

Publication 4491

VITA/TCE Training Guide

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

Volume 8 of 16

2023 RETURNS



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EXERCISES

Answers follow the lesson summary.

Question 1: Hank comes to your site to get some help with his tax return. He is upset because his neighbor told him that he would have to pay tax on all of his Social Security benefits this year. After talking to Hank, you learn that his wife died several years ago. This tax year, he sold all of his stock and moved into senior housing. The sale of the stock created \$31,896 of taxable income for Hank. His neighbor told him, with that much income, the entire \$11,724 of his Social Security benefits would be taxable. What is the maximum taxable amount of Hank's benefits?

- a. \$31,896
- b. \$20,172

c. \$11,724

d. \$9,965

What are lump-sum benefit payments?

Some taxpayers may have received a lump-sum benefit payment. This payment could be for the current tax year and for prior tax years. Box 3 of the taxpayer's Form SSA-1099 or Form RRB-1099 will include the lump-sum payment. The form will also show the year, or years, for which the payment is made. The additional information will be shown in Description of Amount in Box 3 on Form SSA-1099 or in Boxes 7–9 on Form RRB-1099.



Do not confuse this type of lump-sum benefit payment with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

When figuring the taxable portion of Social Security benefits, two options are available for lump-sum benefit payments:

- The **first option** allows the taxpayer to report the whole payment the year it was received. When the taxpayer chooses this option, complete the Social Security Benefits Worksheet as usual by including the entire lump-sum payment as normal.
- The **second option** is to treat the payment as received in the earlier year or years. This is done by figuring whether any part of these benefits is taxable, based on the earlier year's income. Any part that is taxable is then added to any taxable benefits for the current year and included on Form 1040. The taxpayer can elect this method if it lowers the taxable benefits.

Will the lump-sum election method lower taxable benefits?

Figuring the taxable benefits under the lump-sum election method is in scope for the VITA/TCE programs.

If the taxpayer chooses the second option, only the current year income will be adjusted. You do not file amended returns for the earlier years.

Under the lump-sum election method, refigure the taxable part of all the benefits for the earlier years (including both previously reported Social Security payments for the previous year and the current year's payment attributed to the previous year) using that year's income and filing status; then subtract any taxable benefits for that year that were previously reported. The remainder is the taxable part of the lump-sum payment and is added by the software to the taxable part of

the benefits for the current year (figured without the lump-sum for the earlier year).

In order to compute the taxable benefits, you will need copies of the taxpayer's prior year returns. For additional information on the lump-sum election, see Publication 915.



Last year, Jane applied for Social Security disability benefits but was told she was ineligible. She appealed the decision and won. This year, she received a lump-sum payment of \$6,000, of which \$2,000 was for last year and \$4,000 was for the current year. Jane also received \$5,000 in Social Security benefits in the current year, so her Form SSA-1099 shows benefits paid of \$11,000. Jane had other taxable income in both the previous year and the current year. She should figure her taxable benefits under the lump-sum election method to see if her tax is lower.



Because the earlier year's taxable benefits are included in the current year's income, no adjustment is made to the earlier year's return. Do not file an amended return for the earlier year.



Once a taxpayer elects this method of figuring the taxable part of a lump-sum payment, the election can only be revoked with the consent of the IRS.



The tax software will figure all the calculations after you enter the prior year tax return information. Go to the Volunteer Resource Guide, Tab D, Income, Form SSA-1099 Lump-Sum Distributions, for software entries.



Form 1040 includes a checkbox for taxpayers who use the lump-sum election method when figuring taxable Social Security benefits and eliminates the need for the write-in "LSE."

Summary

This lesson explained how to determine whether taxpayers' Social Security benefits and railroad retirement benefits are taxable.

Generally, if Social Security benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer does not need to file a federal income tax return. If the taxpayer received Social Security benefits and other income, the Social Security Benefits Worksheet found in the Form 1040 Instructions is completed by the software to calculate the taxable portion.

When figuring the taxable portion of Social Security benefits, two options are available for lump-sum benefit payments. The taxpayer may report the whole payment in the year it was received or treat the payment as received in the applicable earlier year or years to compute the amount of lump-sum payment that is taxable in the current year.



