	**82,600**	17,867	14,264	18,211	16,339	**85,550**	**85,600**	18,707	15,014	19,051	17,089
79,600	**79,650**	17,041	13,526	17,385	15,601	**82,600**	**82,650**	17,881	14,276	18,225	16,351	**85,600**	**85,650**	18,721	15,026	19,065	17,101
79,650	**79,700**	17,055	13,539	17,399	15,614	**82,650**	**82,700**	17,895	14,289	18,239	16,364	**85,650**	**85,700**	18,735	15,039	19,079	17,114
79,700	**79,750**	17,069	13,551	17,413	15,626	**82,700**	**82,750**	17,909	14,301	18,253	16,376	**85,700**	**85,750**	18,749	15,051	19,093	17,126
79,750	**79,800**	17,083	13,564	17,427	15,639	**82,750**	**82,800**	17,923	14,314	18,267	16,389	**85,750**	**85,800**	18,763	15,064	19,107	17,139
79,800	**79,850**	17,097	13,576	17,441	15,651	**82,800**	**82,850**	17,937	14,326	18,281	16,401	**85,800**	**85,850**	18,777	15,076	19,121	17,151
79,850	**79,900**	17,111	13,589	17,455	15,664	**82,850**	**82,900**	17,951	14,339	18,295	16,414	**85,850**	**85,900**	18,791	15,089	19,135	17,164
79,900	**79,950**	17,125	13,601	17,469	15,676	**82,900**	**82,950**	17,965	14,351	18,309	16,426	**85,900**	**85,950**	18,805	15,101	19,149	17,176
79,950	**80,000**	17,139	13,614	17,483	15,689	**82,950**	**83,000**	17,979	14,364	18,323	16,439	**85,950**	**86,000**	18,819	15,114	19,163	17,189

* This column must also be used by a qualifying widow(er).

(Continued on page 72)

