Publication 525

Taxable and Nontaxable Income

For use in preparing

2023 Returns

Volume 2 of 5

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Limit for deferrals under section 457 plans. If you're a participant in a section 457 plan (a deferred compensation plan for employees of state or local governments or tax-exempt organizations), you should have deferred no more than the lesser of your includible compensation or $22,500 in 2023. However, if you're within 3 years of normal retirement age, you may be allowed an increased limit if the plan allows it. See *Increased limit*, later.

Includible compensation. Generally, this is your Form W-2 wages plus elective deferrals. In most cases, it includes all the following payments.

1. Wages and salaries.
2. Fees for professional services.
3. The value of any employer-provided qualified transportation fringe benefit (defined under *Transportation*, earlier) that isn't included in your income.

4. Other amounts received (cash or noncash) for personal services you performed, including, but not limited to, the following items.

   a. Commissions and tips.

   b. Fringe benefits.

   c. Bonuses.

   d. De minimis financial incentives to make elective deferrals to a qualified cash or deferred arrangement.

5. Employer contributions (elective deferrals) to the following.

   a. The section 457 plan.

   b. Section 401(k) plans that aren't included in your income.

   c. A SARSEP plan.

   d. A tax-sheltered annuity (section 403(b) plan).

e. A SIMPLE plan.

f. A section 125 cafeteria plan.

Instead of using the amounts listed earlier to determine your includible compensation, your employer can use any of the following amounts.

- Your wages as defined for income tax withholding purposes.
- Your wages as reported in Form W-2, box 1.
- Your wages that are subject to social security withholding (including elective deferrals).

Increased limit. During any, or all, of the last 3 years ending before you reach normal retirement age under the plan, your plan may provide that your limit is the lesser of:

1. Twice the annual limit ($45,000 for 2023), or

2. The basic annual limit plus the amount of the basic limit not used in prior years (only allowed if not using age 50-or-over catch-up contributions).

Catch-up contributions. You can generally have additional elective deferrals made to your governmental section 457 plan if:

- You reached age 50 by the end of the year, and
- No other elective deferrals can be made for you to the plan for the year because of limits or restrictions.

If you qualify, your limit can be the lesser of your includible compensation or $22,500, plus $7,500. However, if you're within 3 years of retirement age and your plan provides the increased limit, discussed earlier, that limit may be higher.

Designated Roth contributions. Employers with section 401(k) plans, section 403(b) plans, and governmental section 457 plans can create qualified Roth contribution programs so that you may elect to have part or all of your elective deferrals to the plan designated as after-tax Roth contributions. Designated Roth contributions are treated as elective deferrals, except that they're included in income. Your retirement plan must maintain separate accounts and recordkeeping for the designated Roth contributions. In addition, your retirement plan may allow you to designate certain nonelective contributions or matching contributions as Roth contributions. These Roth contributions are also included in income.

Qualified distributions from a Roth account aren't included in income. A distribution made before the end of the 5-tax-year period beginning with the first tax year for which you made a Roth contribution to the account isn't a qualified distribution.

Reporting by employer. Your employer generally shouldn't include elective deferrals in your wages in Form W-2, box 1. Instead, your employer should mark the Retirement plan checkbox in box 13 and show the total amount deferred in box 12.

Section 501(c)(18)(D) contributions. Wages shown in Form W-2, box 1, shouldn't have been reduced for contributions you made to a section 501(c)(18)(D) plan. The amount you contributed should be identified with code H in box 12. You may deduct the amount deferred subject to the limits that apply. Include your deduction in the total on Schedule 1 (Form 1040), line 24f.

Designated Roth contributions. These contributions are elective deferrals but are included in your wages in Form W-2, box 1. Designated Roth contributions to a section 401(k) plan are reported using code AA in box 12, or, for section 403(b) plans, code BB in box 12. Designated Roth contributions to a governmental section 457 plan are reported using code EE in box 12.

Designated Roth nonelective contributions and designated Roth matching contributions. These contributions are reported on Form 1099-R for the year in which the contributions are allocated to your account. The total amount of designated Roth nonelective contributions and designated Roth matching contributions that are allocated to your account in the year is reported in box 1 and in box 2a. These contributions are reported using code G in box 7.

Excess deferrals. If your deferrals exceed the limit, you must notify your plan by the date required by the plan. If the plan permits, the excess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of any of the plans that permit these distributions. You must notify each plan by the date required by that plan of the amount to be paid from that particular plan. The plan must then pay you the amount of the excess, along with any income earned on that amount, by April 15 of the following year.

You must include the excess deferral in your income for the year of the deferral. File Form 1040 or 1040-SR to add the excess deferral amount to earned income on line 1h.

Excess not distributed. If you don't take out the excess amount, you can't include it in the cost of the contract even though you included it in your income. Therefore, you're taxed twice on the excess deferral left in the plan—once when you contribute it, and again when you receive it as a distribution (unless the excess deferral was a designated Roth contribution).

Excess distributed to you. If you take out the excess after the year of the deferral and you receive the corrective distribution by April 15 of the following year, don't include it in income again in the year you receive it. If you receive it later, you must include it in income in both the year of the deferral and the year you receive it (unless the excess deferral was a designated Roth contribution). Any income on the excess deferral taken out is taxable in the tax year in which you take it out. If you take out part of the excess deferral and the income on it, allocate the distribution proportionately between the excess deferral and the income.