To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L<. If you are unable to complete the entire exercise, complete as much as you can. Come back later to finish the exercise after you cover all the technical topics in later lessons.



EXERCISE Answers

Answer 1: d. \$9,965 or 85% of the net benefits is the maximum amount that could ever be taxable.

Income – Other Income



Introduction

This lesson will help you determine other forms of income and how to report other sources of income. Part of the lesson is for all course levels and part is only for the International level.

The International part of this lesson will help you report income earned from worldwide sources. To do this, you need to be able to identify the type of income and, if reportable, convert it to the equivalent U.S. dollar value of the foreign currency.

This lesson will also cover the foreign earned income exclusion reported on Form 2555, Foreign Earned Income, which also requires International certification.

Objectives

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

- Other types of income and how to report other sources of income
- Determine when canceled credit card debt is included in gross income on Form 1040
- How to properly report income earned from worldwide sources
- Who is eligible for the foreign income exclusion and how to calculate the excludable amount using Form 2555, Foreign Earned Income

What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 54

- Form 1040 Instructions
- Form 1099-NEC
- Form 2555

Optional:

- Publication 525
- Publication 970
- Form W-2G
- Form 1099-MISC
- Form 1099-Q

What is other income?

Income that does not have its own line on Form 1040 is generally reported on the Form 1040, Schedule 1. Here are some examples:

- Prizes and awards
- Gambling winnings, including lotteries and raffles

- Jury duty pay, topic covered in the Adjustments to Income lesson
- Alaska Permanent Fund dividends
- Recovery of a deduction claimed in a prior year
- Nonbusiness credit card debt cancellation

Even if the taxpayer does not receive an income document from the payer, the taxpayer is required to report the income if it is taxable. Refer to the Income Quick Reference Guide in the Volunteer Resource Guide, Tab D, to confirm whether the income is taxable or nontaxable.

If you are unsure about sources of other income, consult the Volunteer Resource Guide, Tab D, Income, and Publication 17, Your Federal Income Tax Other Income, or discuss the income item with your Site Coordinator.

Use the interview techniques and tools discussed in earlier lessons to ensure that all taxable income has been included.

Health Savings Accounts (HSA)

HSA distributions not used to pay or reimburse the taxpayer for qualified medical expenses are generally reported as additional income on Form 1040, Schedule 1. This topic is not covered in this lesson, it is covered in the Adjustments to Income lesson.

What are some examples of other income?

Gambling Winnings

The taxpayer may receive one or more Forms W-2G reporting gambling winnings. Total gambling winnings must be reported as other income. If the taxpayer also had gambling losses or expenses, the losses or expenses can only be deducted on Schedule A if the taxpayer itemizes. For tax years through

2025, expenses to gamble may be added to losses if itemizing (limited to overall winnings). See the Itemized Deductions lesson for more details.



To review information related to reporting gambling income, go to the Volunteer Resource Guide, Tab D, Income, Income Quick Reference Guide.

Cash for Keys Program

Cash for Keys Program income, which is taxable, is income from a financial institution, offered to taxpayers to expedite the foreclosure process. The taxpayers should receive Form 1099-MISC with the income in Box 3.

Penal Income

Amounts received for work performed while an inmate in a penal institution aren't earned income for the earned income credit. This includes amounts received for work

performed while in a work release program or while in a halfway house. Any amount received for work done while an inmate is in a penal institution is included in wages. See the Volunteer Resource Guide, Tab D, Income, for instructions on entering penal income in the software.



Under the PATH Act, a wrongfully incarcerated individual does not include in income any civil damages, restitution, or other monetary award received that relates to his or her incarceration.

Qualified Medicaid Waiver Payments

Qualified Medicaid waiver payments may be excluded from gross income. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC) and the additional child tax credit (ACTC). The taxpayer may include qualified Medicaid waiver payments in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may not choose to include or exclude only a portion of qualified Medicaid waiver payments. Either include all or none of the qualified Medicaid waiver payments for the taxable year in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.
- If both spouses have qualified Medicaid waiver income, each may elect to include

or exclude all their respective MWP in earned income.