If line 40 (taxable income) is—		And you are—				If line 40 (taxable income) is—		And you are—				If line 40 (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**	18,833	15,126	19,177	17,201	**89,000**	**89,050**	19,673	15,876	20,101	17,951	**92,000**	**92,050**	20,513	16,626	21,091	18,701
86,050	**86,100**	18,847	15,139	19,191	17,214	**89,050**	**89,100**	19,687	15,889	20,118	17,964	**92,050**	**92,100**	20,527	16,639	21,108	18,714
86,100	**86,150**	18,861	15,151	19,205	17,226	**89,100**	**89,150**	19,701	15,901	20,134	17,976	**92,100**	**92,150**	20,541	16,651	21,124	18,726
86,150	**86,200**	18,875	15,164	19,219	17,239	**89,150**	**89,200**	19,715	15,914	20,151	17,989	**92,150**	**92,200**	20,555	16,664	21,141	18,739
86,200	**86,250**	18,889	15,176	19,233	17,251	**89,200**	**89,250**	19,729	15,926	20,167	18,001	**92,200**	**92,250**	20,569	16,676	21,157	18,751
86,250	**86,300**	18,903	15,189	19,247	17,264	**89,250**	**89,300**	19,743	15,939	20,184	18,014	**92,250**	**92,300**	20,583	16,689	21,174	18,764
86,300	**86,350**	18,917	15,201	19,261	17,276	**89,300**	**89,350**	19,757	15,951	20,200	18,026	**92,300**	**92,350**	20,597	16,701	21,190	18,776
86,350	**86,400**	18,931	15,214	19,275	17,289	**89,350**	**89,400**	19,771	15,964	20,217	18,039	**92,350**	**92,400**	20,611	16,714	21,207	18,789
86,400	**86,450**	18,945	15,226	19,289	17,301	**89,400**	**89,450**	19,785	15,976	20,233	18,051	**92,400**	**92,450**	20,625	16,726	21,223	18,801
86,450	**86,500**	18,959	15,239	19,303	17,314	**89,450**	**89,500**	19,799	15,989	20,250	18,064	**92,450**	**92,500**	20,639	16,739	21,240	18,814
86,500	**86,550**	18,973	15,251	19,317	17,326	**89,500**	**89,550**	19,813	16,001	20,266	18,076	**92,500**	**92,550**	20,653	16,751	21,256	18,826
86,550	**86,600**	18,987	15,264	19,331	17,339	**89,550**	**89,600**	19,827	16,014	20,283	18,089	**92,550**	**92,600**	20,667	16,764	21,273	18,839
86,600	**86,650**	19,001	15,276	19,345	17,351	**89,600**	**89,650**	19,841	16,026	20,299	18,101	**92,600**	**92,650**	20,681	16,776	21,289	18,851
86,650	**86,700**	19,015	15,289	19,359	17,364	**89,650**	**89,700**	19,855	16,039	20,316	18,114	**92,650**	**92,700**	20,695	16,789	21,306	18,864
86,700	**86,750**	19,029	15,301	19,373	17,376	**89,700**	**89,750**	19,869	16,051	20,332	18,126	**92,700**	**92,750**	20,709	16,801	21,322	18,876
86,750	**86,800**	19,043	15,314	19,387	17,389	**89,750**	**89,800**	19,883	16,064	20,349	18,139	**92,750**	**92,800**	20,723	16,814	21,339	18,889
86,800	**86,850**	19,057	15,326	19,401	17,401	**89,800**	**89,850**	19,897	16,076	20,365	18,151	**92,800**	**92,850**	20,737	16,826	21,355	18,901
86,850	**86,900**	19,071	15,339	19,415	17,414	**89,850**	**89,900**	19,911	16,089	20,382	18,164	**92,850**	**92,900**	20,751	16,839	21,372	18,914
86,900	**86,950**	19,085	15,351	19,429	17,426	**89,900**	**89,950**	19,925	16,101	20,398	18,176	**92,900**	**92,950**	20,765	16,851	21,388	18,926
86,950	**87,000**	19,099	15,364	19,443	17,439	**89,950**	**90,000**	19,939	16,114	20,415	18,189	**92,950**	**93,000**	20,779	16,864	21,405	18,939
