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Taxable and Nontaxable Income

For use in preparing
1997 Returns



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Important Changes for 1997

Employer-provided educational assistance benefits. The exclusion from gross income for up to \$5,250 of qualified employer-provided educational assistance benefits is extended to apply to courses beginning before June 1, 2000. The exclusion does not apply to expenses for graduate level courses. For more information, see Publication 508, *Educational Expenses*.

Contributions to plan providing long-term benefits. Beginning January 1, 1997, contributions by your employer to provide coverage for long-term care services 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 to medical savings accounts. Beginning in 1997, contributions by your employer to your medical savings ac-

count are not included in your income. This amount will, however, be reported in box 13 of Form W-2 with code R designating that the amounts are excludable from income. This amount must be reported on your tax return. See Form 8853, *Medical Savings Accounts and Long-Term Care Services and Contracts*.

Adoption expenses. Beginning in 1997, you may be able to exclude from gross 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.

Accelerated death benefits. Beginning January 1, 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs. The exclusion for payments made on a periodic basis is limited. See *Accelerated Death Benefits*.

Long-term care insurance contracts. Beginning January 1, 1997, qualified 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. See *Long-term care insurance contracts*.

Insurance premiums are deductible as an itemized deduction up to certain limits. These are discussed in Publication 502, *Medical and Dental Expenses*.

Deceased public safety officers. Amounts received as a survivor annuity on the life of a public safety officer who was killed in the line of duty after 1996 generally are not taxable. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. See *Deceased public safety officers*, later, for more information.

Energy conservation subsidies. For amounts received after 1996, the partial exclusion from gross income of any subsidy provided by a public utility to a customer for the purchase or installation of an energy conservation measure on nonresidential property is repealed. Beginning in 1997, the exclusion is available only for dwelling units.

However, the partial exclusion for nonresidential property is still available if the amounts received after 1996 are made under a written binding contract that was in effect on September 13, 1995, and at all times thereafter. For more information, see *Energy conservation subsidies* later under *Income Not Taxed*.

Important Reminders

Foreign source income. If you are a U.S. citizen, 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 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). This rule also applies to resident aliens.

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*.

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

Damages received for injuries or sickness. Generally, amounts received before August 21, 1996, as damages for personal injuries or sickness were not taxable. Generally, for amounts received after August 20, 1996, only damages for personal physical injuries or physical sickness are not taxable. See *Court awards and damages*, under *Miscellaneous Taxable Income*.

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

Introduction

This publication discusses many kinds of income and explains whether they are taxable or nontaxable. Generally, income is taxable unless it is specifically exempted by law. You can receive income in the form of money, property, or services.

Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable may have to be shown on your tax return, but is not subject to tax.

The publication includes discussions on employee wages, fringe benefits and disability payments, and income from bartering, partnerships, S corporations, and royalties. It also includes information on life insurance proceeds as well as welfare and other public assistance benefits. Check the index at the end of this publication for the location of a specific subject.

Useful Items

You may want to see:

Publications

- 520** Scholarships and Fellowships
- 523** Selling Your Home
- 527** Residential Rental Property
- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions
- 575** Pension and Annuity Income
- 915** Social Security and Equivalent Railroad Retirement Benefits

Form

- W-2** Wage and Tax Statement

See *How To Get More Information*, near the end of this publication, for information about getting these publications and forms.

Employee Compensation

Generally, you must include in gross income everything you receive in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options.

Miscellaneous Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order followed by *Restricted Property Received for Services*, which is explained in greater detail.

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 to include in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments*, later.

Back pay awards. Include in gross income amounts you are awarded in a settlement or judgment for back pay. This includes payments made to you for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to you by your employer on Form W-2.

Bonuses and awards. Amounts you receive for outstanding work, such as bonuses or awards, are included in your gross income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you. If you receive an award for length of service or safety achievement, see *Employee achievement awards* under *Income Not Taxed*, later.

Child-care providers. If you provide child care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. You are an employee if you are subject to the will and control of your employer as to what you are to do and how you are to do it.

Babysitting. If you periodically babysit for relatives or neighborhood children, the rules for child-care providers also apply to you.

If you are an employee, you should receive a Form W-2 if your pay is subject to income tax withholding or would be subject to withholding if one exemption were claimed. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

If you are not an employee, you are probably self-employed and must include the payments you receive on Schedule C (Form 1040), *Profit or Loss From Business*. You may also qualify to use the simpler Schedule C-EZ (Form 1040), *Net Profit From Business*. Information on who may use it is listed in Part I of Schedule C-EZ.

Employer-provided educational assistance. The exclusion from gross income for up to \$5,250 of qualified employer-provided educational assistance is extended to apply to courses beginning before June 1, 2000. The exclusion does not apply to graduate-level courses. For more information, get Publication 508, *Educational Expenses*.

Government cost-of-living allowances. Cost-of-living allowances are generally included in your income. However, these allowances are generally not included in your income if you are a federal civilian employee or a federal court employee who is stationed in Alaska, Hawaii, or outside the 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*.

Cost-of-living allowances paid to Red Cross staff members stationed outside the 48 contiguous states and the District of Columbia are included in salary or wages.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, you do not have to include the value of the gift in your income. However, if your employer gives you cash, a gift certificate, or a similar item that you can easily exchange for cash, you include the value of that gift as extra salary or wages regardless of the amount involved.

Interview expenses. If an employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include in income only the amount you receive that is more than your actual expenses.

Pension and annuity contributions. Generally, you cannot exclude from income amounts you pay into a pension plan through payroll deductions.

Contributions to Federal Thrift Savings Plan. If you are a federal employee, you can choose to make contributions from your salary to the Federal Thrift Savings Plan. Your contributions are not included in income for income tax purposes. However, your salary before the contributions are taken out is used

for purposes of figuring social security and Medicare taxes and benefits. Payments you later receive from the fund are taxable as a distribution from a qualified pension or annuity plan.

Employer's contributions to qualified plan. Generally, your employer's contributions to a qualified pension plan for you are not included in income at the time contributed. However, employer contributions that are made out of funds that would otherwise have been paid to you as salary, except that you entered into a salary reduction agreement with your employer (elective deferrals), are excluded from income up to a limit.

For 1997, you cannot set aside more than a total of \$9,500 for all elective deferrals. If you set aside more than \$9,500, the excess is included in your gross income that year.

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums*, later, under *Fringe Benefits*.

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for a tax-free rollover. To qualify, they must be rolled over (normally within 60 days after receipt) to another qualified plan or to an individual retirement account or annuity. If you elect to have an eligible rollover distribution paid directly to you (even if you plan to roll over the distribution), the payer must withhold part of the distribution for income tax. You can avoid withholding if you choose a direct transfer to another qualified retirement plan or individual retirement account or annuity. Your employer may be able to tell you how the amount you receive is taxed. Get Publication 575 for more information.

Employer's contributions to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. However, if your interest is subject to a substantial risk of forfeiture (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 when you receive it. When your interest is no longer subject to a substantial risk of forfeiture, you must include the value in your income.

Severance pay. Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract is income in the tax year you receive it and must be reported in gross income.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W-2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repay in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement given to you by the agency to which you make repayment to explain the difference between the wages on your return and the wages on your Forms W-2.

Employer-provided outplacement services. If you choose to accept a reduced amount of severance pay so that you can receive employer-provided outplacement services (such as training in resumé writing and interview techniques), you must include the unreduced amount of the severance pay in income.

Sick pay. Amounts you receive from your employer while you are sick or injured are part of your salary or wages. You must include in your income payments made by any of the following:

- 1) Your employer,
- 2) A welfare fund,
- 3) A state sickness or disability fund,
- 4) An association of employers or employees, or
- 5) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable. For more information, see *Other Sickness and Injury Benefits* under *Disability Income*, later.

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. You must also treat the payment 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 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 income in the year you use the right.

Work-training programs. If you are enrolled in a state or local work-training program under the Economic Opportunity Act of 1964, payments you receive as compensation for services are wages.

Restricted Property Received for Services

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 been **substantially vested** (discussed later). You can choose to include the value of the property in your income in the year it is transferred to you, as discussed later, rather than the year it is substantially vested. Until the property becomes substantially vested, it is owned by the person who makes the transfer to you, usually your employer. However, any income from the property, or

the right to use the property, is included in your income as wages in the year you receive the income or have the right to use the property.

You must include as compensation (in the year the restricted property becomes substantially vested) the fair market value of the property at that time, minus any amount you paid for the property.

Example. Your employer, the RST Corporation, sells you 100 shares of its stock at \$10 a share. At the time of the sale the fair market value of the stock is \$100 a share. Under the terms of the sale, the stock is under a substantial risk of forfeiture (that is, you could lose it) for a 5-year period. Because your stock is not substantially vested when it is transferred, you do not include any amount in your income in the year you buy it. At the end of the 5-year period, the fair market value of the stock is \$200 a share. You must include \$19,000 in your income [100 shares × (\$200 fair market value – \$10 you paid)]. Dividends paid by the RST Corporation on your 100 shares of stock are taxable to you as compensation during the period the stock can be forfeited.

Substantially vested. Property is substantially vested when:

- 1) It is transferable, or
- 2) It is not subject to a substantial risk of forfeiture (you do not have a good chance of losing it).

Transferable property. Property is transferable if you can sell, assign, or pledge your interest in the property to any person (other than the transferor), and if the person receiving your interest in the property is not required to give up the property, or its value, if the substantial risk of forfeiture occurs.

Substantial risk of forfeiture. A substantial risk of forfeiture exists if the rights in the property transferred depend on the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a certain condition related to the transfer.

Example. The Spin Corporation transfers to you as compensation for services 100 shares of its corporate stock for \$100 a share. Under the terms of the transfer, you must resell the stock to the corporation at \$100 a share if you leave your job for any reason within 3 years from the date of transfer. Because you must perform substantial services over a period of time and you must resell the stock to the corporation at \$100 a share regardless of its value if you do not perform the services, your rights to the stock are subject to a substantial risk of forfeiture.

Choice to include in income in year of transfer. You can choose to include the value of the property at the time of transfer (minus any amount you paid for the property) in your income in the year it is transferred rather than in the year it is substantially vested. If you make this choice, the substantial vesting rules do not apply and, generally, any later appreciation in value is not included in your compensation when the property becomes substantially vested.

You make the choice by filing a written statement with the Internal Revenue Service Center where you file your return. You must file this statement no later than 30 days after

the date the property was transferred. A copy of the statement must be attached to your tax return for the year the property was transferred. You also must give a copy of this statement to the person for whom you performed the services and, if someone other than you received the property, to that person.

You must sign the statement and indicate on it that you are making the choice under section 83(b) of the Internal Revenue Code. The statement must contain all of the following information:

- 1) Your name, address, and taxpayer identification number.
- 2) A description of each property for which you are making the choice.
- 3) The date or dates on which the property was transferred and the tax year for which you are making the choice.
- 4) The nature of any restrictions on the property.
- 5) The fair market value at the time of transfer (ignoring restrictions except those that will never lapse) of each property for which you are making the choice.
- 6) Any amount that you paid for the property.
- 7) A statement that you have provided copies to the appropriate persons.

To figure gain or loss when you sell the property, your basis is the amount you paid for it, plus the amount you included in income as compensation. If you forfeit the property after you have included its value in income, your loss is the amount you paid for the property minus any amount you realized on the forfeiture.



You cannot revoke the choice without the consent of the IRS. Consent will be given only if you were under a mistake of fact as to the underlying transaction.

Dividends received on restricted stock. Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in your income because it was not substantially vested. Your employer should include these payments on your Form W-2. If they are also reported on a Form 1099-DIV, *Dividends and Distributions*, you should list them on Schedule B (Form 1040), *Interest and Dividend Income*, with a statement that you have included them as wages. Do not include them in the total dividends received.

Dividends you receive on stock you chose to include in your income in the year transferred or dividends on substantially-vested stock are treated the same as any other dividends. If you receive both a Form 1099-DIV and a Form W-2 showing these dividends, do not include the dividends in your wages reported on line 7 of Form 1040. List the dividends on line 9 (Form 1040). Also list them on line 5, Part II of Schedule B (Form 1040), along with your other dividends (if the amount of dividends received from all sources is more than \$400). Attach a statement to your return explaining why the amount shown on line 7 of your return is different from the amount shown on your Form W-2.

Sale of property not substantially vested. These rules apply to the sale or other disposition of property that is not substantially vested and not included in your income in the year transferred.

If you sell or otherwise dispose of the property in an arm's-length transaction, include in your income the amount realized minus the amount you paid for the property. This should be included according to your method of accounting. If you exchange the property in an arm's-length transaction for other property that is not substantially vested, treat the new property as if it were substituted for the exchanged property.

If you sell the property in a transaction that is not at arm's length, report as compensation on your tax return for the year of sale the total of any money you received and the fair market value of any substantially vested property you received on the sale. In addition, you will have to report income when the original property becomes substantially vested. Figure this additional income as if you still held the original property. Include the fair market value in your income, minus the total of the amount you paid for the property and the amount included in your income from the earlier sale.

Example. In 1994, you pay your employer \$50 for a share of stock that has a fair market value of \$100 and is subject to forfeiture until 1997. In 1996, you sell the stock to your spouse for \$10 in a transaction not at arm's length. You have income of \$10 in 1996 from this transaction. In 1997, when the stock has a fair market value of \$120, it becomes substantially vested. You have additional income to be reported as wages in 1996 of \$60, figured as follows:

Fair market value of stock at time of substantial vesting	\$120
Minus: Amount paid for stock	\$50
Minus: Compensation previously included in income from sale to spouse	10 <u>–60</u>
Additional income	<u>\$60</u>

Inherited property. If you inherit property not substantially vested at the time of the decedent's death, any income you receive is considered income in respect of a decedent and is taxed according to the rules for restricted property received for services. For information about income in respect of a decedent, get Publication 559, *Survivors, Executors, and Administrators*.