Refer to the Volunteer Resource Guide, Tab D, Income, Entering Medicaid Waiver Payments.

Are distributions from ABLE accounts taxable?

A qualified ABLE program is a program established and maintained by a state agency under which a person may make cash contributions to an ABLE account to pay for the qualified disability expenses of an eligible individual (the designated beneficiary). Qualified beneficiaries can have only one ABLE account. Contributions are made in after-tax dollars and can be made by any person. Contributions must be made in cash and are not deductible for federal income tax purposes.

Distributions from an ABLE account that do not exceed the qualified disability expenses of

the beneficiary during the taxable year are excluded from gross income. A distribution from an ABLE account that exceeds the qualified disability expenses of the beneficiary is included in the beneficiary's gross income and is subject to an additional tax of 10% imposed on the amount not used for qualified disability expenses. Taxable distributions from ABLE accounts are out of scope for the VITA/TCE programs.

Qualified disability expenses include: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses.

Form 1099-QA, Distributions from ABLE Accounts, is used to report distributions from an ABLE Account.

Are distributions from an Educational Savings Account (ESA), such as a Coverdell ESA and a 529 plan, taxable?

Distributions from Coverdell ESAs and Qualified Tuition Plans (QTPs) are reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530). Coverdell ESA distributions can be used to pay for qualified elementary, secondary, and postsecondary expenses. QTP distributions may also be used for qualified educational expenses for elementary and secondary public, private, and religious schools of up to \$10,000 per year for each qualified beneficiary, certain expenses of an apprenticeship program, and the principal or interest on a qualified education loan up to a lifetime limit of \$10,000 per beneficiary.

A portion of the distributions is generally taxable to the beneficiary if the total distributions are more than the beneficiary's

adjusted qualified education expenses for the year. Qualified education expenses are discussed in more detail in the Education Credits lesson.

The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account. The taxable amount must be reported as other income on the tax return. Taxable distributions from ESAs and QTPs are out of scope.

For additional information about educational savings accounts, distributions, and qualified education expenses, refer taxpayers to Publication 970, Tax Benefits for Education.



An American opportunity credit or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP or Coverdell ESA, as long as the same expenses are not used for both benefits. See

Publication 970, Tax Benefits for Education, for more details.

Is a recovery taxable?

Reimbursement in a later year for medical or other expenses deducted in an earlier year must be reported as income up to the amount previously deducted as medical or under another provision. However, do not report as income the amount of reimbursement received up to the amount of the prior year deductions that did not reduce the tax for the earlier year.



Cancellation of Debt – Nonbusiness Credit Card Debt

Cancellation of Debt – Basics

A debt includes any indebtedness for which a taxpayer is liable or which attaches to the taxpayer's property, such as auto loans, credit card debt, medical care, professional

services, mortgages, and home equity loans. Generally, if a debt for which a taxpayer is personally liable is canceled or forgiven, the taxpayer must include the canceled amount in income. There is no income from canceled debt if the cancellation or forgiveness of debt is a gift or bequest.

Use Form 13614-C, Intake/Interview and Quality Review Sheet, to determine if the taxpayer received one or both of Forms 1099-C, Cancellation of Debt, or 1099-A, Acquisition or Abandonment of Secured Property.

Refer to the Temporary Provisions section for possible exclusion of cancellation of debt income on a main home.

Taxability of Canceled Debt

Taxpayers often question the taxability of canceled debt because they did not receive money in hand.

In situations where property is surrendered, such as a foreclosure, taxpayers feel that by giving up the property they are relieved from any further obligation. Explain that the benefit to the taxpayer is the relief from personal liability to pay the debt. Information in Publication 17, Your Federal Income Tax for Individuals, can assist with the explanation and also refer to Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

Generally, when debt is canceled, the lender will issue Form 1099-C, Cancellation of Debt, which is then reported as income by the recipients on their tax return. There are exceptions and exclusions to the general rule that determines whether a canceled debt is included as income. This is covered in greater detail in the Temporary Provisions lesson and later in this lesson.