87,000						**90,000**						**93,000**					
87,000	**87,050**	19,113	15,376	19,457	17,451	**90,000**	**90,050**	19,953	16,126	20,431	18,201	**93,000**	**93,050**	20,793	16,876	21,421	18,951
87,050	**87,100**	19,127	15,389	19,471	17,464	**90,050**	**90,100**	19,967	16,139	20,448	18,214	**93,050**	**93,100**	20,807	16,889	21,438	18,964
87,100	**87,150**	19,141	15,401	19,485	17,476	**90,100**	**90,150**	19,981	16,151	20,464	18,226	**93,100**	**93,150**	20,821	16,901	21,454	18,976
87,150	**87,200**	19,155	15,414	19,499	17,489	**90,150**	**90,200**	19,995	16,164	20,481	18,239	**93,150**	**93,200**	20,835	16,914	21,471	18,989
87,200	**87,250**	19,169	15,426	19,513	17,501	**90,200**	**90,250**	20,009	16,176	20,497	18,251	**93,200**	**93,250**	20,849	16,926	21,487	19,001
87,250	**87,300**	19,183	15,439	19,527	17,514	**90,250**	**90,300**	20,023	16,189	20,514	18,264	**93,250**	**93,300**	20,863	16,939	21,504	19,014
87,300	**87,350**	19,197	15,451	19,541	17,526	**90,300**	**90,350**	20,037	16,201	20,530	18,276	**93,300**	**93,350**	20,877	16,951	21,520	19,026
87,350	**87,400**	19,211	15,464	19,557	17,539	**90,350**	**90,400**	20,051	16,214	20,547	18,289	**93,350**	**93,400**	20,891	16,964	21,537	19,039
87,400	**87,450**	19,225	15,476	19,573	17,551	**90,400**	**90,450**	20,065	16,226	20,563	18,301	**93,400**	**93,450**	20,905	16,976	21,553	19,051
87,450	**87,500**	19,239	15,489	19,590	17,564	**90,450**	**90,500**	20,079	16,239	20,580	18,314	**93,450**	**93,500**	20,919	16,989	21,570	19,064
87,500	**87,550**	19,253	15,501	19,606	17,576	**90,500**	**90,550**	20,093	16,251	20,596	18,326	**93,500**	**93,550**	20,933	17,001	21,586	19,076
87,550	**87,600**	19,267	15,514	19,623	17,589	**90,550**	**90,600**	20,107	16,264	20,613	18,339	**93,550**	**93,600**	20,947	17,014	21,603	19,089
87,600	**87,650**	19,281	15,526	19,639	17,601	**90,600**	**90,650**	20,121	16,276	20,629	18,351	**93,600**	**93,650**	20,961	17,026	21,619	19,101
87,650	**87,700**	19,295	15,539	19,656	17,614	**90,650**	**90,700**	20,135	16,289	20,646	18,364	**93,650**	**93,700**	20,975	17,039	21,636	19,114
87,700	**87,750**	19,309	15,551	19,672	17,626	**90,700**	**90,750**	20,149	16,301	20,662	18,376	**93,700**	**93,750**	20,989	17,051	21,652	19,126
87,750	**87,800**	19,323	15,564	19,689	17,639	**90,750**	**90,800**	20,163	16,314	20,679	18,389	**93,750**	**93,800**	21,003	17,064	21,669	19,139
87,800	**87,850**	19,337	15,576	19,705	17,651	**90,800**	**90,850**	20,177	16,326	20,695	18,401	**93,800**	**93,850**	21,017	17,076	21,685	19,151
87,850	**87,900**	19,351	15,589	19,722	17,664	**90,850**	**90,900**	20,191	16,339	20,712	18,414	**93,850**	**93,900**	21,031	17,089	21,702	19,164
87,900	**87,950**	19,365	15,601	19,738	17,676	**90,900**	**90,950**	20,205	16,351	20,728	18,426	**93,900**	**93,950**	21,045	17,101	21,718	19,176
87,950	**88,000**	19,379	15,614	19,755	17,689	**90,950**	**91,000**	20,219	16,364	20,745	18,439	**93,950**	**94,000**	21,059	17,114	21,735	19,189