You should receive a Form 1099-R for the year in which the excess deferral is distributed to you. Use the following rules to report a corrective distribution shown on Form 1099-R for 2023.

- If the distribution was for a 2023 excess deferral, your Form 1099-R should have code 8 in box 7. Add the excess deferral amount to your wages on your 2023 tax return.

- If the distribution was for a 2023 excess deferral to a designated Roth account, your Form 1099-R should have codes B and 8 in box 7. Don’t add this amount to your wages on your 2023 return.
- If the distribution was for a 2022 excess deferral, your Form 1099-R should have code P in box 7. If you didn't add the excess deferral amount to your wages on your 2022 tax return, you must file an amended return on Form 1040-X. If you didn't receive the distribution by April 15, 2023, you must also add it to your wages on your 2023 tax return.
- If the distribution was for the income earned on an excess deferral, your Form 1099-R should have code 8 in box 7. Add the income amount to your wages on your 2023 income tax return, regardless of when the excess deferral was made.

Report a loss on a corrective distribution of an excess deferral in the year the excess amount (reduced by the loss) is distributed to you. Include the loss as a negative amount on Schedule 1 (Form 1040), line 8z, and identify it as “Loss on Excess Deferral Distribution.”

TIP *Even though a corrective distribution of excess deferrals is reported on Form 1099-R, it isn't otherwise treated as a distribution from the plan. It can't be rolled over into another plan, and it isn't subject to the additional tax on early distributions.*

Excess Contributions

If you're a highly compensated employee, the total of your elective deferrals made for you for any year under a section 401(k) plan or SARSEP plan may be limited by the average deferrals, as a percentage of pay, made by all eligible non-highly compensated employees.

If you contributed more to the plan than allowed, the excess contributions may be distributed to you. You must include the distribution in your income on Form 1040 or 1040-SR, line 1h.

If you receive a corrective distribution of excess contributions (and allocable income), it's included in your income in the year of the distribution. The allocable income is the amount of gain or loss through the end of the plan year for which the contribution was made that is allocable to the excess contributions. You should receive a Form 1099-R for the year the excess contributions are distributed to you. Add the distribution to your wages for that year.

TIP *Even though a corrective distribution of excess contributions is reported on Form 1099-R, it isn't otherwise treated as a distribution from the plan. It can't be rolled over into another plan, and it* *isn't subject to the additional tax on early distributions.*

Excess Annual Additions

The amount contributed in 2023 to a defined contribution plan is generally limited to the lesser of 100% of your compensation or $66,000. Under certain circumstances, contributions that exceed these limits (excess annual additions) may be corrected by a distribution of your elective deferrals or a return of your after-tax contributions and earnings from these contributions.

A corrective payment of excess annual additions consisting of elective deferrals or earnings from your after-tax contributions is fully taxable in the year paid. A corrective payment consisting of your after-tax contributions isn't taxable.

If you received a corrective payment of excess annual additions, you should receive a separate Form 1099-R for the year of the payment with code E in box 7. Report the total payment shown in Form 1099-R, box 1, on Form 1040 or 1040-SR, line 5a. Report the taxable amount shown in Form 1099-R, box 2a, on Form 1040 or 1040-SR, line 5b.

Even though a corrective distribution of excess annual additions is reported on Form 1099-R, it isn't otherwise treated as a distribution from the plan. It can't be rolled over into another plan, and it isn't subject to the additional tax on early distributions.

Stock Options

Employee stock options aren’t subject to Railroad Retirement Tax. In *Wisconsin Central Ltd.* v. *United States*, 138 S. Ct. 2067, the U.S. Supreme Court ruled that “money remuneration” is “currency issued by a recognized authority as a medium of exchange,” and that employee stock options aren’t “money remuneration” subject to the

Railroad Retirement Tax Act (RRTA). Tier 1 and Tier 2 taxes aren’t withheld when employees covered by the RRTA exercise stock options. Federal income tax must still be withheld on taxable compensation from railroad employees exercising their options. If you receive an option to buy or sell stock or other property as payment for your services, you may have income when you receive the option (the grant), when you exercise the option (use it to buy or sell the stock or other property), or when you sell or otherwise dispose of the option or property acquired through exercise of the option. The timing, type, and amount of income inclusion depend on whether you receive a nonstatutory stock option or a statutory stock option. Your employer can tell you which kind of option you hold.

Nonstatutory Stock Options Grant of option. If you're granted a nonstatutory stock option, you may have income when you receive the option. The amount of income to include and the time to include it depend on whether the FMV of the option can be readily determined. The FMV of an option can be readily determined if it’s actively traded on an established market.

The FMV of an option that isn't traded on an established market can be readily determined only if all of the following conditions exist.

- You can transfer the option.
- You can exercise the option immediately in full.
- The option or the property subject to the option isn't subject to any condition or restriction (other than a condition to secure payment of the purchase price) that has a significant effect on the FMV of the option.
- The FMV 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 FMV 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.

CAUTION

If you or a member of your family is an officer, director, or more-than-10% owner of an expatriated corporation, you may owe an excise tax on the value of nonstatutory options and other stock-based compensation from that corporation. For more information on the excise tax, see section 4985.