Fringe Benefits

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation unless the benefits are specifically excluded by law or you pay fair market value for them. The value of the benefits is determined by valuation rules explained later in *Taxation of Certain Fringe Benefits*.

Generally, your employer determines the amount of your taxable fringe benefits and includes this amount on your Form W-2. For more information on how an employer determines taxable fringe benefits, see chapter 4 of Publication 535, *Business Expenses*.

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.

Contributions to Plan Providing Long-Term Care Benefits

Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Contributions to Medical Savings Accounts (MSAs)

Contributions by your employer to your medical savings account are not included in your income. This amount will, however, be reported in box 13 of Form W-2 with code R designating that the amounts are excludable from income. This amount must be reported on your tax return. See Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*.

Adoption Expenses

Beginning in 1997 through 2001, you may be able to exclude from gross income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. The amounts must be paid or the expenses must be incurred as part of an adoption assistance program.

See Publication 968, *Tax Benefits for Adoption*, for more information.

Group Life Insurance Premiums

Generally, the cost of up to \$50,000 of group-term life insurance coverage provided to you by your employer is not included in your income. However, you must include in income the cost of insurance that is more than the cost of \$50,000 of insurance reduced by any amount you pay towards the purchase of the insurance.

The amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 13 with code C. See *Your payment*, later.

Retired employees. If you are a retired employee, you generally will have to include in your income the cost of providing you with more than \$50,000 of insurance coverage. However, you may be able to exclude all of the payments.

Full exclusion. You can exclude from your income the entire cost of the insurance if you:

- 1) Retired by January 1, 1984, and
- 2) Were covered by the group-term life insurance plan when you retired.

You can also exclude the insurance cost if:

- 1) You were age 55 on or before January 1, 1984, and
- 2) The plan was maintained by the same employer for whom you worked during 1983, or by a successor employer.

Group-term life insurance. This insurance is term life insurance protection (insurance for a fixed period or 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.

Your payment. If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount your employer would otherwise include in your income. However, you cannot reduce the amount to include in your income by either:

- 1) Payments for coverage in a different tax year,
- 2) Payments for coverage through a cafeteria plan, unless the coverage is purchased with after-tax employee contributions, or
- 3) Payments not taxed to you because of the exceptions discussed later.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits minus the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

Accidental or other death benefits. Accidental or other death benefits from a policy that does not provide general death benefits (travel insurance, for example) are not included as group-term life insurance coverage.

Exceptions. You are not taxed on the cost of group-term life insurance if any of the following apply:

- 1) You are disabled and have ended your employment.
- 2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
- 3) The only beneficiary is a charitable organization to which contributions are deductible for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.

Entire cost taxed. You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

You are also taxed on the entire cost of the group-term life insurance coverage provided by your employer if you are a key employee and your employer's plan discriminates in favor of key employees.

Life insurance agents. Full-time life insurance agents who are considered employees for social security and Medicare tax withholding purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

More than \$50,000 from one employer. If you have only one employer and you were insured at any time during the tax year for more than \$50,000 under a group-term life insurance policy, your taxable income from this source is included as other compensation on the Form W-2 you receive.

More than \$50,000 from two or more employers. If two or more employers provide you group-term life insurance coverage totaling more than \$50,000, you must figure how much to include in your income. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage (figured to the nearest tenth), less \$50,000 of insurance, by the cost from the following table. You must prorate the cost from the table if less than a full month of coverage is involved.

COST PER \$1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	\$.08
30 through 34	.09
35 through 39	.11
40 through 44	.17
45 through 49	.29
50 through 54	.48
55 through 59	.75
60 through 64	1.17
65 through 69	2.10
70 and older	3.76

Example. You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is \$35,000 with Employer A and \$45,000 with Employer B. You pay premiums of \$50 a year under the Employer B group plan. You figure the amount to include in your income as follows:

Employer A coverage (in thousands)	.....	\$35
Employer B coverage (in thousands)	.....	+ 45
Total coverage (in thousands)	.....	\$80
Minus: Exclusion (in thousands)	.....	- 50
Excess amount (in thousands)	.....	\$30
Multiply by cost per \$1,000 per month, age 51 (from table)	.....	× .48
Cost of excess insurance for 1 month	.....	\$14.40
Multiply by number of full months coverage at this cost	.....	× 12
Cost of excess insurance for tax year	.....	\$172.80
Minus: Premiums you paid	.....	- 50.00
Cost to include in income as wages		\$122.80

Meals and Lodging

You do not include in your income the value of meals and lodging provided to you and your family by your employer at no charge if the following conditions are met.

- 1) The meals are:
 - a) Furnished on the business premises of your employer, and
 - b) Furnished for the convenience of your employer.
- 2) The lodging is:
 - a) Furnished on the business premises of your employer,
 - b) Furnished for the convenience of your employer, and
 - c) A condition of your employment (you must accept it in order to be

able to properly perform your duties).

Faculty lodging. If you are an employee of an educational institution or an academic health center (defined later) and you are provided with lodging that does not meet the three conditions above, you may not have to include in income the value of the lodging. However, the lodging must be qualified campus lodging (defined later), and you must pay an adequate rent (defined later).

Academic health center. This is an organization that meets the following conditions.

- 1) Its principal purpose or function is to provide medical or hospital care or medical education or research.
- 2) It receives payments for graduate medical education under the Social Security Act.
- 3) One of its principal purposes or functions is to provide and teach basic and clinical medical science and research using its own faculty.

Qualified campus lodging. Qualified campus lodging is lodging located on or near a campus of the educational institution or academic health center. It is lodging that is furnished for use as a home but that you do not have to accept as a condition of your employment to properly perform the duties of your job.

Adequate rent. The amount of rent you pay for the year for qualified campus lodging is considered adequate if it is at least equal to the smaller of:

- 1) 5% of the appraised value of the lodging, or
- 2) The average of rentals paid by individuals (other than employees or students) for comparable lodging held for rent by the educational institution.

If the amount you pay is less than the smaller of these amounts, you must include the difference in your income.

The lodging must be appraised by an independent appraiser and the appraisal must be reviewed on an annual basis.

Example. Carl Johnson, a sociology professor for State University, rents a home from the university that is qualified campus lodging. The house is appraised at \$100,000. The average rent paid for comparable university lodging by persons other than employees or students is \$7,000 a year. Carl pays an annual rent of \$5,500. Carl does not include in his income any rental value since the rent he pays equals at least 5% of the appraised value of the house ($5\% \times \$100,000 = \$5,000$). If Carl paid annual rent of only \$4,000, he would have to include \$1,000 in his income ($\$5,000 - \$4,000$).

Transportation

If your employer provides you with a qualified transportation fringe benefit, it can be excluded from your gross income, up to certain limits. A qualified transportation fringe benefit is:

- 1) Transportation in a commuter highway vehicle (such as a van) between your home and work place,
- 2) A transit pass, or

3) Qualified parking.

Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item which can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of \$65 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot be more than \$170 a month, regardless of its value.

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

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

- 1) For transporting employees between their homes and work place, and
- 2) On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

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

More information. For more information on fringe benefits, see chapter 4 of Publication 535, *Business Expenses*.

Other Fringe Benefits

Some other fringe benefits you may receive include the following items.

Executive health program. If an employer pays for a fitness program provided to one of its executives at an off-site resort hotel or athletic club, the value of the program is included in the executive's compensation.

Financial counseling fees. Financial counseling fees paid by a corporation for its executives are included in the executives' gross income and must be reported as part of wages. If the fees are for tax or investment counseling, they can be deducted by the executive as a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040).

Taxation of Certain Fringe Benefits

Fringe benefits you receive in connection with the performance of your services are included in your gross income as compensation unless

you pay fair market value for them or they are specifically excluded by law from your income. 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.

Recipient of fringe benefit. You are the recipient of a fringe benefit if you perform the services for which the fringe benefit is provided. You are considered to be the recipient even if it is given to another person, such as a member of your family. An example is a car your employer gives to your spouse for services you perform. The car is considered to have been provided to you and not to your spouse.

You do not have to be an employee of the provider to be a recipient of a fringe benefit. If you are a partner, director, or independent contractor, you can also be the recipient of a fringe benefit.

Provider of benefit. Your employer or another person for whom you perform services is the provider of a fringe benefit regardless of whether that person actually provides the fringe benefit to you. The provider can be a client or customer of an independent contractor.

Valuation of fringe benefits. The amount that you will have to include in your income is determined under the **general valuation rule** or under the **special valuation rules**.

General valuation rule. You must include in your gross income the amount by which the fair market value of the fringe benefit is more than the sum of:

- 1) The amount, if any, you paid for the benefit, and
- 2) The amount, if any, specifically excluded by law from your gross income.

If you pay fair market value for a fringe benefit, no amount is included in your gross income.

Fair market value. In general, the fair market value of a fringe benefit is determined by all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount you would have to pay a third party to buy or lease the particular fringe benefit. In determining the value of the fringe benefit do not consider:

- 1) Your perceived value of the benefit, or
- 2) The amount your employer paid for the benefit.

Employer-provided vehicles or flights. You determine the value of employer-provided vehicles and/or flights on employer-provided aircraft under the general valuation rule, unless you use the special valuation rules.

Employer-provided vehicles. In general, the value of an employer-provided vehicle is the amount you would have to pay a third party to lease the same or a similar vehicle in the same geographic area where you use the vehicle. The value cannot be determined by multiplying the cents-per-mile rate times the number of miles driven unless you prove the vehicle could have been leased on a cents-per-mile basis. A comparable lease term would be the amount of time the vehicle is available for your use, such as a 1-year period.



The value of certain employer-provided transportation can be excluded from gross income up to certain limits. See the discussion on Transportation, earlier.

Flights on employer-provided aircraft.

Under the general valuation rules, if your flight on an employer-provided piloted aircraft is primarily personal and you control the use of the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.

If there is more than one employee on the flight, the cost to charter the aircraft must be divided among those employees. The division must be based on all the facts, including which employee or employees control the use of the aircraft.

Special valuation rules. You may be able to use special valuation rules instead of the general valuation rule for certain commonly provided benefits. Your employer has the option to use any of the special valuation rules. You generally can use a special valuation rule only if your employer uses the rule, and you cannot use another special rule to value that benefit. You can always use the general valuation rule discussed earlier, based on facts and circumstances, even if the employer uses a special rule. The special valuation rules are:

- 1) Automobile lease rule.
- 2) Vehicle cents-per-mile rule.
- 3) Commuting rule.
- 4) Employer-operated-eating-facility rule.

For more information on these rules, see chapter 4 of Publication 535.

For information on the non-commercial flight and commercial flight valuation rules, see sections 1.61-21(g) and 1.61-21(h) of the Income Tax Regulations.

How To Report Fringe Benefits

The amount of your taxable fringe benefits is shown on your Form W-2.

Different valuation by employer and employee. You and your employer can use a different value for an employer-provided automobile. The following combinations of methods can be used to figure the value.

- 1) You and your employer can both use the same special valuation rule.
- 2) Your employer can use a special valuation rule and you can use the general valuation rule based on facts and circumstances.
- 3) You and your employer can both use the general valuation rule.

If both you and your employer use the same special valuation rule, you must include in your gross income the amount your employer determines under the special rule less any amount you repaid your employer and any other amount you may have excluded from income by law.

Employer-provided car. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable noncash fringe benefit.

Your employer must determine the actual value of this fringe benefit to include in your income.



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

Accounting period. You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable noncash fringe benefits by using either of the following rules:

- 1) The general rule: value the benefit for a full calendar year (January 1 – December 31), or
- 2) The special accounting period rule: treat the value of benefits provided during the last 2 months of the calendar year (or any shorter period) as paid during the following calendar year. For example, each year your employer includes in income the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

You must use the same accounting period to claim an employee business deduction (for use of a car, for example) that you use to report the benefit. Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

Form W-2. Your employer reports your taxable fringe benefits in box 1 (Wages, tips, other compensation) of Form W-2. The total value of your fringe benefits should also be 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.

Disability Income

Generally, if you retire on disability you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, get Publication 524, *Credit for the Elderly or the Disabled*.

Disability Pensions

Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension.

Cost paid by you. If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income.

Cafeteria plans. Generally, if you pay the premiums of a health or accident insurance plan through a cafeteria plan, and the amount of the premiums was not included in your income, you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums and any benefits you receive are not taxable.

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your gross 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 report them as disability income. The payments are taxable and should be reported as a pension or annuity.

For more information on pensions, get Publication 575.

How to report. If you retired on disability, payments you receive are taxed as wages until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. For more information on pensions, get Publication 575.

Military and Government Disability Pensions

Generally, you must report disability pensions as income. But certain military and government disability pensions are not taxable.

You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in the:

- 1) Armed Forces of any country.
- 2) National Oceanic and Atmospheric Administration.
- 3) Public Health Service.
- 4) Foreign Service.

Do not include the disability payments in your income if any of the following apply.

- 1) You were entitled to receive a disability payment before September 25, 1975.
- 2) You were a member of a government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
- 3) You receive disability payments for a "combat-related injury."
- 4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it.

Combat-related injury. A combat-related injury is a personal injury or sickness that:

- 1) Results directly from armed conflict,
- 2) Takes place while you are engaged in extra-hazardous service,
- 3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
- 4) Is caused by an instrumentality of war.

Disability based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But if it is a result of active service in one of the organizations listed 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.

Terrorist attack. You do not include in your income disability payments you receive for injuries resulting directly from a violent attack that occurs while you are a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

VA disability benefits. Disability benefits you receive from the Department of Veterans Affairs (VA) are not included in your gross income. If you are a military retiree and you receive disability benefits from other than the VA, do not include in your income the amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, and file a waiver for reduction of your retirement pay in an amount equal to the VA disability compensation, you do not include in your income for the retroactive period (subject to the statute of limitations) the part of your retirement pay you would have been entitled to receive from the VA during that period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, you do not include 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 non-disability severance payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

Other Sickness and Injury Benefits

In addition to disability pensions and annuities, you may receive other payments for sickness or injury. *Table 1* gives a general overview of some of these payments.