88,000						**91,000**						**94,000**					
88,000	**88,050**	19,393	15,626	19,771	17,701	**91,000**	**91,050**	20,233	16,376	20,761	18,451	**94,000**	**94,050**	21,073	17,126	21,751	19,201
88,050	**88,100**	19,407	15,639	19,788	17,714	**91,050**	**91,100**	20,247	16,389	20,778	18,464	**94,050**	**94,100**	21,087	17,139	21,768	19,214
88,100	**88,150**	19,421	15,651	19,804	17,726	**91,100**	**91,150**	20,261	16,401	20,794	18,476	**94,100**	**94,150**	21,101	17,151	21,784	19,226
88,150	**88,200**	19,435	15,664	19,821	17,739	**91,150**	**91,200**	20,275	16,414	20,811	18,489	**94,150**	**94,200**	21,115	17,164	21,801	19,239
88,200	**88,250**	19,449	15,676	19,837	17,751	**91,200**	**91,250**	20,289	16,426	20,827	18,501	**94,200**	**94,250**	21,129	17,176	21,817	19,251
88,250	**88,300**	19,463	15,689	19,854	17,764	**91,250**	**91,300**	20,303	16,439	20,844	18,514	**94,250**	**94,300**	21,143	17,189	21,834	19,264
88,300	**88,350**	19,477	15,701	19,870	17,776	**91,300**	**91,350**	20,317	16,451	20,860	18,526	**94,300**	**94,350**	21,157	17,201	21,850	19,276
88,350	**88,400**	19,491	15,714	19,887	17,789	**91,350**	**91,400**	20,331	16,464	20,877	18,539	**94,350**	**94,400**	21,171	17,214	21,867	19,289
88,400	**88,450**	19,505	15,726	19,903	17,801	**91,400**	**91,450**	20,345	16,476	20,893	18,551	**94,400**	**94,450**	21,185	17,226	21,883	19,301
88,450	**88,500**	19,519	15,739	19,920	17,814	**91,450**	**91,500**	20,359	16,489	20,910	18,564	**94,450**	**94,500**	21,199	17,239	21,900	19,314
88,500	**88,550**	19,533	15,751	19,936	17,826	**91,500**	**91,550**	20,373	16,501	20,926	18,576	**94,500**	**94,550**	21,213	17,251	21,916	19,326
88,550	**88,600**	19,547	15,764	19,953	17,839	**91,550**	**91,600**	20,387	16,514	20,943	18,589	**94,550**	**94,600**	21,227	17,264	21,933	19,339
88,600	**88,650**	19,561	15,776	19,969	17,851	**91,600**	**91,650**	20,401	16,526	20,959	18,601	**94,600**	**94,650**	21,241	17,276	21,949	19,351
88,650	**88,700**	19,575	15,789	19,986	17,864	**91,650**	**91,700**	20,415	16,539	20,976	18,614	**94,650**	**94,700**	21,255	17,289	21,966	19,364
88,700	**88,750**	19,589	15,801	20,002	17,876	**91,700**	**91,750**	20,429	16,551	20,992	18,626	**94,700**	**94,750**	21,269	17,301	21,982	19,376
88,750	**88,800**	19,603	15,814	20,019	17,889	**91,750**	**91,800**	20,443	16,564	21,009	18,639	**94,750**	**94,800**	21,283	17,314	21,999	19,389
88,800	**88,850**	19,617	15,826	20,035	17,901	**91,800**	**91,850**	20,457	16,576	21,025	18,651	**94,800**	**94,850**	21,297	17,326	22,015	19,401
88,850	**88,900**	19,631	15,839	20,052	17,914	**91,850**	**91,900**	20,471	16,589	21,042	18,664	**94,850**	**94,900**	21,311	17,339	22,032	19,414
88,900	**88,950**	19,645	15,851	20,068	17,926	**91,900**	**91,950**	20,485	16,601	21,058	18,676	**94,900**	**94,950**	21,325	17,351	22,048	19,426
88,950	**89,000**	19,659	15,864	20,085	17,939	**91,950**	**92,000**	20,499	16,614	21,075	18,689	**94,950**	**95,000**	21,339	17,364	22,065	19,439