Option with readily determinable value. If you receive a nonstatutory stock option that has a readily determinable FMV at the time it's granted to you, the option is treated like other property received as compensation. See *Restricted Property*, later, for rules on how much income to include and when to include it. However, the rule described in that discussion for choosing to include the value of property in your income for the year of the transfer doesn't apply to a nonstatutory option.

Option without readily determinable value. If the FMV of the option isn't readily determinable at the time it's granted to you (even if it's determined later), you don't have income until you exercise or transfer the option.

Exercise or transfer of option. When you exercise a nonstatutory stock option, the amount to include in your income depends on whether the option had a readily determinable value.

Option with readily determinable value. When you exercise a nonstatutory stock option that had a readily determinable value at the time the option was granted, you don't have to include any amount in income.

Option without readily determinable value. When you exercise a nonstatutory stock option that didn't have a readily determinable value at the time the option was granted, the restricted property rules apply to the property received. The amount to include in your income is the difference between the amount you pay for the property and its FMV when it becomes substantially vested. If it isn't substantially vested at the time you exercise this nonstatutory stock option (so that you may have to give the stock back), you don't have to include any amount in income. You include the difference in income when the option becomes substantially vested. For more information on restricted property, see Restricted Property, later.

Transfer in arm's-length transaction. If you transfer a nonstatutory stock option without a readily determinable value in an arm's-length transaction to an unrelated person, you must include in your income the money or other property you received for the transfer as if you had exercised the option.

Transfer in non-arm's-length transaction. If you transfer a nonstatutory stock option without a readily determinable value in a non-arm's-length transaction (for example, a gift), the option isn't treated as exercised or closed at that time. You must include in your income, as compensation, any money or property received. When the transferee exercises the option, you must include in your income, as compensation, the excess of the FMV of the stock acquired by the transferee over the sum of the exercise price paid and any amount you included in income at the time you transferred the option. At the time of the exercise, the transferee recognizes no income and has a basis in the stock acquired equal to the FMV of the stock.

Any transfer of this kind of option to a related person is treated as a non-arm's-length transaction. See Regulations section 1.83-7 for the definition of a related person.

Recourse note in satisfaction of the exercise price of an option. If you're an employee, and you issue a recourse note to your employer in satisfaction of the exercise price of an option to acquire your employer's stock, and your employer and you subsequently agree to reduce the stated principal amount of the note, you generally recognize compensation income at the time and in the amount of the reduction.

Tax form. If you have income from the exercise of nonstatutory stock options, your employer should report the amount to you in Form W-2, box 12, with code V. The employer should show the spread (that is, the FMV of stock over the exercise price of options granted to you for that stock) from your exercise of the nonstatutory stock options. Your employer should include this amount in boxes 1, 3 (up to the social security wage base), and 5. Your employer should include this amount in box 14 if it's a railroad employer.

If you're a nonemployee spouse and you exercise nonstatutory stock options you received incident to a divorce, the income is reported to you in box 3 of Form 1099-MISC.

Sale of the stock. There are no special income rules for the sale of stock acquired through the exercise of a nonstatutory stock option. Report the sale as explained in the Instructions for Schedule D (Form 1040) for the year of the sale. You may receive a Form 1099-B reporting the sales proceeds.

Your basis in the property you acquire under the option is the amount you pay for it plus any amount you included in income upon grant or exercise of the option.

Your holding period begins as of the date you acquired the option, if it had a readily determinable value, or as of the date you exercised or transferred the option if it had no readily determinable value.

For options granted on or after January 1, 2014, the basis information reported to you on Form 1099-B won't reflect any amount you included in income upon grant or exercise of the option. For options granted before January 1, 2014, any basis information reported to you on Form 1099-B may or may not reflect any amount you included in income upon grant or exercise; therefore, the basis may need to be adjusted.

It’s your responsibility to make any appropriate adjustments to the basis information reported on Form 1099-B by completing Form 8949.

Statutory Stock Options

There are two kinds of statutory stock options.

- Incentive stock options (ISOs).
- Options granted under employee stock purchase plans.

For either kind of option, you must be an employee of the company granting the option, or a related company, at all times during the period beginning on the date the option is granted and ending 3 months before the date you exercise the option (for an ISO, 1 year before if you're disabled). Also, the option must be nontransferable except at death.

If you don't meet the employment requirements, or you receive a transferable option, your option is a nonstatutory stock option.

Grant of option. If you receive a statutory stock option, don't include any amount in your income when the option is granted.

Exercise of option. If you exercise a statutory stock option, don't include any amount in income when you exercise the option.

Alternative minimum tax (AMT). For the AMT, you must treat stock acquired through the exercise of an ISO as if no special treatment applied. This means that, when your rights in the stock are transferable or 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 FMV of the stock exceeds the option price. Enter this adjustment on Form 6251, line 2i. Increase your AMT basis in any stock you acquire by exercising the ISO by the amount of the adjustment. However, no adjustment is required if you dispose of the stock in the same year you exercise the option.

See *Restricted Property*, later, for more information.

Your AMT basis in stock acquired through an ISO is likely to differ from your regular tax basis. Therefore, keep adequate records for both the AMT and regular tax so that you can figure your adjusted gain or loss.

Example 7. Your employer, Elm Company, granted you an ISO on April 8, 2022, to buy 100 shares of Elm Company at $9 a share, its FMV at the time. You exercised the option on January 7, 2023, when the stock was selling on the open market for $14 a share. On January 27, 2023, when the stock was selling on the open market for $16 a share, your rights to the stock first became transferable.