Railroad sick pay. If you receive sick pay under the Railroad Unemployment Insurance Act, these payments are taxable and you must include them in your income. However, you do not include them in your income if they are for an on-the-job injury.

 **Table 1. Are Your Sickness and Injury Benefits Taxable?**

<i>This table is intended as a general overview. Additional rules may apply depending on your situation. For more information about your benefits, see "Other Sickness and Injury Benefits."</i>	
Type of Benefit	General Rule
Workers' Compensation	<u>Not taxable</u> if paid under a workers' compensation act or a statute in the nature of a workers' compensation act <u>and</u> paid due to a work related sickness or injury. However, payments received after returning to work are <u>taxable</u> .
Federal Employees' Compensation Act (FECA)	<u>Not taxable</u> if paid because of personal injury or sickness. However, payments received as "continuation of pay" for up to 45 days while a claim is being decided and pay received for sick leave while a claim is being processed are <u>taxable</u> .
Compensatory Damages	<u>Not taxable</u> if received for injury or sickness.
Accident or Health Insurance Benefits	<u>Not taxable</u> if you paid the insurance premiums.
Disability Benefits	<u>Not taxable</u> if received for loss of income or earning capacity due to an injury covered by a "no-fault" automobile policy.
Compensation for Permanent Loss or Loss of Use of a Part or Function of Your Body, or for Permanent Disfigurement	<u>Not taxable</u> if paid due to the injury. The payments must be figured without regard to any period of absence from work.
Reimbursements for Medical Care	<u>Not taxable</u> —but the reimbursement may reduce your medical expense deduction.

Workers' compensation. Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivor(s). The exemption from tax, however, does not apply to retirement 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.

Note. If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

For a discussion of the taxability of these benefits, see *Social security and equivalent railroad retirement benefits* under *Miscellaneous Taxable Income*, later.

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.

Disability pension. Part of your disability pension may be workers' compensation. That part is exempt from tax. The rest of your pension, based on years of service, is taxable as pension or annuity income. If you die, the part of your survivors' benefit that is a con-

tinuation of the workers' compensation is exempt from tax.

Black lung benefit payments. These payments are similar to workers' compensation and generally are not taxable.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as "continuation of pay" for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

You can deduct the amount you spend to "buy back" sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you 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 injury or illness are not taxable. These include:

- Compensatory damages you receive for physical injury or physical illness, whether paid in a lump sum or in periodic payments;

- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your gross income;
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a "no-fault" car insurance policy; and
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even though your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see *Recoveries*, later.

Stock Options

If you receive a nonstatutory option to buy stock or other property as payment for your services, you will usually have income when you receive the option or when you exercise (use) the option. However, if your option is a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan), special rules generally delay the tax until you sell or exchange your shares of stock. Your employer can tell you which kind of option you hold.

Nonstatutory Stock Options

If you are granted a nonstatutory stock option, the amount of income to include and the time to include it depend on whether the fair market value of the option can be readily determined. The fair market value of an option can be readily determined if it is actively traded on an established market.

The fair market value of an option that is not traded on an established market can be readily determined only if all of the following conditions exist:

- 1) You can transfer the option,
- 2) You can exercise the option immediately in full,
- 3) The option or the property subject to the option is not subject to any condition or restriction (other than a condition to secure payment of the purchase price), that has a significant effect on the fair market value of the option, and
- 4) The fair market value of the option privilege can be readily determined.

The option privilege for an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option without risking any capital. For example, if during the exercise period, the fair market value of stock subject to an option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the stock at its higher value. The option privilege for an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option.

If you receive a nonstatutory stock option that has a readily determined fair market value at the time it is granted to you, the option is treated like other property received as compensation. See *Restricted Property Received for Services*, earlier, for rules on how much income to include and when to include it. However, you cannot choose to include any part of the value of a nonstatutory stock option in your income in the year of the transfer.

If the fair market value of the option is not readily determined at the time it is granted to you (even if it is determined later), you do not have income until you transfer or exercise the option. When you exercise this kind of option, the amount to include in your income is the difference between the amount you pay for the property and its fair market value when it becomes substantially vested.

Your basis in the property you acquire under the option is the amount you pay for it plus any amount you must include in your gross income under this rule. For more information on restricted property, see *Restricted Property Received for Services*, earlier.

If you transfer this kind of option in an arm's-length transaction, you must include in your income the money or other property you received for the transfer, as if you had exercised the option.

Statutory Stock Options

There are two kinds of statutory stock options:

- 1) Incentive stock options, and
- 2) Options granted under employee stock purchase plans.

In each case, you must be an employee of the company granting the option, or a related company, at all times beginning with the date of the grant of the option, until 3 months before you exercise the option (for an incentive stock option, 1 year before if you are disabled). Also, the option must be nontransferable except at death. If you do not meet the employment requirements, or you receive a transferable option, your option is a nonstatutory stock option. See *Nonstatutory Stock Options*, earlier.

Incentive stock options. If your option is an incentive stock option, generally you do not include any amount in your gross income either at the time the option is granted or at the time you use it. You report income or loss when you sell the stock you purchased by using the option. If you exercise an incentive stock option, your employer will give you a statement containing the required information.

Tax treatment. You generally treat income or loss from the sale of the stock as capital gain or loss. However, if you do not meet the holding period tests explained next, you may have ordinary income up to the amount of the gain.

Holding period. If you hold the stock you buy under the option for more than 1 year after the stock is transferred to you, and more than 2 years after the option was granted to you, gain or loss from the sale of the stock is generally a capital gain or loss. The difference between the amount you pay for the stock (the option price) and the amount you receive when you sell it is a capital gain or loss reported on Schedule D (Form 1040).

If you do not meet these holding period tests, you have compensation in the year you sell the stock. That income is the amount by which the stock's fair market value, as of the

date you exercise the option, is more than the option price. However, this amount cannot be more than your gain on the sale. If your gain is more than the amount you report as compensation, the rest is a capital gain reported on Schedule D (Form 1040). If you sell the stock for less than the option price, your loss is a capital loss.

Example. Your employer, X Corporation, granted you an incentive stock option on March 11, 1995, to buy 100 shares of X Corporation stock at \$10 a share, its fair market value at the time. You exercised the option on January 19, 1996, when the stock was selling on the open market for \$12 a share. On January 25, 1997, you sold the stock for \$15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 1997, you must report the difference between the option price (\$10) and the value of the stock when you exercised the option (\$12) as compensation. The rest of your gain is capital gain figured as follows:

Selling price (\$15 × 100 shares)	\$1,500
Purchase price (\$10 × 100 shares)	-1,000
Gain	\$500
Amount reported as compensation [(\$12 × 100 shares) - \$1,000]	-200
Amount reported as capital gain	\$300

Alternative minimum tax. When your rights in the stock are transferable and no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price.

See *Restricted Property Received for Services*, earlier, for more information.

Employee stock purchase plans. If your stock option is granted under an employee stock purchase plan, you do not include any amount in your gross income as a result of the grant or exercise of your option. You report income or loss when you sell the stock that you purchased by exercising the option.

Tax treatment. You generally treat gain or loss from the sale of the stock as capital gain or loss. However, you may have ordinary income if:

- 1) The option price of the stock was below the stock's fair market value at the time the option was granted, or
- 2) You did not meet the holding period requirement, explained next.

Holding period. You must hold the stock for more than 2 years from the time the stock option is granted to you and for more than 1 year from when the stock was transferred to you.

If you meet the holding period requirement and the option price was below the fair market value of the stock at the time the option was granted, you report the difference as ordinary income (wages) when you sell the stock. However, this ordinary income cannot be more than your gain on the sale. If your gain is more than the amount you report as ordinary income, the rest is a capital gain reported on Schedule D (Form 1040). If you sell the stock for less than the option price, your loss is a capital loss.

Example. Your employer, Y Corporation, granted you an option to buy 100 shares of stock of Y Corporation for \$20 a share at a

time when the stock had a value of \$22 a share. Eighteen months later, when the value of the stock was \$23 a share, you exercised the option, and 14 months after that you sold your stock for \$30 a share. In the year of sale, you must report as ordinary income (wages) the difference between the option price (\$20) and the value at the time the option was granted (\$22). The rest of your gain (\$8) is capital gain.

Selling price (\$30 × 100 shares)	\$3,000
Purchase price (option price)	
(\$20 × 100 shares)	<u>-2,000</u>
Gain	\$1,000
Amount reported as ordinary income (wages)	
[((\$22 × 100 shares) - \$2,000)]	<u>-200</u>
Amount reported as capital gain	<u>\$800</u>

Holding period requirement not met. If you do not meet the holding period requirement, you must report as compensation the difference between the option price and the fair market value of the stock when you exercised the option.

This income is reported on line 7, Form 1040 as compensation, even if it is more than your total gain. Increase your basis in the stock by the amount you report as compensation. The difference between your increased basis and the selling price is a capital gain or loss reported on Schedule D (Form 1040).

In the previous example, if you had not held the stock long enough, your ordinary income (wages) would be \$300 and your capital gain would be \$700, figured as follows:

Selling price (\$30 × 100 shares)	\$3,000
Purchase price (option price)	
(\$20 × 100 shares)	<u>-2,000</u>
Gain	\$1,000
Amount reported as ordinary income (wages)	
[((\$23 × 100 shares) - \$2,000)]	<u>-300</u>
Amount reported as capital gain	<u>\$700</u>

Special Rules for Certain Employees

This part of the publication deals with special rules for people in certain types of employment: members of the clergy, people working for foreign employers, military personnel, veterans, and ACTION and Peace Corps 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. Get Publication 526, *Charitable Contributions*. Also, see *Members of religious orders*, later.

Housing

Special rules for housing apply to members of the clergy.

Rental value of a home. You do not include in your income the rental value of a home (or utility expenses) provided to you as part of your pay for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

Housing allowance. A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home you are provided. The amount of the housing allowance you can exclude from your income cannot be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated. The amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

Homeowner. If you own your home or are buying it, you can exclude your housing allowance from your income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. The fair rental value of a home includes the fair rental value of the furnishings in it.

Interest and taxes on your home. You can deduct on Schedule A (Form 1040) the qualified mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the rental exclusion. However, if you perform services as a teacher or administrator on the faculty of a nonchurch college, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.



TIP If you live in qualified campus lodging as an employee of an educational institution or academic health center, all or part of the value of that housing may be nontaxable. See Faculty lodging, discussed earlier under Fringe Benefits.

If you serve as a minister of music or minister of education, or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church (even though you are commissioned as a "minister of the gospel"), you cannot exclude from your income a housing allowance or the value of a home provided to you.

Theological students. You cannot exclude a housing allowance from your income if you are a theological student serving a required internship as an assistant pastor unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. If you are an ordained minister and are providing evangelistic services, you can exclude amounts received from out-of-town churches that are designated as a housing allowance, provided you actually use them to maintain your permanent home.

Jewish cantors. If you are a Jewish cantor, you can exclude a rental allowance from gross income although you are not ordained, provided you have a bona fide commission and are employed by a congregation on a full-time basis to perform substantially all the religious functions of the Jewish faith.

Retired members of the clergy. The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses directly related to providing a home. These amounts are also not included in net earnings from self-employment.

The general convention of a national religious denomination can designate a housing allowance for retired ministers that can be excluded from income. This applies if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

Pension. A pension or retirement pay for a member of the clergy is usually treated as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A.

Members of religious orders. If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform which you renounce and turn over to the order may or may not be included in your income.

Services performed for the order. If you are performing the services as an agent of the order in the exercise of duties required by the order, you do not include in your income the amounts turned over to the order.

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as

an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your gross income.

Services performed outside the order.

If you are directed to work outside the order, the work will not constitute the exercise of duties required by the order unless the services you perform meet both of the following requirements:

- 1) The services are the kind that are ordinarily the duties of members of the order, and
- 2) The services are part of the duties that must be exercised for, or on behalf of, the religious order as its agent.

If the legal relationship of employer and employee exists between you and a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your gross income, even if you have taken a vow of poverty.

Example 1. 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 schoolteacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his gross income.

Example 2. Gene Dennis is a member of a religious order who, as a condition of membership, has taken vows of poverty and obedience. All claims to his earnings are renounced. Gene received permission from the order to establish a private practice as a psychologist and counsels members of religious orders as well as nonmembers. Although the order reviews Gene's budget annually, Gene controls not only the details of his practice but also the means by which his work as a psychologist is accomplished.

Gene's private practice as a psychologist does not make him an agent of the religious order. The psychology services provided by Gene are not the type of services that are provided by the order. The income Gene earns as a psychologist is earned in his individual capacity. Gene must include in his income the earnings from his private practice.

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 employee taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

Alien status. If you are an alien who works for a foreign government and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, you generally are not entitled to exempt your salary from tax. Generally, any salary you receive after the date you file the waiver is taxable. However, you may still be entitled to exempt it under a treaty or agreement. See Publication 519, *U.S. Tax Guide for Aliens*, for more information about treaties.

Non-wage income. This exemption applies only to employees' wages, salaries, and fees. Pensions and other income do not qualify for this exemption.

Employment abroad. For information on income earned abroad, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more information on military allowances and benefits, get Publication 3, *Armed Forces Tax Guide*.

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your gross income as a pension on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Do not include in your income the amount of reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For a more detailed discussion of survivor annuities, get Publication 575.

Disability. If you are retired on disability, see *Military and Government Disability Pensions* under *Disability Income*, earlier.

Veterans

Veterans' benefits generally are not taxable.