* This column must also be used by a qualifying widow(er).

(Continued on page 73)

2003 Tax Table—*Continued*

If line 40 (taxable income) is—		And you are—				If line 40 (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**	21,353	17,376	22,081	19,451	**98,000**	**98,050**	22,193	18,126	23,071	20,201
95,050	**95,100**	21,367	17,389	22,098	19,464	**98,050**	**98,100**	22,207	18,139	23,088	20,214
95,100	**95,150**	21,381	17,401	22,114	19,476	**98,100**	**98,150**	22,221	18,151	23,104	20,226
95,150	**95,200**	21,395	17,414	22,131	19,489	**98,150**	**98,200**	22,235	18,164	23,121	20,239
95,200	**95,250**	21,409	17,426	22,147	19,501	**98,200**	**98,250**	22,249	18,176	23,137	20,251
95,250	**95,300**	21,423	17,439	22,164	19,514	**98,250**	**98,300**	22,263	18,189	23,154	20,265
95,300	**95,350**	21,437	17,451	22,180	19,526	**98,300**	**98,350**	22,277	18,201	23,170	20,279
95,350	**95,400**	21,451	17,464	22,197	19,539	**98,350**	**98,400**	22,291	18,214	23,187	20,293
95,400	**95,450**	21,465	17,476	22,213	19,551	**98,400**	**98,450**	22,305	18,226	23,203	20,307
95,450	**95,500**	21,479	17,489	22,230	19,564	**98,450**	**98,500**	22,319	18,239	23,220	20,321
95,500	**95,550**	21,493	17,501	22,246	19,576	**98,500**	**98,550**	22,333	18,251	23,236	20,335
95,550	**95,600**	21,507	17,514	22,263	19,589	**98,550**	**98,600**	22,347	18,264	23,253	20,349
95,600	**95,650**	21,521	17,526	22,279	19,601	**98,600**	**98,650**	22,361	18,276	23,269	20,363
95,650	**95,700**	21,535	17,539	22,296	19,614	**98,650**	**98,700**	22,375	18,289	23,286	20,377
95,700	**95,750**	21,549	17,551	22,312	19,626	**98,700**	**98,750**	22,389	18,301	23,302	20,391
95,750	**95,800**	21,563	17,564	22,329	19,639	**98,750**	**98,800**	22,403	18,314	23,319	20,405
95,800	**95,850**	21,577	17,576	22,345	19,651	**98,800**	**98,850**	22,417	18,326	23,335	20,419
95,850	**95,900**	21,591	17,589	22,362	19,664	**98,850**	**98,900**	22,431	18,339	23,352	20,433
95,900	**95,950**	21,605	17,601	22,378	19,676	**98,900**	**98,950**	22,445	18,351	23,368	20,447
95,950	**96,000**	21,619	17,614	22,395	19,689	**98,950**	**99,000**	22,459	18,364	23,385	20,461
96,000						**99,000**					
96,000	**96,050**	21,633	17,626	22,411	19,701	**99,000**	**99,050**	22,473	18,376	23,401	20,475
96,050	**96,100**	21,647	17,639	22,428	19,714	**99,050**	**99,100**	22,487	18,389	23,418	20,489
96,100	**96,150**	21,661	17,651	22,444	19,726	**99,100**	**99,150**	22,501	18,401	23,434	20,503
96,150	**96,200**	21,675	17,664	22,461	19,739	**99,150**	**99,200**	22,515	18,414	23,451	20,517
96,200	**96,250**	21,689	17,676	22,477	19,751	**99,200**	**99,250**	22,529	18,426	23,467	20,531
96,250	**96,300**	21,703	17,689	22,494	19,764	**99,250**	**99,300**	22,543	18,439	23,484	20,545
96,300	**96,350**	21,717	17,701	22,510	19,776	**99,300**	**99,350**	22,557	18,451	23,500	20,559
96,350	**96,400**	21,731	17,714	22,527	19,789	**99,350**	**99,400**	22,571	18,464	23,517	20,573
96,400	**96,450**	21,745	17,726	22,543	19,801	**99,400**	**99,450**	22,585	18,476	23,533	20,587
96,450	**96,500**	21,759	17,739	22,560	19,814	**99,450**	**99,500**	22,599	18,489	23,550	20,601
96,500	**96,550**	21,773	17,751	22,576	19,826	**99,500**	**99,550**	22,613	18,501	23,566	20,615
96,550	**96,600**	21,787	17,764	22,593	19,839	**99,550**	**99,600**	22,627	18,514	23,583	20,629
96,600	**96,650**	21,801	17,776	22,609	19,851	**99,600**	**99,650**	22,641	18,526	23,599	20,643
96,650	**96,700**	21,815	17,789	22,626	19,864	**99,650**	**99,700**	22,655	18,539	23,616	20,657
96,700	**96,750**	21,829	17,801	22,642	19,876	**99,700**	**99,750**	22,669	18,551	23,632	20,671
96,750	**96,800**	21,843	17,814	22,659	19,889	**99,750**	**99,800**	22,683	18,564	23,649	20,685
96,800	**96,850**	21,857	17,826	22,675	19,901	**99,800**	**99,850**	22,697	18,576	23,665	20,699
96,850	**96,900**	21,871	17,839	22,692	19,914	**99,850**	**99,900**	22,711	18,589	23,682	20,713
96,900	**96,950**	21,885	17,851	22,708	19,926	**99,900**	**99,950**	22,725	18,601	23,698	20,727
96,950	**97,000**	21,899	17,864	22,725	19,939	**99,950**	**100,000**	22,739	18,614	23,715	20,741
97,000											
97,000	**97,050**	21,913	17,876	22,741	19,951						
97,050	**97,100**	21,927	17,889	22,758	19,964						
97,100	**97,150**	21,941	17,901	22,774	19,976						
97,150	**97,200**	21,955	17,914	22,791	19,989						
97,200	**97,250**	21,969	17,926	22,807	20,001						
97,250	**97,300**	21,983	17,939	22,824	20,014						
97,300	**97,350**	21,997	17,951	22,840	20,026						
97,350	**97,400**	22,011	17,964	22,857	20,039						
97,400	**97,450**	22,025	17,976	22,873	20,051						
97,450	**97,500**	22,039	17,989	22,890	20,064						
97,500	**97,550**	22,053	18,001	22,906	20,076						
97,550	**97,600**	22,067	18,014	22,923	20,089						
97,600	**97,650**	22,081	18,026	22,939	20,101						
97,650	**97,700**	22,095	18,039	22,956	20,114						
97,700	**97,750**	22,109	18,051	22,972	20,126						
97,750	**97,800**	22,123	18,064	22,989	20,139						
97,800	**97,850**	22,137	18,076	23,005	20,151						
97,850	**97,900**	22,151	18,089	23,022	20,164						
97,900	**97,950**	22,165	18,101	23,038	20,176						
97,950	**98,000**	22,179	18,114	23,055	20,189						

$100,000 or over — use the Tax Rate Schedules on page 74

* This column must also be used by a qualifying widow(er).