Form 1099-C

Generally, if a taxpayer receives Form 1099-C for canceled credit card debt and was **solvent** (assets greater than liabilities) immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

Sometimes, Form 1099-C will show an interest amount in Box 3. Because only **nonbusiness** credit card debt income is in scope, any interest on the account would not have been deductible. The amount shown in Box 3 is included in Box 2; therefore, the full amount shown in Box 2 should be reported as other income.



John made a deal with his credit card company to pay \$2,000 on his \$7,000 balance, and the company agreed to take it as payment in full. In January of the current year, John received a

Form 1099-C from his credit card company reporting \$5,000 (the amount of debt canceled). John was solvent immediately before the debt was canceled. John must include the entire \$5,000 as other income on his tax return.

Lenders and creditors are required to issue Form 1099-C if they cancel a debt of \$600 or more. If the debt canceled is less than \$600, some lenders or creditors may send a letter or some other form of notification to the taxpayer. Generally, taxpayers must include all canceled amounts (even if less than \$600) in income.



For information on cancellation of debt on a principal residence, refer to the Temporary Provisions lesson.



The discharge of certain student loan debt in tax years 2021 through 2025 is excluded from gross income. If excludible, the lender will not issue Form 1099-C.

Insolvency (Out of Scope for VITA/TCE)

Insolvency is a condition in which the fair market value (FMV) of all assets is less than one's liabilities. The amount or level of insolvency is expressed as a negative net worth.

For purposes of determining insolvency, assets include the value of everything owned (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors under the law, such as an interest in a pension plan and the value of a retirement account).

Liabilities are amounts owed and include:

- The entire amount of recourse debts
- The amount of nonrecourse debt that is not in excess of the FMV of the property and is security for the debt

Refer to the Insolvency Determination Worksheet in the Volunteer Resource Guide, Tab D, Income, as a resource. Taxpayers must determine if they are considered insolvent.



If the taxpayer had nonbusiness credit card debt canceled, all or part of the debt may be excluded if the cancellation occurred in bankruptcy, or if the taxpayer was insolvent immediately before the cancellation. These situations are beyond the scope of VITA/TCE. If any of these situations apply, refer the taxpayer to a professional tax preparer. See IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments, for more information.



Publication 4731, Screening Sheet for Nonbusiness Credit Card Debt Cancellation, located in the Volunteer Resource Guide, Tab D, Income, provides step-by-step guidance for the volunteer tax

return preparer to determine if the cancellation of credit card debt is within scope.

Taxpayer Interview and Tax Law Application

Here is how a volunteer advised Michelle regarding her canceled credit card debt.

Sample Interview

| Volunteer Says... | Michelle Responds... |
|--|--|
| I notice you received a 1099-C from a credit card company. | Yes, I negotiated with them to cancel \$3,000 of my debt. |
| Yes, Form 1099-C shows the amount of debt discharged. | I could only afford to pay them \$1,000, so it really helped me. |

| | |
|---|--|
| Do you think your debts at the time exceeded your assets? | I'm not sure, but it's certainly possible. |
| Let's fill out the Insolvency Determination Worksheet to help us determine whether you were insolvent. | OK. |
| According to the worksheet, you are insolvent. I am afraid I am not able to help you. VITA/TCE volunteers are not trained to compute the nontaxable portion of canceled credit card debt. | Oh, I understand. |

| | |
|---|--------------------|
| I suggest you seek assistance from a professional tax preparer. | I will, thank you. |
|---|--------------------|

Insolvency Determination Worksheet

| Assets (FMV) | | Liabilities | |
|-----------------------------|--------------|--------------------------|--------------|
| Homes | \$120,000.00 | Mortgages | \$180,000.00 |
| Cars | \$15,000.00 | Home equity loans | \$50,000.00 |
| Recreational vehicles, etc. | | Vehicle loans | \$18,000.00 |
| Bank accounts | \$1,000.00 | Personal signature loans | |
| IRAs, 401Ks, etc. | \$60,000.00 | Credit card debts | \$3,000.00 |

| | | | |
|--|--------------|--|--------------|
| Jewelry | | Past-due mortgage interest, real estate taxes, utilities, and child care costs | |
| Furniture | \$2,000.00 | | |
| Clothes | \$1,550.00 | | |
| Misc. | | Student loans | |
| Other assets | | Other liabilities | |
| Total Assets: | \$199,550.00 | Total Liabilities | \$251,000.00 |
| <p>Total Assets minus Total Liabilities = (\$51,450.00)</p> <p>Liabilities are more than assets (Negative amount equals insolvency)</p> <p>Positive amount equals solvency</p> | | | |