Nontaxable Income

Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs (VA), are not included in gross income. The following amounts paid to veterans or their families are not taxable:

- 1) Education, training, or subsistence allowances.
- 2) Disability compensation and pension payments for disabilities.
- 3) Grants for homes designed for wheelchair living.
- 4) Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- 5) Veterans' pensions paid either to veterans or to their families.
- 6) Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- 7) Interest on insurance dividends you leave on deposit with the VA.

Taxable Income

Certain amounts paid by the VA are taxable.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are included as income other than wages. These payments are reported on line 21 of Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some allowances you receive are taxable and others are exempt from tax.

Taxable allowances. Any taxable allowances you receive must be included in your income and reported as wages. These include:

- 1) Cash allowances received during training.
- 2) Allowances paid to your spouse and minor children while you are training in the United States.
- 3) The part of living allowances designated by the President under the Peace Corps Act as basic compensation.
- 4) Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recre-

ation, transportation, and other miscellaneous expenses.

- 5) Leave allowances.
- 6) Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets \$175 a month during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

ACTION

ACTION participants perform services in antipoverty programs and older American volunteer programs. Some amounts these participants receive are taxable and others are exempt from tax.

VISTA. If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

University Year for Action program. If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in your income as wages.

Older American programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs:

- Retired Senior Volunteer Program (RSVP),
- Foster Grandparent Program, and
- Senior Companion Program.

Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under any of the following volunteer programs, you do not include these amounts in gross income:

- Service Corps of Retired Executives (SCORE), and
- Active Corps of Executives (ACE).

Volunteer tax counseling. You do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

Miscellaneous Taxable Income

You can receive taxable income from various sources. For example, income is treated as received from transactions, such as the cancellation of a debt. Under *Recoveries* is a discussion of when to include in your income

amounts you receive that you deducted in an earlier year, such as a state income tax refund.

The following brief discussions of numerous income items are arranged in alphabetical order. Those that are discussed in greater detail in another publication include a reference to that publication. These discussions are followed by in-depth discussions of other taxable income items as shown in the Table of Contents.



When you report miscellaneous taxable income on line 21 of Form 1040, write a brief description of the income on the dotted line next to line 21.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040). See *Not-for-Profit Activities* in chapter 1 of Publication 535, *Business Expenses*, for information on whether an activity is considered carried on for a profit.

Alaska Permanent Fund dividend income. If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividend), you should report this amount on line 21 of Form 1040. The state of Alaska sends each recipient a document that shows this amount with the check. The amount is also reported to IRS.



If you otherwise qualify to use Form 1040A or 1040EZ, you can report the Alaska Permanent Fund dividend on line 12 of Form 1040A or line 3 of Form 1040EZ. See your form instructions.

Alimony. Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive from your former spouse for child support are not income to you. For complete information, get Publication 504, *Divorced or Separated Individuals*.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, get Publication 463, *Travel, Entertainment, Gift, and Car Expenses*. If you are reimbursed for moving expenses, get Publication 521, *Moving Expenses*.

Below-market loans. A below-market loan is a loan on which no interest is charged or, if it is charged, it is at a rate below the applicable federal rate. If you make a below-market loan, you must include the forgone interest (at the federal rate) from the loan as interest income on your return. These loans are considered a transaction in which you, the lender, are treated as having made:

- 1) A loan to the borrower in exchange for a note which requires the payment of interest at the applicable federal rate, and
- 2) An additional payment to the borrower, which the borrower transfers back to you as interest.

Depending on the transaction, the additional payment to the borrower is treated as a:

- 1) Gift,
- 2) Dividend,
- 3) Contribution to capital,
- 4) Payment of compensation, or
- 5) Another type of payment.

The borrower may have to report this payment as income, depending on its classification. For more information on below-market loans, see chapter 1 of Publication 550.

Canceled sales contract. If you sell property (such as land or a residence) under a contract, but the contract is canceled and you return the buyer's money in the same tax year as the original sale, you have no income from the sale. If the contract is canceled and you return the buyer's money in a later tax year, you must include your gain in your income for the year of the sale. When you return the money and take back the property in the later year, you treat the transaction as a purchase that gives you a new basis in the property equal to the funds you return to the buyer. See chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*, for more information.

Special rules apply to the reacquisition of real property where a secured indebtedness (mortgage) to the original seller is involved. For further information, see *Repossession* in Publication 537, *Installment Sales*.

Constructively received income. You are generally taxed on income that is available to you, regardless of whether it is actually in your possession.

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 received the income and paid it to the third party.

Agent receives your income. Income received by an agent for you is income you constructively received in the year the agent received it. If you agree by contract that a third party is to receive income for you, you must include the amount in gross income when the third party receives it.

Example 1. You and your employer agree that part of your salary is to be paid directly to your former spouse. You must include that amount in gross income when your former spouse receives it.

Example 2. You assign your "lifetime services" to a trust. By agreement, your employer pays the trust a monthly fee for your services equal to what otherwise would be your gross monthly salary. You continue to do the same work for your employer. You must include in your income as wages the amounts your employer pays to the trust.

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

For example, if the postal service tries to deliver a check to you on the last day of the tax year but you are not at home to receive it, you must include the amount in your income for that tax year. If the check was mailed so that it could not possibly reach you

until after the end of the tax year, and you could not otherwise get the funds before the end of the year, you include the amount in your income for the next tax year.

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

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

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. See *Punitive damages*, later.
- 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. If emotional distress is due to physical injuries or physical sickness, the damages you receive for medical care due to that emotional distress are not taxable. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Punitive damages. Punitive damages generally are taxable. It does not matter if they relate to a physical injury or physical sickness. This rule does not create any inference about punitive damages under prior law.

You can exclude from income punitive damages awarded in a civil action if the following conditions are met:

- 1) It is a wrongful death action, and
- 2) Applicable state law provided, or has been determined by a court of competent jurisdiction to provide, that only punitive damages can be awarded in such an action. The state law must have been in effect on September 13, 1995, and the court decision must have been issued on or before that date.

Pre-existing agreement. If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued on or before) September 13,

1995, you do not have to include in income any of those damages received on account of personal injuries or sickness.

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 receive during the year that is more than the amount of the premiums you paid during the year.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and your share of the income is reported to you on Schedule K-1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income whether or not you actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

- 1) All income that is required to be distributed to you, whether or not it is actually distributed, plus
- 2) All other amounts actually paid or credited to you,

to the extent of your share of distributable net income.

How to report estate and trust income. Each item of income is treated the same for you as for the estate or trust. For example, if dividend income is distributed to you from a trust, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse. The grantor is the one who transferred property to the trust.

Generally, 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 gross income. Examples of these fees are amounts you receive for services you perform as:

- 1) A corporate director.
- 2) An executor or administrator of an estate.
- 3) A notary public.
- 4) An election precinct official.

Corporate director. If you received (or should have received) a Form W-2 showing corporate director fees, report these fees on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Otherwise, report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040) as self-employment income.

Executor or administrator of an estate. If these payments total \$600 or more for the year, you may receive a Form 1099-MISC. Report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040) as self-employment income. **Exception:** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), do not include these amounts on Schedule C or Schedule C-EZ. Report them on line 21 of Form 1040.

Notary public. Report payments for these services on Schedule C (Form 1040) or Schedule C-EZ (Form 1040). These payments are not subject to self-employment tax.

Election precinct official. You should receive a Form W-2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Free tour. If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the tour on line 21 of Form 1040 or on Schedule C or Schedule C-EZ (Form 1040). You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request.

Gambling winnings. You must include your gambling winnings in your 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.

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, you must include in your gross income the annual payments and any amount you receive designated as "interest" on the unpaid installments.

Form W-2G. You may have received a Form W-2G showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 54 of Form 1040.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.

 **CAUTION** If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain.

However, if you sell items from your collection at a loss, you cannot deduct a net loss.

Illegal income. Illegal income, such as stolen or embezzled funds, must be included in your gross income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Jury duty. Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to income. Include the amount you repay your employer on line 31 of Form 1040. Write "Jury pay" and the amount on the dotted line next to line 31.

Kickbacks. You must include in your income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040), kickbacks, side commissions, push money, or similar payments you receive.

Example. You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Note received for services. If your employer gives you a 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, the proportionate part of each payment is a recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

If your employer gives you an unsecured note as payment for your services, payments on the note that are credited toward the principal amount of the note are compensation income when you receive them.

Prepaid income. Prepaid income is generally included in your gross income in the year you receive it. Prepaid income includes amounts such as rents or interest received in advance and compensation for future services.

However, if you use an accrual method of accounting, you can defer prepaid income you receive for services to be performed before the end of the next tax year. In this case, you can include the payment in your gross income as you earn it by performing the services.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a \$50 prize in a photography contest, you must report this income on line 21

of Form 1040. If you refuse to accept a prize, do not include its value in your income.

Employee cash awards or bonuses.

Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain employee awards can be excluded from income. See *Employee achievement awards* under *Income Not Taxed*, later.

Goods or services. Prizes and awards in goods or services must be included in your income at their fair market value.

If you are a salesperson and receive "prize points" redeemable for merchandise, which are awarded by a distributor to employees of dealers, you must include their fair market value in your income. The "prize points" are taxable in the year they are paid or made available to you, rather than in the year you redeem them for merchandise.

Pulitzer, Nobel, and other prizes. If you were awarded a Pulitzer, Nobel, or other prize in recognition of past accomplishments (in religious, charitable, scientific, artistic, educational, literary, or civic fields), you do not include this prize in your income if you meet **all** of the following requirements.

- 1) You were selected without any action on your part to enter the contest or proceeding.
- 2) You are not required to perform substantial future services as a condition for receiving the prize or award.
- 3) The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you. The following conditions apply to the transfer:
 - a) You cannot use the prize or award before it is transferred.
 - b) You should provide the designation before the prize or award is presented to prevent a disqualifying use. The designation should contain:
 - i) The purpose of the designation by making a reference to section 74(b)(3) of the Internal Revenue Code.
 - ii) A description of the prize or award.
 - iii) The name and address of the organization to receive the prize or award.
 - iv) Your name, address, and taxpayer identification number.
 - v) Your signature and the date signed.
 - c) In the case of an unexpected presentation, you must return the prize or award before using it (or spending, depositing, investing it, etc., in the case of money) and then prepare the statement as described in (b).
 - d) After the transfer, you should receive from the payer a written response stating when and to whom the designated amounts were transferred.

These rules do not apply to scholarships and fellowship awards. For information, see

Publication 520, *Scholarships and Fellowships*.

Railroad retirement annuities. If you received:

- 1) Tier 1 railroad retirement benefits that are more than the "social security equivalent benefit,"
- 2) Tier 2 benefits, or
- 3) Vested dual benefits,

these payments are treated as pension or annuity income and are taxable under the rules explained in Publication 575.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain that you report on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Social security and equivalent railroad retirement benefits. Social security or equivalent railroad retirement benefits, if taxable, must be included in the income of the person who has the legal right to receive the benefits.

Social security benefits include any monthly benefit under Title II of the Social Security Act or the part of a tier I railroad retirement benefit treated as a social security benefit. Social security benefits **do not** include any supplemental security income (SSI) payments.

Joint return. If you are married and file a joint return, you and your spouse must combine your incomes and your social security and equivalent railroad retirement benefits when figuring if any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours when figuring if any of your benefits are taxable.

Form SSA-1099. If you received social security benefits during the year, you will receive Form SSA-1099, *Social Security Benefit Statement*. An IRS Notice 703 will be enclosed with your Form SSA-1099. This notice includes a worksheet you can use to figure whether any of your benefits are taxable.

For an explanation of the information found on your Form SSA-1099, get Publication 915.

Form RRB-1099. If you received equivalent railroad retirement or special guaranty benefits during the year, you will receive Form RRB-1099, *Payments by the Railroad Retirement Board*. For an explanation of the information found on your Form RRB-1099, get Publication 915.

If you received other railroad retirement benefits, get Publication 575 for information on how these benefits are taxed.

Lump-sum payment. If you received a lump-sum benefit payment during the year that is for one or more earlier years, use the worksheets in Publication 915 to determine the amount, if any, that is taxable.

Taxable amount. Use the worksheet in the Form 1040 or Form 1040A instruction package to determine the amount of your benefits to include in your income. Publication 915 also has worksheets you can use. However, you **must** use the worksheets in

Publication 915 if you exclude interest from U.S. Savings Bonds issued after 1989, or if you take the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from U.S. possessions, or the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

Benefits may affect your IRA deduction. You must use the special worksheets in Appendix B of Publication 590 to figure your taxable benefits and your IRA deduction if all of the following conditions apply.

- 1) You receive social security or equivalent railroad retirement benefits,
- 2) You have taxable compensation,
- 3) You contribute to your IRA, and
- 4) You or your spouse is covered by a retirement plan at work.

How to report. If any of your benefits are taxable, you must use either Form 1040 or Form 1040A to report the taxable part. You cannot use Form 1040EZ. Report your net benefits (the amount in box 5 of your Forms SSA-1099 and RRB-1099) on line 20a of Form 1040, or line 13a of Form 1040A. Report the taxable part (from the last line of the worksheet) on line 20b of Form 1040, or on line 13b of Form 1040A.

State tuition programs. Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. Previously, the tax treatment of these programs was not clearly defined.

A qualified state tuition program is one that is established and maintained by a state or agency and that:

- 1) Allows a person to:
 - a) Buy tuition credits or certificates for a designated beneficiary who would then be entitled to a waiver or payment of qualified higher educational expenses, or
 - b) Make contributions to an account that is set up to meet the qualified higher educational expenses of a designated beneficiary of the account,
- 2) Requires all purchases or contributions to be made only in cash,
- 3) Prohibits the contributor and the beneficiary from directing the amount invested, and
- 4) Allows a change of beneficiary to be made only between members of the same family.