2003 Tax Rate Schedules

CAUTION Use **only** if your taxable income (Form 1040, line 40) 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 40, is: *Over—*	*But not over—*	Enter on Form 1040, line 41	*of the amount over—*
$0	$7,000	--------- **10%**	**$0**
7,000	28,400	**$700.00 + 15%**	**7,000**
28,400	68,800	**3,910.00 + 25%**	**28,400**
68,800	143,500	**14,010.00 + 28%**	**68,800**
143,500	311,950	**34,926.00 + 33%**	**143,500**
311,950	---------	**90,514.50 + 35%**	**311,950**

Schedule Y-1—Use if your filing status is **Married filing jointly** or **Qualifying widow(er)**

If the amount on Form 1040, line 40, is: *Over—*	*But not over—*	Enter on Form 1040, line 41	*of the amount over—*
$0	$14,000	--------- **10%**	**$0**
14,000	56,800	**$1,400.00 + 15%**	**14,000**
56,800	114,650	**7,820.00 + 25%**	**56,800**
114,650	174,700	**22,282.50 + 28%**	**114,650**
174,700	311,950	**39,096.50 + 33%**	**174,700**
311,950	---------	**84,389.00 + 35%**	**311,950**

Schedule Y-2—Use if your filing status is **Married filing separately**

If the amount on Form 1040, line 40, is: *Over—*	*But not over—*	Enter on Form 1040, line 41	*of the amount over—*
$0	$7,000	--------- **10%**	**$0**
7,000	28,400	**$700.00 + 15%**	**7,000**
28,400	57,325	**3,910.00 + 25%**	**28,400**
57,325	87,350	**11,141.25 + 28%**	**57,325**
87,350	155,975	**19,548.25 + 33%**	**87,350**
155,975	---------	**42,194.50 + 35%**	**155,975**

Schedule Z—Use if your filing status is **Head of household**

If the amount on Form 1040, line 40, is: *Over—*	*But not over—*	Enter on Form 1040, line 41	*of the amount over—*
$0	$10,000	--------- **10%**	**$0**
10,000	38,050	**$1,000.00 + 15%**	**10,000**
38,050	98,250	**5,207.50 + 25%**	**38,050**
98,250	159,100	**20,257.50 + 28%**	**98,250**
159,100	311,950	**37,295.50 + 33%**	**159,100**
311,950	---------	**87,736.00 + 35%**	**311,950**

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 will happen 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 area director or the center where you filed your return.

Representation. You may either represent yourself or, with proper written authorization, have someone else represent you. 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 a representative, 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. The Taxpayer Advocate Service can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, see *Contacting your Taxpayer Advocate* under *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 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).*

Claims for Refund

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, Appeal 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 independently 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 toll free at **1 – 877 – 777 – 4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1 – 800 – 829 – 4059** if you are a TTY/TDD user.
- Visit the web site at **www.irs.gov/advocate**.

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.

Internet. You can access the IRS web site 24 hours a day, 7 days a week at **www.irs.gov** to:

- ***E-file.*** Access commercial tax preparation and *e-file* services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on "Where's My Refund" and then on "Go Get My Refund Status." Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products on-line.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.
- Send us comments or request help by e-mail.
- Sign up to receive local and national tax news by e-mail.
- Get information on starting and operating a small business.

You can also reach us using File Transfer Protocol at **ftp.irs.gov**.

Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703 – 368 – 9694** from your fax machine. 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 **703 – 487 – 4608.**

Long-distance charges may apply.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1 – 800 – 829 – 3676** to order current – year forms, instructions, and publications and prior year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at **1 – 800 – 829 – 1040.**
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1 – 800 – 829 – 4059** to ask tax or account questions or to order forms and publications.
- *TeleTax topics.* Call **1 – 800 – 829 – 4477** to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2003 refund, call **1 – 800 – 829 4477** for automated refund information and follow the recorded instructions or call **1 – 800 – 829 – 1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* 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 government offices, credit unions, and office supply stores have a 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
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."

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. Use 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 for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at

www.irs.gov/cdorders for $22 (no handling fee) or call **1–877–233–6767** toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling **1–800–829–3676** or by visiting the web site at **www.irs.gov/smallbiz**.

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. A variety of Braille tax products can be ordered at no charge by calling the IRS at 1–800–829–3676. You can also download accessible products by visiting the *Accessibility* section of the IRS web site at **www.irs.gov**.