You include $700 ($1,600 value when your rights first became transferable minus $900 option price) as an adjustment on Form 6251, line 2i.

If you exercise an ISO during 2023, you should receive Form 3921, or a statement, from the corporation for each transfer made during 2023. The corporation must send or provide you with the form by January 31, 2024. Keep this information for your records.

Sale of the stock. You have taxable income or a deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it as explained in the Instructions for Schedule D (Form 1040) for the year of the sale.

However, you may have ordinary income for the year that you sell or otherwise dispose of the stock in either of the following situations.

- You don't satisfy the holding period requirement.
- You satisfy the conditions described under *Option granted at a discount* under *Employee stock purchase plan*, later.

Your employer or former employer should report the ordinary income to you as wages in Form W-2, box 1, and you must report this ordinary income amount on Form 1040 or 1040-SR, line 1a. Enter on Schedule 1 (Form 1040), line 8k, any income from the exercise of stock options not otherwise reported on Form 1040 or 1040-SR, line 1a.

For options granted on or after January 1, 2014, the basis information reported to you on Form 1099-B won't reflect any amount you included in income upon grant or exercise of the option. For options granted before

January 1, 2014, any basis information reported to you on Form 1099-B may or may not reflect any amount you included in income upon grant or exercise; therefore, the basis may need to be adjusted.

It’s your responsibility to make any appropriate adjustments to the basis information reported on Form 1099-B by completing Form 8949.

Holding period requirement. You satisfy the holding period requirement if you don't sell the stock until the end of the later of the 1-year period after the stock was transferred to you or the 2-year period after the option was granted. However, you're considered to satisfy the holding period requirement if you sold the stock to comply with conflict-of-interest requirements.

Your holding period for the property you acquire when you exercise an option begins on the day after you exercise the option.

ISOs. If you sell stock acquired by exercising an ISO, you need to determine if you satisfied the holding period requirement.

Holding period requirement satisfied. If you sell stock acquired by exercising an ISO and satisfy the holding period requirement, your gain or loss from the sale is capital gain or loss. Report the sale as explained in the Instructions for Schedule D (Form 1040). The basis of your stock is the amount you paid for the stock.

Holding period requirement not satisfied. If you sell stock acquired by exercising an ISO, don't satisfy the holding period requirement, and have a gain from the sale, the gain is ordinary income up to the amount by which the stock's FMV when you exercised the option exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it's a capital loss and you don't have any ordinary income.

Your employer or former employer should report the ordinary income to you as wages in Form W-2, box 1, and you must report this ordinary income amount on Form 1040 or 1040-SR, line 1a. If your employer or former employer doesn't provide you with a Form W-2, or if the Form W-2 doesn't include the ordinary income in box 1, you must report the ordinary income as wages on Schedule 1 (Form 1040), line 8k, for the year of the sale or other disposition of the stock. Report the capital gain or loss as explained in the Instructions for Schedule D (Form 1040). In determining capital gain or loss, your basis is the amount you paid when you exercised the option plus the amount reported as wages.

Example 8. Your employer, Oak Corporation, granted you an ISO on March 12, 2021, to buy 100 shares of Oak Corporation stock at $10 a share, its FMV at the time. You exercised the option on January 7, 2022, when the stock was selling on the open market for $12 a share. On January 27, 2023, 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 2023, you must report the difference between the option price ($10) and the value of the stock when you exercised the option ($12) as wages. 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 wages [($12 × 100 shares) − $1,000]	− 200
Amount reported as capital gain	$ 300

Employee stock purchase plan. If you sold stock acquired by exercising an option granted under an employee stock purchase plan, you need to determine if you satisfied the holding period requirement.

Holding period requirement satisfied. If you sold stock acquired by exercising an option granted under an employee stock purchase plan, and you satisfy the holding period requirement, determine your ordinary income as follows.

Your basis is equal to the option price at the time you exercised your option and acquired the stock. The timing and amount of pay period deductions don't affect your basis.

Example 9. Pine Company has an employee stock purchase plan. The option price is the lower of the stock price at the time the option is granted or at the time the option is exercised. The value of the stock when the option was granted was $25. Pine Company deducts $5 from Adrian's pay every week for

48 weeks (total = \$240 (\$5 × 48)). The value of the stock when the option is exercised is \$20. Adrian receives 12 shares of Pine Company’s stock (\$240 ÷ \$20). Adrian's holding period for all 12 shares begins the day after the option is exercised, even though the money used to purchase the shares was deducted from Adrian's pay on 48 separate days. Adrian's basis in each share is \$20.

Option granted at a discount. If, at the time the option was granted, the option price per share was less than 100% (but not less than 85%) of the FMV of the share, and you dispose of the share after meeting the holding period requirement, or you die while owning the share, you must include in your income as compensation the lesser of:

- The excess of the FMV of the share at the time the option was granted over the option price, or
- The excess of the FMV of the share at the time of the disposition or death over the

amount paid for the share under the option.

For this purpose, if the option price wasn't fixed or determinable at the time the option was granted, the option price is figured as if the option had been exercised at the time it was granted.

Any excess gain is capital gain. If you have a loss from the sale, it's a capital loss, and you don't have any ordinary income.

Example 10. Your employer, Willow Corporation, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Willow 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 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 per share) is capital gain, figured as follows.