For more information on a specific program, contact the state or agency that established and maintains it.

Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ.

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your unemployment compen-

sation. To make this choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 15% of your payment.



If you do not choose to have tax withheld from your unemployment compensation, you may be liable for estimated tax. For more information on estimated tax, get Publication 505.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes:

- 1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- 2) Unemployment insurance benefits.
- 3) Railroad unemployment compensation benefits.
- 4) Disability payments from a government program paid as a **substitute** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness **are not** unemployment compensation.)
- 5) Trade readjustment allowances under the Trade Act of 1974.
- 6) Benefits under the Airline Deregulation Act of 1978.
- 7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Supplemental unemployment benefits. Benefits received from a company-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages subject to income tax withholding but not subject to social security, Medicare, or federal unemployment taxes. Report these payments on line 7 of Form 1040 or Form 1040A.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income. Include the repayment on line 31 of Form 1040, and put "Sub-pay TRA" and the amount on the dotted line next to line 31. 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 information on this, see the discussion on *Repayments*, later.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

State employees. Payments can be made by a state to its employees who are not covered by the state's unemployment compensation law. If the payments are similar to benefits under that state law, they are fully taxable. Report these payments on line 21 of Form 1040.

Fraud. Fraudulently obtained unemployment compensation is fully taxable. Report it on line 21 of Form 1040.

Repayment of unemployment compensation benefits. If you repaid in 1997 unemployment compensation benefits you received in 1997, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ. Also, enter "Repaid" and the amount you repaid on the dotted line next to line 19, line 12, or line 3. If, in 1997, you repaid unemployment compensation that you included in your gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. See *Repayments*, later.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your gross income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize deductions on Schedule A (Form 1040). For more information, get Publication 529, *Miscellaneous Deductions*.

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.

Reimbursed union convention expenses. If you are a delegate of your local union chapter and you attend the annual convention of the international union, do not include in your income amounts you receive from the international union to reimburse you for expenses of traveling away from home to attend the convention. You cannot deduct the reimbursed expenses, even if you are reimbursed in a later year. If you are reimbursed for lost salary, you must include that reimbursement in your income.

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 or Schedule C-EZ (Form 1040). But if the barter involves exchange of some-

thing other than services, such as in Example 4 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 a self-employed accountant. You and a house painter are members of a barter club. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services you provided, the house painter painted your home. You must report as your income on Schedule C or Schedule C-EZ (Form 1040) the fair market value of the house painting services you received. The house painter must include in income the fair market value of the accounting services you provided.

Example 3. 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 or 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 4. 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 (Form 1040) the fair market value of the artwork, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

Form 1099-B from barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099-B or a similar statement from the barter exchange. You should receive the statement by January 31, 1998, and it should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also receive a copy of Form 1099-B.

Backup withholding. The income you receive from bartering is generally not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income.

Under backup withholding, the barter exchange must withhold, as income tax, 31% of the income if:

- 1) You do not give the barter exchange your taxpayer identification number (generally a social security number or an employer identification number), or
- 2) The IRS notifies the barter exchange that you gave it an incorrect identification number.

If you join a barter exchange, you must certify under penalties of perjury that your taxpayer identification number is correct and that you are not subject to backup withholding. If you do not make this certification, backup withholding may begin immediately. The barter exchange will give you a Form W-9, *Request for Taxpayer Identification Number and Certification*, or a similar form, for you to make this certification.



If tax is withheld from your barter income, the barter exchange will report the amount of tax withheld on Form 1099-B, or similar statement.

Canceled Debts

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If you are not self-employed, report the amount on line 21 of Form 1040. If you are self-employed, report the amount on Schedule C or C-EZ (Form 1040) if you are a sole proprietor or on Schedule F (Form 1040) if you are a farmer.

Form 1099-C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your gross income depends on whether the interest would be deductible if you paid it.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099-C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (shown in box 2) less the interest amount (shown in box 3).

Mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your gross income.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Exceptions and Exclusions

There are several exceptions and exclusions to the inclusion of canceled debt in income. These are explained next.

Nonrecourse debt. If you are not personally liable for the debt (nonrecourse debt), different rules apply. You may have a gain or loss if nonrecourse debt is canceled or forgiven in conjunction with the sale or foreclosure 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 government — federal, state, or local, or an instrumentality, agency, or subdivision thereof,
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
- 3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Loans canceled after August 5, 1997. If the loan was canceled after August 5, 1997, it will qualify if it was made by an educational institution designed as part of a program of the institution to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A loan will also qualify if it was made by an educational institution or a tax-exempt 501(c)(3) organization to refinance any loan that meets the requirements above.

An educational institution is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes:

- Charitable,
- Religious,
- Educational,
- Scientific,
- Literary,
- Testing for public safety,
- Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment), or
- The prevention of cruelty to children or animals.

Exception. You do have income if your student loan is canceled because of services performed for an educational institution.

Deductible debt. If a debt that qualified for a tax deduction is canceled, you do not realize income from the canceled debt. However, whether or not you must include the canceled debt in your gross income depends on

whether you use the cash or an accrual method of accounting. If you use the cash method, you do not include it in income. If you use an accrual method, you do include it in income. For more information, see chapter 5 of Publication 334, *Tax Guide for Small Business*.

Price reduced after purchase. Generally, if the seller reduces the amount 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.

Bankruptcy exclusion. If your debt is canceled in a bankruptcy case under title 11 of the United States Code, do not include the canceled debt in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. See Publication 908, *Bankruptcy Tax Guide*, for more information.

Insolvency exclusion. If your debt is canceled when you are insolvent, you do not include the canceled debt (up to a certain limit) in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income. This exclusion applies only to the amount by which you are insolvent. See Publication 908 for more information.

Qualified farm debt exclusion. If you have qualified farm debt that is canceled, it is excluded from your income (up to certain limits). See chapter 4 of Publication 225, *Farmer's Tax Guide*, for more information.

Qualified real property business indebtedness (QRPBI) exclusion. QRPBI is certain debt connected with business real property. If you have QRPBI that is canceled after December 31, 1992, you can elect to exclude (up to certain limits) the canceled debt from your gross income. If you make the election, you must reduce the basis of your depreciable real property by the excluded amount. (A C corporation cannot make this election.) See chapter 5 of Publication 334 for more information.

Order of exclusions. If the canceled debt occurs because of a title 11 bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency, qualified farm debt, or QRPBI exclusions. If the canceled debt occurs because you are insolvent, the insolvency exclusion takes precedence over qualified farm debt or QRPBI exclusions.

Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are "passed through" to the partners based on each partner's distributive share of these items.

Partner's distributive share. Your distributive share of partnership income, gains, losses, deductions, or credits is your share of these items of the partnership. Your share of these amounts is generally based on the partnership agreement, whether or not they are actually distributed to you. Generally, your distributive share of the partnership losses is limited to the adjusted basis of your partner-

ship interest at the end of the partnership year in which the losses took place.

Partnership agreement. The partnership agreement usually covers the distribution of profits, losses, and other items. However, if the agreement does not state how a specific item of gain or loss will be shared, generally each partner's distributive share is figured according to the partner's interest in the partnership.

Partnership return. Although a partnership pays no tax, it must file an information return on Form 1065, *U.S. Partnership Return of Income*. This shows the result of the partnership's operations for its tax year and the items that must be "passed through" to the partners.

Partner's return. You must generally treat partnership items on your individual return the same as they are treated on the partnership return. That is, if the partnership had a capital gain, you report your share on Schedule D (Form 1040). You report your share of partnership ordinary income on Schedule E (Form 1040).

Schedule K-1 (Form 1065). You should receive from each partnership in which you are a member a copy of Schedule K-1 (Form 1065) showing your share of income, deductions, credits, and tax preference items of the partnership for the tax year.

 **TIP** Generally, Schedule K-1 will tell you where to report each item of income on your individual return. Retain Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040.

More information. For more information, get Publication 541, *Partnerships*.

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are "passed through" to the shareholders.

S corporation return. An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation*. This shows the results of the corporation's operations for its tax year and the items of income, gains, losses, deductions, or credits that affect the shareholders' individual income tax returns.

Shareholder's return. If you are a shareholder in an S corporation, you must include on Form 1040 your share of the corporation's items of income, loss, deduction, or credit in the same way as a partnership would report these items.

All current year income or loss and other tax items are taxed to each shareholder at the corporation's year end. Generally, these items passed through to you as a shareholder will increase or decrease the basis of your S corporation stock as appropriate.

Distributions. Generally, S corporation distributions are a nontaxable return of your basis in the corporation stock. However, in certain cases, part of the distributions may be taxable as a dividend, or as a long-term or short-term capital gain, or as both. The corporation's distributions may be in the form of cash or property.

Schedule K-1 (Form 1120S). You should receive from the S corporation in which you are a shareholder a copy of Schedule K-1 (Form 1120S) showing your

share of income, credits, and deductions of the S corporation for the tax year. Your distributive share of the items of income, gains, losses, deductions, or credits of the S corporation must be shown separately on your Form 1040. The character of these items generally is the same as if you had realized or incurred them personally.

 **TIP** Generally, Schedule K-1 will tell you where to report each item of income on your individual return. Do not attach Schedule K-1 (Form 1120S) to your Form 1040. Keep it for your records.

More information. For more information, see the instructions for Form 1120S.

Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. Generally, you must include all or part of the recovered amounts in your income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recoveries include such items as payments you receive on previously deducted bad debts and recoveries of items for which you previously claimed a tax credit.

If you recover amounts that are for itemized deductions and non-itemized deductions you deducted in a previous year, recompute your taxable income first as shown in *Non-Itemized Deduction Recoveries* before you determine the amount to include in your income as shown in *Itemized Deduction Recoveries*.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

Form 1099-G. If you received a state or local income tax refund in 1997, you may receive a statement, Form 1099-G, *Certain Government Payments*, from the payer of the refund (or credit or offset) by January 31, 1998. The IRS will also receive a copy of the Form 1099-G.

Interest. 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 deductible expense occur in the same year, the recovery reduces the deduction and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year.

Example. You paid 1996 estimated state income tax of \$4,000 in four equal payments. You made your fourth payment in January 1997. You had no state income tax withheld

during 1996. In 1997, you received a \$400 tax refund based on your 1996 state income tax return. You claimed itemized deductions each year on your federal income tax return.

You must allocate the \$400 refund between 1996 and 1997, the years in which you paid the tax on which the refund is based. Since you paid 75% ($\$3,000 \div \$4,000$) of the estimated tax in 1996, 75% of the \$400 refund, or \$300, is for amounts you paid in 1996 and is a recovery item. If all of the \$300 is a taxable recovery item, you will include \$300 on line 10, Form 1040, for 1997, and attach a copy of your computation showing why that amount is less than the amount shown on the Form 1099-G you received from the state.

The balance (\$100) of the \$400 refund is for your January 1997 estimated tax payment. When you figure your deduction for state and local income taxes paid during 1997, you will reduce the \$1,000 paid in January by \$100. Your deduction for state and local income taxes paid during 1997 will include the January net amount of \$900 ($\$1,000 - \100), plus any estimated state income taxes paid in 1997 for 1997, and any state income tax withheld during 1997.



CAUTION If you did not itemize deductions in the year for which you received the recovery, do not include any of the recovery amount in your income.

Example. In 1996, you filed your federal income tax return on Form 1040A. In 1997 you received a refund from your 1996 state income tax. Do not report any of the refund as income because you did not itemize deductions in 1996.

Itemized Deduction Recoveries

Total recoveries generally included in income. If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must generally include the full amount of the refund or recovery in your income in the year you receive it. This is true if for the earlier taxable year:

- 1) Your itemized deductions were not subject to the limit on itemized deductions. (If your deductions were limited, see *Previously limited itemized deductions*, later.)
- 2) Your deduction for the item recovered exceeds the amount recovered. (If your deduction was less than the amount recovered, see *Recovery limited to deduction*, later.)
- 3) You had taxable income. (If you had no taxable income, see *Negative taxable income*, later.)
- 4) Your itemized deductions exceeded the standard deduction by at least the amount of the refund or recovery. (If your itemized deductions did not exceed the standard deduction by at least the amount of the recovery, see *Total recoveries not included in income*, later.)
- 5) You had no tax credits. (If you had tax credits, see *Tax credits—earlier year*, later.)
- 6) You were not subject to alternative minimum tax. (If you were subject to alternative minimum tax, see *Alternative minimum tax—earlier year*, later.)

Where to report. Enter your state and local income tax refund on line 10 of Form 1040, and the total of all other recoveries as other income on line 21 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

Example. For 1996, you filed a joint return. Your taxable income was \$20,000 and you were not entitled to any tax credits. Your standard deduction was \$6,700, and you had itemized deductions of \$7,800. In 1997, you received the following recoveries for amounts deducted on your 1996 return:

Medical expenses	\$200
State and local income tax refund	400
Refund of mortgage interest	325
Total recoveries	<u>\$925</u>

None of the recoveries were more than the deductions taken for 1996.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($\$7,800 - \$6,700 = \$1,100$), you must include your total recoveries in your income for 1997. 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.

Worksheet for refunds of itemized deductions. If your itemized deductions were not limited, you had no tax credits, and you were not subject to the alternative minimum tax, you can use *Table 5* at the end of this publication to determine the amount of your recovery of amounts deducted after 1986 to include in your income.

Standard deduction for earlier years. To determine if amounts recovered in 1997 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. The standard deduction tables for 1996, 1995, and 1994 are at the end of this publication (*Tables 2, 3, and 4*.) If you need the standard deduction amounts for years before 1994, see the copy of your return for that year. For information on the standard deduction, get Publication 501, *Exemptions, Standard Deduction, and Filing Information*.

Total recoveries not included in income. The total recovery that must be included in your income is limited to the itemized deduction amount that reduced your tax for the earlier year. (See *Tax Benefit Rule*, later.)