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, call **1–800–424–8567**. Braille materials currently available for review include this publication, Publication 334, *Tax Guide for Small Business,* and Forms 1040, 1040A, and 1040EZ. All of these products come with related schedules, instructions and tax tables.

Free help in preparing your return. Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance **(VITA)**program is designed to help low-income taxpayers and the Tax Counseling for the Elderly **(TCE)** program is designed to assist taxpayers age 60 or older with their tax returns. Some locations offer free electronic filing. 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. For the location of an American Association of Retired Persons **(AARP)** Tax-Aide site in your community, call **1–888–227–7669** or visit their Internet Web Site at **www.aarp.org/taxaide**.

To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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■

Where To File

Note. Use this table only if you are an individual taxpayer filing your own return.

IF you live in...	THEN send your return to...	AND use the zip code below according to the form you are filing and whether you are enclosing payment					
		Form 1040		Form 1040A		Form 1040EZ	
		No payment enclosed	Payment enclosed	No payment enclosed	Payment enclosed	No payment enclosed	Payment enclosed
Alabama, Florida, Georgia, Mississippi, North Carolina, Rhode Island, South Carolina, West Virginia	Internal Revenue Service Center Atlanta, GA	39901–0002	39901–0102	39901–0015	39901–0115	39901–0014	39901–0114
Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming	Internal Revenue Service Center Fresno, CA	93888–0002	93888–0102	93888–0015	93888–0115	93888–0014	93888–0114
Arkansas, Colorado, Kentucky, Louisiana, New Mexico, Oklahoma, Tennessee, Texas	Internal Revenue Service Center Austin, TX	73301–0002	73301–0102	73301–0015	73301–0115	73301–0014	73301–0114
Connecticut, District of Columbia, Maryland, New Jersey, Pennsylvania	Internal Revenue Service Center Philadelphia, PA	19255–0002	19255–0102	19255–0015	19255–0115	19255–0014	19255–0114
Delaware, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, Wisconsin	Internal Revenue Service Center Kansas City, MO	64999–0002	64999–0102	64999–0015	64999–0115	64999–0014	64999–0114
Maine, Massachusetts, New Hampshire, New York, Vermont	Internal Revenue Service Center Andover, MA	05501–0002	05501–0102	05501–0015	05501–0115	05501–0014	05501–0114
Ohio, Virginia	Internal Revenue Service Center Memphis, TN	37501–0002	37501–0102	37501–0015	37501–0115	37501–0014	37501–0114
American Samoa	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Puerto Rico (*or exclude income under Internal Revenue Code section 933*)	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Guam — permanent resident	Department of Revenue and Taxation, Government of Guam, P.O. Box 23607 GMF, GU 96921						
Guam — nonpermanent resident	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Virgin Islands — permanent resident	V.I. Bureau of Internal Revenue, 9601 Estate Thomas, Charlotte Amalie, St. Thomas, VI 00802						
Virgin Islands — nonpermanent resident	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Any location and have an APO, FPO, or foreign address	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Any location and file Form 2555, 2555–EZ, or 4563	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						
Any location and are a dual-status alien	Internal Revenue Service Center, Philadelphia, PA 19255–0215 USA						

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The items in blue 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	8582	Pub. 17	Pub. 525	Pub. 596
Schedules A&B (1040)	Schedule H (1040)	**1040EZ**	3903	8606	Pub. 334	Pub. 527	Pub. 910
Schedule C (1040)	Schedule J (1040)	1040-ES (2004)	4506	8812	Pub. 463	Pub. 529	Pub. 926
Schedule C-EZ (1040)	Schedule R (1040)	1040-V	4562	8822	Pub. 501	Pub. 535	Pub. 929
Schedule D (1040)	Schedule SE (1040)	1040X	4868	8829	Pub. 502	Pub. 550	Pub. 936
Schedule D-1 (1040)	**1040A**	2106	5329	8863	Pub. 505	Pub. 554	Pub. 970
Schedule E (1040)	**Schedule 1 (1040A)**	2106-EZ	8283	9465	Pub. 521	Pub. 575	Pub. 972
Schedule EIC (1040A or 1040)	**Schedule 2 (1040A)**	2210	8379	Pub. 1	Pub. 523	Pub. 590	