Selling price ($30 × 100 shares) . . .	$ 3,000
Purchase price (option price) ($20 × 100 shares)	− 2,000
Gain	$ 1,000
Amount reported as wages[($22 × 100 shares) − $2,000] . . .	− 200
Amount reported as capital gain .	$ 800

Holding period requirement not satisfied. If you don't satisfy the holding period requirement, your ordinary income is the amount by which the stock's FMV when you exercised the option exceeded the option price. This ordinary income isn't limited to your gain from the sale of the stock. Increase your basis in the stock by the amount of this ordinary income. The difference between your increased basis and the selling price of the stock is a capital gain or loss.

Example 11. The facts are the same as in *Example 10*, except that you sold the stock only 6 months after you exercised the option. You didn't satisfy the holding period requirement, so you must report $300 as wages and $700 as capital gain, figured as follows.

Selling price ($30 × 100 shares) . .	$3,000
Purchase price (option price) ($20 × 100 shares)	− 2,000
Gain	$1,000
Amount reported as wages [($23 × 100 shares) − $2,000] . . .	− 300
Amount reported as capital gain [$3,000 – ($2,000 + $300)]	$700

TIP *If you sold stock in 2023 that you acquired by exercising an option granted at a discount under an employee stock purchase plan, you should receive Form 3922 from the corporation. The corporation must send or provide you with the form by January 31, 2024. Keep this information for your records.*

Qualified Equity Grants

P.L. 115-97 made a change in the law that allows a new election for “qualified employees” of private corporations to elect to defer income taxation for up to 5 years from the date of vesting on “qualified stock” granted in connection with broad-based compensatory stock option and restricted stock unit (RSU) programs. This election is available for stock attributable to options exercised or RSUs settled after 2017. The corporation must have a written plan providing RSU or option to at least 80% of U.S. employees. The recipients must have the same rights and privileges under RSU or option plan.

The term “qualified employee” doesn’t include:

- 1% owner of corporation (current or any point during prior 10 calendar years),
- Current or former CEO or CFO (current or any point previously),
- Family of previously mentioned individuals, or
- One of the four highest compensated officers (current or any point during prior 10 calendar years).

The term “qualified stock” means any stock in a corporation that is the employer of the employee if:

- Stock is received relating to the exercise of an option, or
- Stock is received in settlement of an RSU,

and

- Option or RSU was granted by the corporation.

The term “qualified stock” can’t include stock from stock-settled stock appreciation rights or restricted stock awards (restricted property). It won’t include any stock if the employee may receive cash instead of stock. The election is made in a manner similar to the election described under *Choosing to include in income for year of transfer*, later, under *Restricted Property*, even though the “qualified stock” isn't restricted property. The election must be made no later than 30 days after the first date the rights of the employee in such stock are transferable or aren’t subject to a substantial risk of forfeiture, whichever occurs earlier. See *Restricted Property*, later, for how to make the choice.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the year that includes the earliest of (1) the first date the qualified stock becomes transferable, (2) the date the employee first becomes an excluded employee (as excluded from “qualified employee”), (3) the first date on which any stock of the employer becomes readily tradable on an established securities market, (4) the date 5 years after the first date the employee's right to the stock becomes substantially vested, or (5) the date on which the employee revokes his or her inclusion deferral election.

The employer corporation is required to provide notification of rights to employees covered under a qualified program or face penalties. There will be withholding at the highest marginal rate.

Restricted Property

In most cases, if you receive property for your services, you must include its FMV 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 don't include the value of the property in your income until it has been substantially vested. (You can choose to include the value of the property in your income in the year it's transferred to you, as discussed later, rather than the year it's substantially vested.)

Until the property becomes substantially vested, it's 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 additional compensation in the year you receive the income or have the right to use the property.

When the property becomes substantially vested, you must include its FMV, minus any amount you paid for it, in your income for that year. Your holding period for this property begins when the property becomes substantially vested.

Example 12. Your employer, the Holly Corporation, sells you 100 shares of its stock at $10 a share. At the time of the sale, the FMV of the stock is $100 a share. Under the terms of the sale, the stock is under a substantial risk of forfeiture (you have a good chance of losing it) for a 5-year period. Your stock isn't substantially vested when it's transferred, so you don't include any amount in your income in the year you buy it. At the end of the 5-year period, the FMV of the stock is $200 a share. You must include $19,000 in your income [100 shares × ($200 FMV − $10 you paid)]. Dividends paid by the Holly Corporation on your 100 shares of stock are taxable to you as additional compensation during the period the stock can be forfeited.

Substantially vested. Property is substantially vested when:

- It’s transferable, or
- It isn't subject to a substantial risk of forfeiture. (You don't 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 isn't required to give up the property, or its value, if the substantial risk of forfeiture occurs.

Substantial risk of forfeiture. Generally, a substantial risk of forfeiture exists only if rights in property that are transferred are conditioned, directly or indirectly, on the future performance (or refraining from performance) of substantial services by any person, or on the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial.

Example 13. The Redwood 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. 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 don't perform the services; so, your rights to the stock are subject to a substantial risk of forfeiture.