You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the smaller of:

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

Example. You filed a joint return for 1996 with a taxable income of \$25,000. Your itemized deductions were \$8,500. The standard deduction that you could have claimed was \$6,700. In 1997 you recover \$2,400 of your 1996 itemized deductions. None of the re-

coveries were more than the actual deductions for 1996. Include \$1,800 of the recoveries in your 1997 income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction ($\$8,500 - \$6,700 = \$1,800$).

Negative taxable income. If your taxable income was a negative amount, reduce the recovery you must include in your income by the negative amount.

Example. In the previous example assume you had a negative taxable income of \$200 in 1996. You would include \$1,600 in your 1997 income, rather than \$1,800.

Recovery limited to deduction. You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

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

Example. During 1996, 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 1997, you received a \$500 reimbursement from your medical insurance for your 1996 expenses. The only amount of the \$500 reimbursement that must be included in your income in 1997 is \$200 — the amount actually deducted.

Allocation of recoveries to be included. If you are not required to include all of your recoveries in your income, and you have both a state income tax refund and other itemized deduction recoveries, you must allocate part of the taxable recoveries to report as a state tax refund on line 10 of Form 1040. The balance of your taxable recoveries is reported as other income on line 21 of Form 1040. You can use *Table 5* at the end of this publication to figure the part to report as a state tax refund, or you can figure that part as follows:

- 1) Divide your state income tax refund by the total of all your itemized deduction recoveries. The result is the percentage that the state income tax refund represents of the total recoveries.
- 2) Multiply the amount of taxable recoveries by the percentage.

Example. Assume you recovered in 1997 \$2,500 of your 1996 itemized deductions, but that the recoveries you must include in your 1997 income are only \$1,500. Of the \$2,500 you recovered, \$500 was due to your state income tax refund. The amount you report as a tax refund on line 10 of Form 1040 is \$300 [$(\$500 \div \$2,500) \times \$1,500$]. The balance of the taxable recoveries, \$1,200, is reported as other income on line 21 of Form 1040.

Non-Itemized Deduction Recoveries

This section discusses recovery of deductions other than those deducted on Schedule A (Form 1040). Recovery of tax credits is discussed later.

Total recoveries included in income. Recovery of amounts deducted in an earlier year must be included in your income in the year received to the extent the deduction reduced your tax in the year of the deduction. (See *Tax Benefit Rule*, later.)

Total recoveries not included in income. If your taxable income is a negative amount, reduce the recovery by that negative amount. Include this reduced recovery in your income.

Itemized and non-itemized deduction recoveries. If you recover amounts due to both itemized deductions and non-itemized deductions taken in the same year, you must determine the amounts to include in your income as follows:

- 1) Figure your non-itemized deduction recoveries,
- 2) Add the non-itemized deduction recoveries to your taxable income, and then
- 3) Figure your itemized deduction recoveries.

This order is required because your taxable income will change and you must use taxable income to figure your itemized deduction recoveries.

Amounts Recovered for Credits

If you received a recovery in 1997 for an item on which you claimed a tax credit in an earlier year, you must increase your 1997 tax to the extent the credit reduced your tax in the earlier year. You have a recovery if there is a downward price adjustment or similar adjustment on the item for which you claimed a credit.

This rule does not apply to the investment credit or the foreign tax credit. Recoveries of these credits are covered by other provisions of the law. See Publication 514, *Foreign Tax Credit for Individuals*, or Form 4255, *Recapture of Investment Credit*, for details.

Tax Benefit Rule

If you recover an amount that you deducted or took a credit for in an earlier year, include the recovery in your income only to the extent the deduction or credit reduced your tax in the earlier year. Generally, you can figure the deduction amount that reduced your tax in the earlier year by using the methods discussed earlier. These methods are for the most common situations and are comparatively simple because you are not required to recompute the earlier year's tax.

Itemized deductions limited. Special rules apply if your itemized deductions on Schedule A (Form 1040) were limited in a prior year and in a later year you receive a recovery of amounts deducted in the prior year (for example, state income taxes or mortgage interest). When the limit applies, you must reduce your itemized deductions by the lesser of:

- 1) 3% of the amount by which your adjusted gross income (AGI) exceeds a specified base amount (\$117,950 for 1996, \$58,975 if you were married filing separately), or
- 2) 80% of your otherwise allowable itemized deductions affected by the limit.

(For more information on the limit, see chapter 22 of Publication 17, *Your Federal Income Tax*.)

Previously limited itemized deductions. If you received a refund or recovery of an itemized deduction that was limited as explained earlier under *Itemized deductions limited*, the refund or recovery is, in general, fully included in your gross income in the year you received it.

If your 1996 AGI was **more than** \$117,950 (\$58,975 if you were married filing separately), you should complete the following steps to determine if you can include less than the full refund or recovery in your gross income. This is also true if the 80% limit applied to your itemized deductions (for example, line 4 was smaller than line 8 on the *Itemized Deduction Worksheet* in your 1996 Form 1040 instructions).

To determine the portion of the refund or recovery you must include in income, follow the five steps below. If your earlier tax year does **not** involve negative taxable income or an unused tax credit, skip *steps 1* and *2* and start with *step 3*.

- 1) If your taxable income for the earlier year was a negative amount, reduce your recovery by the negative amount.
- 2) If your tax for the earlier year was reduced to zero by a tax credit that was not fully used in that year, and if reducing your deduction for that year by the recovery would result in tax for that year, reduce your recovery by an amount equal to your recovery multiplied by the following fraction:
 - a) Your tax for the earlier year, determined after reducing your deductions by the recovery and applying the credit; over
 - b) The total increase in your tax for the earlier year, determined by subtracting your as-filed earlier year's tax (without applying the credit) from your earlier year's tax determined after reducing your deductions by the recovery (without applying the credit).
- 3) Determine your deduction for itemized deductions you **actually claimed** in the earlier year after applying the limit on itemized deductions.
- 4) Figure the greater of:
 - a) The standard deduction for the earlier year, or
 - b) Your itemized deductions for the earlier year figured as you **would have claimed** them (after taking into account the limit on itemized deductions) if you had paid the proper amount of the item for which you later received a refund or recovery. The proper amount is the amount you actually paid reduced by the refund or recovery (as reduced under *steps 1* or *2*, if necessary). For example, if you paid \$12,000 in state income taxes in 1996 and in 1997 you received a \$2,000 refund of 1996 state income taxes, \$10,000 is the proper amount, and you would figure your itemized deductions for 1996 as

though you had paid only \$10,000 in state income taxes in 1996.

Note. If you were required to itemize your deductions in the earlier year, use *step 4(b)* and not *step 4(a)*.

- 5) Subtract the amount in *step 4* from the amount in *step 3*. The difference is the amount of the refund or recovery to include in your gross income in the year you receive the refund or recovery.

Example. Eileen Martin is single. She had an AGI of \$1,117,950 and itemized her deductions on her federal income tax return for 1996. She was not subject to alternative minimum tax and was not entitled to any credit against income tax. Her only allowable deduction was \$40,000 of state income taxes. However, Eileen deducted only \$10,000 in 1996 because her otherwise allowable deductions of \$40,000 were reduced by \$30,000. In 1997, she received a \$5,000 refund of her state income taxes for 1996.

The following table shows how Eileen calculated the \$30,000 reduction and other amounts from the 1996 *Itemized Deduction Worksheet* in her Form 1040 package. These amounts are needed to figure the portion of the \$5,000 refund that Eileen must include in her income for 1997.

AGI for 1996	\$1,117,950
State income taxes paid in 1996	\$40,000
3% reduction (amount on line 8 of 1996 <i>Itemized Deduction Worksheet</i>)	
$[(\$1,117,950 - \$117,950) \times 3\%]$	\$30,000
80% reduction not applied (amount on line 4 of 1996 <i>Itemized Deduction Worksheet</i>) (\$40,000 \times 80%)	\$32,000
1996 deduction (amount on line 10 of 1996 <i>Itemized Deduction Worksheet</i>) (\$40,000 - \$30,000)	\$10,000
Refund received in 1997 of 1996 state income taxes	\$5,000
Proper amount of 1996 state income taxes (\$40,000 - \$5,000)	\$35,000

If Eileen had paid only \$35,000 in state income taxes in 1996 (the proper amount of state income taxes for 1996 after the 1997 refund (\$40,000 - \$5,000), Eileen's otherwise allowable itemized deductions of \$35,000 would have been reduced by \$28,000 (\$35,000 \times 80%). This is the amount that would have been entered on line 4 and on line 9 of the 1996 *Itemized Deduction Worksheet*. Further, \$28,000 is less than the amount that would have been entered on line 8 (\$30,000). She would have claimed a deduction in 1996 of \$7,000 (\$35,000 - \$28,000). She derived a tax benefit to the extent of the \$3,000 difference between her deduction for 1996 (\$10,000) and the deduction for 1996 that she would have claimed (\$7,000) had Eileen paid the proper amount of state income taxes in 1996 and not received a state income tax refund in 1997. Only \$3,000 (\$10,000 - \$7,000) of the \$5,000 state income tax refund that Eileen received in 1997 is includible in her gross income in 1997.

If you need more information, see Revenue Ruling 93-75. This ruling can be found in many libraries and IRS offices.

Special situations. If a deduction reduced your taxable income, but did not reduce your tax because you either were subject to the alternative minimum tax or had tax credits that reduced your tax to zero, you will need to recompute the earlier year's tax to determine whether you can exclude the recovery amount from your income.

Tax credits—earlier year. If you recover an item deducted in an earlier year in which your tax credits were at least as much as your tax, you must refigure the earlier year's tax to determine if you must include the recovery in your income. To do this, add the amount of the recovery to your earlier year's taxable income and figure the tax on the recomputed amount. If your tax credits were at least as much as the recomputed tax, you did not have a tax benefit from the deduction. Do not include the recovery in your income. If the tax credits are less than the recomputed tax, include the recovery in your income to the extent it reduced your tax in the earlier year.

Example. In 1996, Jean Black filed as head of household and itemized her deductions. Her taxable income was \$5,260 and her tax was \$791. She claimed a child care credit of \$1,200. The credit reduced her tax to zero and she had an unused tax credit of \$409 (\$1,200 - \$791). In 1997, Jean recovered \$1,000 of her itemized deductions. She adds \$1,000 to her 1996 taxable income and recomputes that year's tax, but the child care credit exceeds the recomputed tax of \$941, as shown in the following table:

	1996 Taxable Income	Tax 791	Tax Credit 1,200	Net Tax \$ 0
As Filed	\$ 5,260			
Recovery	+ 1,000			
Recomputed	\$ 6,260	941	1,200	\$ 0

Jean's tax liability for 1996 has not changed by including the recovery in her income for that year. She did not have a tax benefit from the recovered deduction and does not include any of the recovery in her income for 1997. If, however, the recomputed tax had been more than her tax credit, she would have to include the recovery in her 1997 income to the extent it reduced her tax in 1996.

Alternative minimum tax—earlier year. If you were subject to the alternative minimum tax in the year of the deduction, you will have to recompute your tax for the earlier year to determine if the recovery must be included in your income. This will require a recomputation of your regular tax, as shown in the example for tax credits, and a recomputation of your alternative minimum tax. If inclusion of the recovery does not change your total tax, you do not include the recovery in your income. However, if your total tax increases (by any amount), you received a tax benefit from the deduction and you must include the recovery in your income to the extent the deduction reduced your tax in the earlier year.

Rental of Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

- 1) Whether or not the rental activity is a business, and
- 2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

Reporting business income and expenses. If you are in the business of renting personal property, report your income and expenses on Schedule C or C-EZ. The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

Reporting nonbusiness expenses. If you rent personal property for a profit, report your rental expenses on line 31 of Form 1040. Enter the amount and "PPR" on the dotted line to the left and include the amount of your deductible expenses in the total amount you enter on line 31.

If you do not rent personal property for a profit, your deductions are limited and you cannot report a loss to offset other income. You report these rental expenses on Schedule A (Form 1040). Chapter 1 of Publication 535 has details on how to claim these expenses.

Repayments

If you had to repay an amount that you had included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income in the year in which you repay it.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss.

If you repaid social security or equivalent railroad retirement benefits, get Publication 915. If you repaid other railroad retirement benefits, get Publication 575.

Repayment—\$3,000 or less. If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it. If you reported it as wages, unemployment compensation, or other ordinary income, enter it on line 22 of Schedule A (Form 1040). If you reported it as a capital gain, deduct it on Schedule D (Form 1040).

Repayment—over \$3,000. If the amount you repaid was more than \$3,000, you can take a deduction for the amount repaid or you can take a credit against your tax. Follow the steps below and compare the results. Use the method that results in less tax.

- 1) Figure your tax for 1997 claiming a deduction for the repaid amount.
- 2) Figure your tax for 1997 **without** deducting the repaid amount. Then,
 - a) Refigure your tax from the earlier year without including in income the amount you repaid in 1997.
 - b) Subtract the tax in (a) from the tax shown on your return for the earlier year.
 - c) Then subtract the answer in (b) from the tax for 1997 figured without the deduction.

How you treat the repayment on your 1997 return depends on which answer above results in less tax.

If the answer in step (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it on Schedule C or Schedule C-EZ (Form 1040), or if you reported it as wages, deduct it on line 27 of Schedule A (Form 1040).

If the answer in step (2) is less tax, claim a credit on line 59 of Form 1040, and write "I.R.C. 1341" next to line 59.