Choosing to include in income for year of transfer. You can choose to include the value of restricted property at the time of transfer (minus any amount you paid for the property) in your income for the year it's transferred. If you make this choice, the substantial vesting rules don't apply and, generally, any later appreciation in value isn't included in your compensation when the property becomes substantially vested. Your basis for figuring gain or loss when you sell the property is the amount you paid for it plus the amount you included in income as compensation.

If you make this choice, you can't revoke it without the consent of the IRS. Consent will be given only if you were under a mistake of fact as to the underlying transaction.

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 can't make this choice for a nonstatutory stock option.

How to make the choice. 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. Mail your statement to the address listed for your state under “Are requesting a refund or aren’t enclosing a check or money order...” given in *Where Do You File* in the Instructions for Forms 1040 and 1040-SR. You 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're making the choice under section 83(b) of the Internal Revenue Code. The statement must contain all of the following information.

- Your name, address, and TIN.

- A description of each property for which you're making the choice.
- The date or dates on which the property was transferred and the tax year for which you're making the choice.
- The nature of any restrictions on the property.
- The FMV at the time of transfer (ignoring restrictions except those that will never lapse) of each property for which you're making the choice.
- Any amount that you paid for the property.
- A statement that you have provided copies to the appropriate persons.

CAUTION *You can't make this choice for a nonstatutory stock option.*

Dividends received on restricted stock. Dividends you receive on restricted stock are treated as compensation and not as dividend income. Your employer should include these payments on your Form W-2. If they are also reported on a Form 1099-DIV, you should list them on Schedule B (Form 1040), with a statement that you have included them as wages. Don’t include them in the total dividends received.

Stock you chose to include in your income. Dividends you receive on restricted stock you chose to include in your income in the year transferred are treated the same as any other dividends. You should receive a Form 1099-DIV showing these dividends. Don’t include the dividends in your wages on your return. Report them as dividends.

Sale of property not substantially vested. These rules apply to the sale or other disposition of property that you didn't choose to include in your income in the year transferred and that isn't substantially vested.

If you sell or otherwise dispose of the property in an arm's-length transaction, include in your income as compensation for the year of sale the amount realized minus the amount you paid for the property. If you exchange the property in an arm's-length transaction for other property that isn't substantially vested, treat the new property as if it were substituted for the exchanged property.

The sale or other disposition of a nonstatutory stock option to a related person isn't considered an arm's-length transaction. See Regulations section 1.83-7 for the definition of a “related person.”

If you sell the property in a transaction that isn't at arm's length, include in your income as compensation for the year of sale the total of any money you received and the FMV of any substantially vested property you received on the sale. In addition, you'll have to report income when the original property becomes substantially vested, as if you still held it. Report as compensation its FMV minus the total of the amount you paid for the property and the amount included in your income from the earlier sale.

Example 14. In 2020, you paid your employer $50 for a share of stock that had an FMV of $100 and was subject to forfeiture until 2023. In 2022, you sold the stock to your spouse for $10 in a transaction not at arm's length. You had compensation of $10 from this transaction. In 2023, when the stock had an FMV of $120, it became substantially vested. For 2022, you must report additional compensation of $60, figured as follows.

FMV 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	− 60
Additional income		$60

Inherited property not substantially vested. If you inherit property not substantially vested at the time of the decedent's death, any income you receive from the property 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, see Pub. 559.

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, members of religious orders, people working for foreign employers, military personnel, and volunteers.

Clergy

If you’re 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 isn't taxable to you.

If you’re a member of a religious organization and you give your outside earnings to the organization, you must still include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. See Pub. 526. Also, see *Members of Religious Orders*, later.

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 5a and 5b of Form 1040 or 1040-SR.

Housing

Special rules for housing apply to members of the clergy. Under these rules, you don't include in your income the rental value of a home (including utilities) or a designated housing allowance provided to you as part of your pay. However, the exclusion can't be more than the reasonable pay for your service. If you pay for the utilities, you can exclude any allowance designated for utility cost, up to your actual cost. The home or allowance must be provided as compensation for your services as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040) if you’re subject to the self-employment tax. For more information, see Pub. 517.

Members of Religious Orders

If you're a member of a religious order who has taken a vow of poverty, how you treat earnings that you renounce and turn over to the order depends on whether your services are performed for the order.

Services performed for the order. If you're performing the services as an agent of the order in the exercise of duties required by the order, don't 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're 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 aren't included in your income.

Example 15. You're 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're 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're considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order aren't included in your income.

Services performed outside the order. If you're directed to work outside the order, your services aren't an exercise of duties required by the order unless they meet both of the following requirements.

- They're the kind of services that are ordinarily the duties of members of the order.
- They're part of the duties that you must exercise for, or on behalf of, the religious order as its agent.

If you're an employee of a third party, the services you perform for the third party won't be considered directed or required of you by the order. Amounts you receive for these services are included in your income, even if you have taken a vow of poverty.

Example 16. You are a member of a religious order and have taken a vow of poverty. You renounce all claims to your earnings and turn over your earnings to the order.

You are a schoolteacher. You were instructed by the superiors of the order to get a job with a private tax-exempt school. You became an employee of the school, and, at your request, the school made the salary payments directly to the order.

Because you are an employee of the school, you’re performing services for the school rather than as an agent of the order. The wages you earn working for the school are included in your income.

Example 17. You are a member of a religious order who, as a condition of membership, have taken vows of poverty and obedience. All claims to your earnings are renounced. You received permission from the order to establish a private practice as a psychologist and counsel members of religious orders as well as nonmembers. Although the order reviews your budget annually, you control not only the details of your practice but also the means by which your work as a psychologist is accomplished.