Example. For 1996 you filed a single return and reported your income on the cash method. In 1997 you repaid \$5,000 included in your 1996 gross income under a claim of right. Your filing status in 1997 is the same as 1996. Your income and tax for both years are as follows:

	1996 With Income	1996 Without Income
Taxable Income	\$15,000	\$10,000
Tax Liability	\$ 2,254	\$ 1,504

	1997 Without Deduction	1997 With Deduction
Taxable Income	\$49,950	\$44,950
Tax Liability	\$10,789	\$ 9,389

Your tax under method (1) is \$9,389. Your tax under method (2) is \$10,039, figured as follows:

Tax previously determined for 1996	\$2,254
Less: Tax as refigured	<u>- 1,504</u>
Decrease in 1996 tax	<u>\$750</u>
Regular tax liability for 1997	\$10,789
Less: Decrease in 1996 tax	<u>- 750</u>
Refigured tax for 1997	<u>\$10,039</u>

Because you pay less tax under method (1), you should take a deduction for the repayment in 1997.

Repayment does not apply. This discussion does not apply to:

- 1) Deductions for bad debts.
- 2) Deductions from sales to customers, such as returns and allowances, and similar items.

Year payment deducted. If you use the cash method, you can take the deduction for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment only for the tax year in which it is a proper deduction under your accounting method. For example, if you use an accrual method, you are entitled to the deduction in the tax year in which the obligation for the repayment accrues.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties on Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your gross income and expenses on Schedule C or Schedule C-EZ (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 13 of Publication 535.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544, *Sales and Other Dispositions of Assets*.

Interest in the property sold. If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040).

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Retained interest. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

Income Not Taxed

You generally should not report the following income items on your return. Each has been discussed in this publication or is discussed in another publication. A discussion of other totally and partly excluded items follows this list.

Accident and health insurance proceeds
“Black lung” benefits

Casualty insurance and other reimbursements (get Publication 547)

Child support payments (get Publication 504)

Compensatory damages awarded for physical injury or physical sickness

Federal Employees' Compensation Act payments

Government cost-of-living allowances for civilian employees stationed outside the continental U.S. (or in Alaska)

Housing allowance for members of the clergy

Interest on state or local obligations (get Publication 550)

Meals and lodging provided by employer

Military allowances (get Publication 3)

Moving expense reimbursements (get Publication 521)

Scholarship and fellowship grants (get Publication 520)

Supplemental security income (SSI)

Veterans' benefits

Welfare benefits

Workers' compensation

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains 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.

Car pools. Do not include in your income amounts you receive from the passengers for driving a car in a car pool to and from work. These amounts are considered reimbursement for your expenses. However, this rule does not apply if you have developed car pool arrangements into a profit-making business of transporting workers for hire.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

Example. You buy a new car for \$9,000 cash and receive a \$400 rebate check from the manufacturer. The \$400 is not income to you. Your cost is \$8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Employee achievement awards. Exclude from your income employee achievement awards you receive only if your employer can deduct them. To be deducted by your employer, and excluded by you, the award must meet all the following requirements:

- 1) Be given for length of service or safety achievement.
- 2) Be tangible personal property other than cash, gift certificates, or equivalent items.
- 3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
- 4) Be given as part of a meaningful presentation.

- 5) Be no more than the specified dollar limits.

Dollar limits. There are limits to the total awards you can exclude in one year. Awards from nonqualified plans are limited to \$400, and total awards from both qualified and nonqualified plans are limited to \$1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

Qualified plan award. A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the tax year is more than \$400. In determining average cost, awards of nominal value are not taken into account.

Example. Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at \$250, and two qualified plan awards of a stereo valued at \$1,000 and a set of golf clubs valued at \$500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, since the \$1,750 total value of the awards is more than \$1,600, Ben must include \$150 (\$1,750 – \$1,600) in his income.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

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.

Nonresidential property. For property that is not a dwelling unit (nonresidential property), you can exclude 50% of the subsidy, but only for amounts received under a written contract in effect on September 13, 1995, and at all times thereafter.

Food program payments to day care service. If you operate a day care service and receive payments under the Child Care Food Program administered by the Department of Agriculture, do not include the payments in your gross income to the extent you use them to provide food to children eligible for help under the program.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing care to qualified foster individuals in your home generally are not included in your income. You must include in your income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

A qualified foster individual is a person who:

- 1) Is living in a foster family home, and

2) Was placed there by:

- a) An agency of a state or one of its political subdivisions, or
- b) If the individual is under age 19, a tax-exempt placement agency licensed by a state or one of its political subdivisions.

Difficulty-of-care payments. These are additional payments that are designated by the payor as compensation for providing the additional care which is required for physically, mentally, or emotionally handicapped qualified foster individuals. To be difficulty-of-care payments, a state must determine that the additional compensation is needed and the care for which the payments are made must be provided in your home.

You must include in your income difficulty-of-care payments received for more than:

- 1) 10 qualified foster individuals under age 19, and
- 2) 5 qualified foster individuals age 19 or older.

Maintaining space in home. If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. You must include these payments in income.

Get Publication 587, *Business Use of Your Home*, to help you determine the amount you can deduct for the use of your home. For more information on foster care, get Publication 501.

Gifts and inheritances. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or 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 also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Items given to you as an incentive to enter into a business transaction are not gifts. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See *Survivors and Beneficiaries* in Publication 575, *Pension and Annuity Income*, if you inherited a pension. See *Inherited IRAs* in Publication 590, *Individual Retirement Arrangements (IRAs)*, if you inherited an IRA.

Expected inheritance. If you sell an interest in an expected inheritance from a living person, include the entire amount you receive in gross income on line 21 of Form 1040.

Bequest for services. If you receive cash or other property as a bequest for services you performed while the decedent was alive, the value is taxable compensation.

Historic preservation grants. Do not include in your income any payment you receive under the National Historic Preservation Act to preserve a historically significant property.

Interest on frozen deposits. In general, you exclude from your income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of the calendar 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.

Excludable amount. The amount of interest you exclude from gross income for the year is the interest that was credited on the frozen deposit for that tax year minus the sum of:

- 1) The net amount withdrawn from the deposit during that year, and
- 2) The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in your gross income in the tax year it becomes withdrawable.

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. "Qualified higher educational expenses" are those you pay for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A "qualified U.S. savings bond" is a Series EE savings bond issued after December 31, 1989, to an individual 24 years of age or older. For more information on this exclusion, see *Education Savings Bond Program* in chapter 1 of Publication 550.

Interest on state and local government obligations. This interest is usually exempt from federal tax. For more information, see *State or Local Government Obligations* in chapter 1 of Publication 550.

Living expenses paid by insurance. Do not include in your income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home due to a fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

Qualified scholarships. A candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount you receive that is for:

- 1) Tuition and fees to enroll at or attend an educational organization, or

- 2) Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board **do not** qualify.

Payments for services. Payments you receive for services required as a condition of receiving a scholarship or fellowship grant, must be included in your income, even if the services are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Get Publication 520 for information on scholarships and fellowship grants.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your gross income. These allowances are not considered scholarship or fellowship grants.

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

Prizes in recognition of past accomplishments, such as Pulitzer, Nobel or similar prizes, are discussed earlier under *Prizes and awards*, under *Miscellaneous Taxable Income*.

Qualified tuition reductions. These reductions are excluded from your income. A qualified tuition reduction is the amount of reduction in tuition for education (below the graduate level) furnished to an employee of an educational institution (or certain other persons) provided certain requirements are met. However, graduate students who engage in teaching or research activities for the educational institution may qualify for this exclusion. For more information, get Publication 520.

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. Get Publication 523.

Tax-exempt interest. Even though it is not taxable, you must report all tax-exempt interest you receive on Form 1040, Form 1040A, or Form 1040EZ.

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.

Utility rebates. If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

- 1) A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your gross income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

Example. The face amount of the policy is \$75,000 and, as beneficiary, you choose to receive 120 monthly installments of \$1,000 each. The excluded part of each installment is \$625 a month ($\$75,000 \div 120$), or \$7,500 for an entire year. The rest of each payment, \$375 a month (or \$4,500 for an entire year), is interest income to you.

Specified amount payable. If each installment you receive under the insurance contract is a specific amount, you figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example. As beneficiary, you choose to receive \$40,000 of proceeds in 10 annual installments of \$4,000 plus \$400 of guaranteed interest each year. During the year you receive \$4,400. You can exclude from gross income \$4,000 ($\$40,000 \div 10$) as a return of principal. The rest of the installment, \$400, is taxable as interest income. (However, see *Surviving spouse*, later.)

Installments for life. If, as the beneficiary under an insurance contract, you are entitled to receive the proceeds in installments for the rest of your life without a refund or period-certain guarantee, you figure the excluded part of each installment by dividing the amount held by the insurance company by your life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are paid to you because of the death of your spouse, and you receive them in installments, you can exclude up to \$1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

Interest option on insurance. If an insurance company pays you interest only on proceeds from life insurance left on deposit with them, the interest you are paid is taxable.

If you chose to receive only the interest from your insurance proceeds, the \$1,000 interest exclusion for a surviving spouse does not apply. If you later decide to receive the proceeds from the policy in installments, you can take the interest exclusion from the time you begin to receive the installments.

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 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. This is explained more fully in Publication 575.

Reporting. You should receive a Form 1099-R. Report these amounts on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A.

Endowment proceeds. Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, add the aggregate amount of premiums (or other consideration) paid for the contract and subtract any amount that you previously received under the contract and excluded from your income. Include any amount of the lump sum payment over your cost in your income.

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity. This is explained in Publication 575. For this treatment to apply, you must choose to receive the proceeds in installments before receiving any part of the lump sum. This election must be made within 60 days after the lump-sum payment first becomes payable to you.

Survivor Benefits

Generally, payments made by or for an employer because of an employee's death must be included in income. However, if the decedent died before August 21, 1996, the first \$5,000 paid to beneficiaries can be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than \$5,000 regardless of the number of employers or the number of beneficiaries.

This exclusion also covers payments of the balance to the credit of a deceased employee under a stock bonus, pension, or profit-sharing plan, as long as they are received during one tax year of the beneficiary.

Example. William Smith was an officer of a corporation at the time of his death in July 1996. The board of directors voted to pay Mr. Smith's salary to his widow for the rest of the year for his past services. During the year the corporation made payments of \$18,000 to the widow. She can exclude from her income the first \$5,000 she received, but must include the remaining \$13,000 on line 21 of her Form 1040.

Self-employed individuals. The death benefit exclusion also applies to lump-sum distributions paid on behalf of self-employed individuals, if paid under a qualified pension, profit-sharing, or stock bonus plan.

Payments not qualifying. Any amount that the deceased employee (or self-employed individual) had a guaranteed right to receive, had death not occurred, cannot be excluded as a tax-free death benefit. If the deceased employee was receiving a retirement annuity and the beneficiary continues to receive payments under a joint and survivor annuity option, these payments do not qualify for the death benefit exclusion. However, if the deceased employee had retired on disability and at the time of death had not reached minimum retirement age, payments to the beneficiary may qualify for the death benefit exclusion. Minimum retirement age generally is the age at which an individual can first receive a pension or annuity if that individual is not disabled.

Paid in installments. Death benefits paid in installments over a period of years are annuity payments. If you are the beneficiary of an employee who died while still employed, the pension or annuity you receive may qualify for the death benefit exclusion. This exclusion is limited to \$5,000 and generally applies to the amount by which the present value of the annuity, figured as of the date of the employee's death, is more than the larger of:

- 1) The employee's contributions to the plan, or
- 2) The amount the employee had a guaranteed right to receive.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity in figuring, at the annuity starting date, the investment in the contract. Figure the amount of each payment to exclude from your income in the same way as an annuity. Get Publication 575 for more information.

Lump-sum payments. Lump-sum payments you receive as the surviving spouse or beneficiary of a person who died may be accrued salary payments; distributions from employee profit-sharing, pension, annuity, and stock bonus plans; or other items that should be treated separately for tax purposes. The tax treatment of these lump-sum payments depends on the type of payment.

Salary or wages. Salary or wages received after the death of the employee are usually ordinary income to you.

Qualified employee retirement plans. Lump-sum distributions from qualified employee retirement plans are subject to special tax treatment. For information on these distributions, get Publication 575.

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

Bureau of Justice Assistance payments. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit paid to you by the Bureau of Justice Assistance.

Governmental plan annuity. If you are a surviving child or spouse (or former spouse) of a public safety officer who was killed in the line of duty after 1996, you generally do not

have to include in income that part of the survivor annuity that you receive under a governmental plan that meets the requirements of a qualified employer plan and that is based on the deceased's service as a public safety officer.

For purposes of the preceding paragraph, the term "public safety officer" includes law enforcement officers, firefighters, rescue squad or ambulance crew.

The exclusion does not apply in situations involving intentional misconduct, intent to commit suicide, voluntary intoxication, or gross negligence. Nor does it apply to payments made to anyone who substantially contributed to the death of the officer.

Accelerated Death Benefits

Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. See the exception later. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs.

In addition, if any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual is sold or assigned to a viatical settlement provider, the amount received is also excluded from income. Generally, a viatical settlement provider is one 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.

Terminally or chronically ill defined. A terminally ill person is one 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. A chronically ill person is one who is not terminally ill but has been certified by a licensed health care practitioner as meeting one of the following conditions:

- 1) Is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity,
- 2) Has a level of disability similar to the disability in (1) above, or
- 3) Requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

Exception. The exclusion does not apply to any amount paid to a person other than the insured if that other person has an insurable interest in the life of the insured:

- Because the insured is a director, officer, or employee of the other person, or
- Because the insured has a financial interest in the business of the other person.

Limit on exclusion. The amount of accelerated death benefits you may exclude may be limited if:

- 1) They are paid on account of chronic illness, and

- 2) They are received as periodic payments.

There is no limit on amounts paid on account of terminal illness.

For 1997, the most you can exclude is \$175 per day (\$63,875 a year). See Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*, for more information.

Long-Term Care Insurance Contracts

Beginning January 1, 1997, qualified 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.

A long-term care insurance contract is any insurance contract that only provides coverage of qualified long-term care services. The contract:

- 1) Must be guaranteed renewable.
- 2) Must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.
- 3) Must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits.
- 4) Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

- 1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
- 2) Maintenance or personal care services required by a chronically ill individual as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified as one of the following:

- 1) An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
- 2) An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

The certification must have been made by a licensed health care practitioner within the previous 12 months.

Limit on exclusion. You can generally exclude from gross income up to \$175 a day (\$63,875 a year) for 1997. The \$175 is indexed for inflation after 1997.

Medical Savings Accounts (MSAs)

Do not include in income amounts you withdraw from your MSA if you use the money to pay for qualified medical expenses for you, your spouse, or your dependents. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040), *Itemized Deductions*. You must have paid these expenses yourself. For more information about qualified medical expenses, see Publication 502, *Medical and Dental Expenses*.



You cannot buy health insurance with distributions from your MSA unless you are receiving unemployment benefits, buying continuation coverage required by Federal law, or buying long-term care insurance.

Taxable distributions and penalty. If you use the money from your MSA for any purpose besides qualified medical expenses, it will be taxable income that you must report on your tax return. In addition to the tax, you will be charged a 15 percent penalty for an early distribution. The penalty will not be charged if you are disabled or age 65.

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 gross income on line 21 of Form 1040.

Work-training program. Payments you receive from a state welfare agency for taking part in a work-training program are not included in your gross income (except for extra allowances for transportation, etc.), as long as the payments do not total more than the public welfare benefits you would have received otherwise. If the amount you receive (minus the extra allowances) is more than the welfare benefits you would have received, the entire amount must be included in your income as wages.

Persons with disabilities. If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation because you have a disability. Excludable amounts include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

Disaster relief grants. Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in in-

come. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* under *Miscellaneous Taxable Income*, earlier.

Mortgage assistance payments. Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's gross income. Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

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.

How To Get More Information



You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1-800-829-1040.

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

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them to measure the quality of assistance.
- We value our customers' opinions. Throughout the year, we will be surveying our customers for their opinions on our service.

Table 2. 1996 Standard Deduction Tables and Worksheets

Check correct boxes for yourself:
 65 or older Blind

Check correct boxes for your spouse if you are claiming your spouse's exemption:
 65 or older Blind

Total number of boxes checked (if none, enter zero). _____

If your filing status was:	and number of boxes you checked was:	your 1996 standard deduction was:
Single	0	\$4,000
	1	5,000
	2	6,000
Married filing jointly	0	\$6,700
	1	7,500
	2	8,300
	3	9,100
	4	9,900
Married filing separately	0	\$3,350*
	1	4,150*
	2	4,950*
	3	5,750*
	4	6,550*
Head of household	0	\$5,900
	1	6,900
	2	7,900
Qualifying widow(er)	0	\$6,700
	1	7,500
	2	8,300

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

If your filing status was:	and number of boxes you checked was:	your 1996 standard deduction was:
Single	0	\$ 650
	1	1,650
	2	2,650
Married filing separately	0	650*
	1	1,450*
	2	2,250*

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

A. Enter your earned income for 1996 _____		
B. Enter correct amount from following table _____		
If your filing status was:	and number of boxes you checked was:	enter on line B:
Single	0	\$ -0-
	1	1,000
	2	2,000
Married filing separately	0	-0-
	1	800
	2	1,600
C. Add lines A and B and enter total _____		
D. Enter correct amount from following table _____		
If your filing status was:	and number of boxes you checked was:	enter on line D:
Single	0	\$4,000
	1	5,000
	2	6,000
Married filing separately	0	3,350*
	1	4,150*
	2	4,950*
E. Compare lines C and D and enter the smaller amount. This was your standard deduction for 1996 _____		

* If your spouse itemized deductions on a separate return, enter zero on line D.

Table 3. 1995 Standard Deduction Tables and Worksheets

Check correct boxes for yourself:
 65 or older Blind

Check correct boxes for your spouse if you are claiming your spouse's exemption:
 65 or older Blind

Total number of boxes checked (if none, enter zero). _____

If your filing status was:	and number of boxes you checked was:	your 1995 standard deduction was:
Single	0	\$3,900
	1	4,850
	2	5,800
Married filing jointly	0	\$6,550
	1	7,300
	2	8,050
	3	8,800
	4	9,550
Married filing separately	0	\$3,275*
	1	4,025*
	2	4,775*
	3	5,525*
	4	6,275*
Head of household	0	\$5,750
	1	6,700
	2	7,650
Qualifying widow(er)	0	\$6,550
	1	7,300
	2	8,050

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Table II — For Dependents Who Have Earned Income of \$650 or Less

If your filing status was:	and number of boxes you checked was:	your 1995 standard deduction was:
Single	0	\$ 650
	1	1,600
	2	2,550
Married filing separately	0	650*
	1	1,400*
	2	2,150*

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Worksheet For Dependents Who Have Earned Income of More Than \$650

A. Enter your earned income for 1995 _____

B. Enter correct amount from following table _____

If your filing status was:	and number of boxes you checked was:	enter on line B:
Single	0	-0-
	1	950
	2	1,900
Married filing separately	0	-0-
	1	750
	2	1,500

C. Add lines **A** and **B** and enter total _____

D. Enter correct amount from following table _____

If your filing status was:	and number of boxes you checked was:	enter on line D:
Single	0	3,900
	1	4,850
	2	5,800
Married filing separately	0	3,275*
	1	4,025*
	2	4,775*

E. Compare lines **C** and **D** and enter the smaller amount.
 This was your standard deduction for 1995 _____

* If your spouse itemized deductions on a separate return, enter zero on line D.

Table 4. 1994 Standard Deduction Tables and Worksheets

Check correct boxes for yourself:
 65 or older Blind

Check correct boxes for your spouse if you are claiming your spouse's exemption:
 65 or older Blind

Total number of boxes checked (if none, enter zero). _____

If your filing status was:	and number of boxes you checked was:	your 1994 standard deduction was:
Single	0	\$3,800
	1	4,750
	2	5,700
Married filing jointly	0	\$6,350
	1	7,100
	2	7,850
	3	8,600
	4	9,350
Married filing separately	0	\$3,175*
	1	3,925*
	2	4,675*
	3	5,425*
	4	6,175*
Head of household	0	\$5,600
	1	6,550
	2	7,500
Qualifying widow(er)	0	\$6,350
	1	7,100
	2	7,850

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

If your filing status was:	and number of boxes you checked was:	your 1994 standard deduction was:
Single	0	\$ 600
	1	1,550
	2	2,500
Married filing separately	0	600*
	1	1,350*
	2	2,100*

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

A. Enter your earned income for 1994 _____		
B. Enter correct amount from following table _____		
If your filing status was:	and number of boxes you checked was:	enter on line B:
Single	0	\$ -0-
	1	950
	2	1,900
Married filing separately	0	-0-
	1	750
	2	1,500
C. Add lines A and B and enter total _____		
D. Enter correct amount from following table _____		
If your filing status was:	and number of boxes you checked was:	enter on line D:
Single	0	\$3,800
	1	4,750
	2	5,700
Married filing separately	0	3,175*
	1	3,925*
	2	4,675*
E. Compare lines C and D and enter the smaller amount. This was your standard deduction for 1994 _____		

* If your spouse itemized deductions on a separate return, enter zero on line D.



Table 5. **Worksheet for Refunds of Itemized Deductions—Deducted After 1986**

If you received refunds, rebates, or reimbursements for any expense you deducted on Schedule A (Form 1040) after 1986, complete this worksheet to figure the amount to include in income on your 1997 Form 1040. If you recovered amounts from more than one year, such as a state income tax refund from 1995 and a casualty loss reimbursement from 1993, complete a separate worksheet for each year. Use information from Schedule A (Form 1040) for the year the expense was deducted.

The amount you may have to include in income is limited to the lesser of the amount deducted for an expense or the amount recovered for that expense. For example, the recovery amount included in income for medical expenses cannot be more than the amount taken on Schedule A (Form 1040) as a medical expense reduction for the year of deduction, or the amount of the medical expense recovery, whichever is less.

A recovery is included in income only to the extent of the deduction amount that reduced your tax in the prior year (year of the deduction). If you were subject to the alternative minimum tax or your tax credits reduced your tax to zero, see "Tax Benefit Rule," under "Recoveries," earlier in this publication. If your recovery was for an itemized deduction that was previously limited, you should read "Itemized deductions limited" under "Itemized Deduction Recoveries."

- | | | |
|---|-----------|-----------|
| 1. State/local income tax refund or credit. ¹ | | 1) _____ |
| 2. Total all other Schedule A refunds or reimbursements. ¹ | | 2) _____ |
| 3. Add lines 1 and 2. | | 3) _____ |
| 4. Itemized deductions for prior year (for example, line 28, Sch. A for 1996). | 4) _____ | |
| 5. Enter the amount previously refunded to you (do not enter an amount from line 1 or line 2). | 5) _____ | |
| 6. Subtract line 5 from line 4. | 6) _____ | |
| 7. Standard deduction for prior year. | 7) _____ | |
| 8. Subtract line 7 from line 6. If the result is zero or less, stop here. The amounts on lines 1 and 2 are not taxable. | | 8) _____ |
| 9. Enter the smaller of line 3 or line 8. | | 9) _____ |
| 10. Taxable income for prior year ² (for example, line 37, Form 1040 for 1996). | 10) _____ | |
| 11. Enter the following amount to include in income— | | 11) _____ |
| If line 10 is: | | |
| • -0- or more, enter the amount from line 9. | | |
| • A negative amount, add lines 9 and 10 and enter net amount (but not less than zero). ³ | | |

Where To Include In Income For 1997

If line 11 equals line 3—

Enter the amount from line 1 on line 10, Form 1040.

Enter the amount from line 2 on line 21, Form 1040.

If line 11 is less than line 3, and either line 1 or line 2 is zero—

If there is an amount on line 1, enter the amount from line 11 as your state/local income tax refund on line 10, Form 1040.

If there is an amount on line 2, enter the amount from line 11 as other income on line 21, Form 1040, or line 9.

If line 11 is less than line 3, and there are amounts on both lines 1 and 2, complete this worksheet.

- | | | |
|--|----------|----------|
| A. Divide the amount on line 1 by the amount on line 3. Enter the percentage. | A) _____ | |
| B. Multiply the amount on line 11 by the percentage on line A.
This is your state/local income tax refund that you enter on line 10, Form 1040. | | B) _____ |
| C. Subtract the amount on line B from the amount on line 11.
This is your other itemized deduction recovery that you enter on line 21, Form 1040. | | C) _____ |

¹Do not enter more than the amount deducted for the prior year.

²If taxable income is a negative amount, enter that amount in brackets. Do not enter zero unless your taxable income is exactly zero. Taxable income will have to be adjusted for any net operating loss carryover. For more information, see Publication 536, *Net Operating Losses*.

³For example, \$700 + (\$400) = \$300.

Tax Publications for Individual Taxpayers

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 1998
- 553 Highlights of 1997 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

Specialized Publications

- 3 Armed Forces' Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 508 Educational Expenses
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 520 Scholarships and Fellowships
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property
- 529 Miscellaneous Deductions

- 530 Tax Information for First-Time Homeowners
- 531 Reporting Tip Income
- 533 Self-Employment Tax
- 534 Depreciating Property Placed in Service Before 1987
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 550 Investment Income and Expenses
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Older Americans' Tax Guide
- 555 Federal Tax Information on Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
- 575 Pension and Annuity Income
- 584 Nonbusiness Disaster, Casualty, and Theft Loss Workbook
- 587 Business Use of Your Home (Including Use by Day-Care Providers)
- 590 Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- 594 Understanding the Collection Process
- 596 Earned Income Credit
- 721 Tax Guide to U.S. Civil Service Retirement Benefits

- 901 U.S. Tax Treaties
- 907 Tax Highlights for Persons with Disabilities
- 908 Bankruptcy Tax Guide
- 911 Direct Sellers
- 915 Social Security and Equivalent Railroad Retirement Benefits
- 919 Is My Withholding Correct for 1998?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide
- 929 Tax Rules for Children and Dependents
- 936 Home Mortgage Interest Deduction
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 IRS Will Figure Your Tax
- 968 Tax Benefits for Adoption
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

- 1040 U.S. Individual Income Tax Return
 - Sch A Itemized Deductions
 - Sch B Interest and Dividend Income
 - Sch C Profit or Loss From Business
 - Sch C-EZ Net Profit From Business
 - Sch D Capital Gains and Losses
 - Sch E Supplemental Income and Loss
 - Sch EIC Earned Income Credit
 - Sch F Profit or Loss From Farming
 - Sch H Household Employment Taxes
 - Sch R Credit for the Elderly or the Disabled
 - Sch SE Self-Employment Tax
- 1040EZ Income Tax Return for Single and Joint Filers With No Dependents
- 1040A U.S. Individual Income Tax Return
 - Sch 1 Interest and Dividend Income for Form 1040A Filers

- Sch 2 Child and Dependent Care Expenses for Form 1040A Filers
- Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers
- 1040-ES Estimated Tax for Individuals
- 1040X Amended U.S. Individual Income Tax Return
- 2106 Employee Business Expenses
- 2106-EZ Unreimbursed Employee Business Expenses
- 2119 Sale of Your Home
- 2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts
- 2441 Child and Dependent Care Expenses
- 2848 Power of Attorney and Declaration of Representative
- 3903 Moving Expenses
- 4562 Depreciation and Amortization

- 4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- 4952 Investment Interest Expense Deduction
- 5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- 6251 Alternative Minimum Tax—Individuals
- 8283 Noncash Charitable Contributions
- 8582 Passive Activity Loss Limitations
- 8606 Nondeductible IRAs (Contributions, Distributions, and Basis)
- 8822 Change of Address
- 8829 Expenses for Business Use of Your Home