Your private practice as a psychologist doesn't make you an agent of the religious order. The psychological services you provide aren't the type of services that are provided by the order. The income you earn as a psychologist is earned in your individual capacity. You must include in your income the earnings from your private practice.

Foreign Employer

Special rules apply if you work for a foreign employer.

U.S. citizen. If you're 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're exempt from social security and Medicare employee taxes if you're 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 aren't self-employed. This rule also applies if you're an employee of a qualifying wholly owned instrumentality of a foreign government.

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

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

- You aren't a citizen of the United States or you're a citizen of the Philippines (whether or not you're a citizen of the United States).
- Your work is like the work done by employees of the United States in foreign countries.

- The foreign government gives an equal exemption to employees of the United States in its country.

Waiver of alien status. If you're an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, any salary you receive after the date you file the waiver isn't exempt under this rule. However, it may be exempt under a treaty or agreement. See Pub. 519, U.S. Tax Guide for Aliens, for more information about treaties.

Nonwage income. This exemption applies only to employees' wages, salaries, and fees. Pensions and other income, such as investment income, don't qualify for this exemption.

Employment abroad. For information on the tax treatment of income earned abroad, see Pub. 54.

Military

Payments you receive as a member of a military service are generally taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally aren't taxed. For more information on the tax treatment of military allowances and benefits, see Pub. 3.

Differential wage payments. Any payments made to you by an employer during the time you're performing service in the uniformed services are treated as compensation. These wages are subject to income tax withholding and are reported on Form W-2. See the discussion under *Miscellaneous Compensation*, earlier.

Military retirement pay. If your retirement pay is based on age or length of service, it’s taxable and must be included in your income as a pension on lines 5a and 5b of Form 1040 or 1040-SR. Don’t include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For a more detailed discussion of survivor annuities, see Pub. 575.

Disability. If you're retired on disability, see *Military and Government Disability Pensions* under *Sickness and Injury Benefits*, later.

Qualified reservist distribution (QRD). If you received a QRD of all or part of the balance in your health FSA because you're a reservist and you have been ordered or called to active duty for a period of 180 days or more, the QRD is treated as wages and is reportable on Form W-2.

Veterans' benefits. Don’t include in your income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans

Affairs (VA). The following amounts paid to veterans or their families aren't taxable.

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

- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the U.S. Armed Forces who died after September 10, 2001.
- Payments made under the compensated work therapy program.
- Any bonus payment by a state or political subdivision because of service in a combat zone.

Note. If, in a previous year, you received a bonus payment by a state or political subdivision because of service in a combat zone that you included in your income, you can file a claim for refund of the taxes on that income. Use Form 1040-X to file the claim. File a separate form for each tax year involved. In most cases, you must file your claim within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. See the Instructions for Form 1040-X for information on filing that form.

Volunteers

The tax treatment of amounts you receive as a volunteer is covered in the following discussions.

Peace Corps. Living allowances you receive as a Peace Corps volunteer or volunteer leader for housing, utilities, household supplies, food, and clothing are exempt from tax.

Taxable allowances. The following allowances must be included in your income and reported as wages.

- Allowances paid to your spouse and minor children while you're a volunteer leader training in the United States.
- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for

personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.

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

Example 18. You are a Peace Corps volunteer and get $175 a month as a readjustment allowance during your period of service, to be paid to you in a lump sum at the end of your tour of duty. Although the allowance isn't available to you until the end of your service, you must include it in your income on a monthly basis as it’s credited to your account.

Volunteers in Service to America (VISTA). If you're a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

National Senior Service Corps programs. Don’t include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

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

Service Corps of Retired Executives (SCORE). If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, don't include these amounts in gross income.

Volunteer tax counseling. Don’t 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.

Volunteer firefighters and emergency medical responders. If you are a volunteer firefighter or emergency medical responder, do not include in your income the following benefits you receive from a state or local government.

- Rebates or reductions of property or income taxes you receive because of services you performed as a volunteer firefighter or emergency medical responder.
- Payments you receive because of services you performed as a volunteer firefighter

or emergency medical responder, up to $50 for each month you provided services.

The excluded income reduces any related tax or contribution deduction.

Business and Investment Income

This section provides information on the treatment of income from certain rents and royalties, and from interests in partnerships and S corporations.

Note. You may be subject to the Net Investment Income Tax (NIIT). The NIIT is a 3.8% tax on the lesser of net investment income or the excess of your modified adjusted gross income (MAGI) over a threshold amount. For details, see Form 8960 and its instructions.

CAUTION

Income from sales at auctions, including online auctions, may be business income. For more information, see Pub. 334.

Rents From Personal Property

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

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

In most cases, if your primary purpose is income or profit and you're involved in the rental activity with continuity and regularity, your rental activity is a business.

Reporting business income and expenses. If you're in the business of renting personal property, report your income and expenses on Schedule C (Form 1040). The form instructions have information on how to complete them.

Reporting nonbusiness income. If you aren't in the business of renting personal property, report your rental income on Schedule 1 (Form 1040), line 8l.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on Schedule 1 (Form 1040), line 24b.

If you don't rent personal property for profit, your deductions are limited and you can't report a loss to offset other income. See *Activity not for profit* under *Other Income*, later.

Royalties

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

In most cases, you report royalties on Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C (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 generally based on production or revenue and are paid to you by a person or company who leases the property from you.

Depletion. If you're the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance.

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, see chapter 2 of Pub. 544.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment as explained in the Instructions for Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Pub. 544.

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

Part of future production sold (carved out production payment). If you own mineral property but sell part of the future production, in most cases you treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Don’t 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.

Partnership Income

A partnership generally isn't a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items. For more information, see Pub. 541.

Partner's distributive share. Your distributive share of partnership income, gains, losses, deductions, or credits is generally based on the partnership agreement. You must report your distributive share of these items on your return whether or not they are actually distributed to you. However, your distributive share of the partnership losses is limited to the adjusted basis of your partnership 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 doesn't state how a specific item of gain or loss will be shared, or the allocation stated in the agreement doesn't have substantial economic effect, your distributive share is figured according to your interest in the partnership.

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

Schedule K-1 (Form 1065). You should receive from each partnership in which you're 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. Keep Schedule K-1 for your records. Don’t attach it to your Form 1040 or 1040-SR, unless you're specifically required to do so.

Partner's return. You must generally report partnership items on your individual return the same way as they're reported on the partnership return. That is, if the partnership had a capital gain, you report your share as explained in the Instructions for Schedule D (Form 1040).

You report your share of partnership ordinary income on Schedule E (Form 1040).

TIP *In many cases, Schedule K-1 (Form 1065) will tell you where to report an item of income on your individual return.*

Qualified joint venture. If you and your spouse each materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership. To make this election, you must divide all items of income, gain, loss, deduction, and credit attributable to the business between you and your spouse in accordance with your respective interests in the venture. For further information on how to make the election and which schedule(s) to file, see the instructions for your individual tax return.

S Corporation Income

In most cases, an S corporation doesn't pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's pro rata share. You must report your share of these items on your return. In most cases, the items passed through to you will increase or decrease the basis of your S corporation stock as appropriate.

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

Schedule K-1 (Form 1120-S). You should receive a copy of Schedule K-1 (Form 1120-S) from any S corporation in which you're a shareholder. Schedule K-1 (Form 1120-S) shows your share of income, losses, deductions, and credits for the tax year. Keep Schedule K-1 (Form 1120-S) for your records. Don’t attach it to your Form 1040 or 1040-SR, unless you're specifically required to do so.

Shareholder's return. Your distributive share of the items of income, losses, deductions, or credits of the S corporation must be shown separately on your Form 1040 or 1040-SR. The character of these items is generally the same as if you had realized or incurred them personally.

TIP *In many cases, Schedule K-1 (Form 1120-S) will tell you where to report an item of income on your individual return.*

Distributions. In most cases, 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.

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

Sickness and Injury Benefits

In most cases, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. For information on nontaxable payments, see *Military and Government*

Disability Pensions and *Other Sickness and Injury Benefits*, later in this discussion.

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

Cost paid by you. If you pay the entire cost of an accident or health plan, don't include any amounts you receive from the plan for personal injury or sickness as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Recoveries* under *Miscellaneous Income*, later.

Cafeteria plans. In most cases, if you're covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums wasn't included in your income, you aren't considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you're considered to have paid the premiums and any benefits you receive aren't taxable.

Disability Pensions

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments on line 1h of Form 1040 or 1040-SR until you reach minimum retirement age. Minimum retirement age is generally the age at which you can first receive a pension or annuity if you aren't disabled.

TIP *You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see Pub. 524.*

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 5a and 5b of Form 1040 or 1040-SR. For more information on pensions and annuities, see Pub. 575.

Terrorist attacks or military action. Don’t include in your income disability payments you receive for injuries incurred as a direct result of terrorist attacks or military action directed against the United States (or its allies), whether outside or within the United States. In the case of the September 11 attacks, injuries eligible for coverage by the September 11 Victim Compensation Fund are treated as incurred as a direct result of the attack. However, you must include in your income any amounts that you received that you would have received in retirement had you not become disabled as a result of a terrorist attack or military action. Accordingly, you must include in your income any payments you receive from a 401(k), pension, or other retirement plan to the extent that you would have received the amount at the same or later time regardless of whether you had become disabled. See Pub. 907.

A terrorist action is one that is directed against the United States or any of its allies (including a multinational force in which the United States is participating). A military action is one that involves the U.S. Armed Forces and is a result of actual or threatened violence or aggression against the United States or any of its allies, but doesn't include training exercises.

TIP *Contact the company or agency making these payments if it incorrectly reports your payments as taxable income to the IRS on Form W-2, or on Form 1099-R, to request that it reissue the form to report some or all of these payments as nontaxable income in box 12 (under code*

J) of Form W-2 or in box 1 but not in box 2a of Form 1099-R. If income taxes are being incorrectly withheld from these payments, you may also submit Form W-4 to the company or agency to stop the withholding of income taxes from payments reported on Form W-2 or you may submit Form W-4P to stop the withholding of income taxes from payments reported on Form 1099-R.

Disability payments you receive for injuries not incurred as a direct result of a terrorist attack or military action or for illnesses or diseases not resulting from an injury incurred as a direct result of a terrorist attack or military action can't be excluded from your income under this provision but may be excludable for other reasons. See Pub. 907.