EXERCISES

Question 1: Greg was released from his obligation to pay \$5,000 of personal credit card debt. The credit card company sent Form 1099-C showing canceled debt of \$5,000. Greg is fairly certain he has more debt than he has assets.

Can the VITA/TCE site provide tax return preparation assistance to Greg?

- a. Yes, since the entire \$5,000 in canceled debt is considered income and reported on Schedule 1.
- b. No, because it appears Greg is insolvent, which might mean some of the canceled credit card debt would be nontaxable and beyond the scope of the VITA/TCE programs.

Question 2: Kay was released from her obligation to pay personal credit card debt. She owed \$10,000 to her credit card company, which agreed to accept \$2,500 as payment in full. Before paying the credit card company, it was determined Kay was solvent (assets greater than liabilities) and not in bankruptcy. The credit card company issued Kay a Form 1099-C, reporting \$7,500 as the amount of debt discharged.

Based on the information above, can Kay be assisted at her local VITA/TCE site?

- a. Yes
- b. No

Question 3: Review the information in Question 2 about Kay's canceled debt. If the VITA/TCE site is able to assist Kay, what amount would be reported on Kay's Schedule 1?

- a. \$0
- b. \$10,000
- c. \$2,500
- d. \$7,500



What is Worldwide Income?

U.S. citizens and U.S. resident aliens are required to report worldwide income on a U.S. tax return regardless of where they live and even if the income is taxed by the country in which it was earned. Filing requirements are the same as for U.S. citizens and U.S. resident aliens and apply whether income is from within or outside the U.S.

U.S. citizens and U.S. resident aliens living abroad may be able to claim tax benefits such as the foreign earned income exclusion or the foreign tax credit. This part of the lesson covers the foreign earned income exclusion. The foreign tax credit will be covered in another lesson.



In the current year, Alfredo Kendall earned \$40,000 while working in Dallas, Texas, for Dade Corporation. In September of this year, he transferred to their office in Stuttgart, Germany. While in Germany, he earned \$30,000 (U.S. dollars). All of Alfredo's wages, including the income he earned in Germany, is included in his gross income. His Form 1040 will show \$70,000 in wages.

Income is treated the same on the return regardless of the country from which it is derived. Similar income earned inside or outside the U.S. is generally taxed in the

same way on the return. Likewise, income earned in the U.S. and not taxed will be treated in the same way if earned outside the U.S. The lines on which income is reported on Form 1040 are the same whether the U.S. citizen or U.S. resident alien is living within or outside U.S. boundaries. See the Military Income lesson for information regarding Combat pay.



Foreign income might be reported to taxpayers on forms or in ways that are not used in the United States.

Question taxpayers closely to ensure that they are reporting all worldwide income. Review the income records to ensure that includible amounts are accurate and complete.



Taxpayers with foreign income, bank accounts, or assets may have additional filing responsibilities, which are out of scope. See Schedule B and

Form 8938, Statement of Specified Foreign Financial Assets, for additional information.



To review information related to income from a foreign employer, go to the Volunteer Resource Guide, Tab D, Income, Entering Other Compensation in TaxSlayer.

Answers are listed following the lesson summary.

Question 4: Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her income included \$22,000 in wages earned in Germany. She earned \$300 in interest from her U.S. bank. What is Marta's total income?

- a. \$0
- b. \$22,300
- c. \$300
- d. \$22,000

Question 5: Mary Carleton, a U.S. citizen, lives in Belgium. Her income included \$10,000 in wages from her Belgian employer, \$200 in interest from her U.S. bank, \$8,000 in gambling winnings, and \$7,000 in child support payments from her ex-spouse. What is Mary's gross income?

- a. \$8,000
- b. \$10,200
- c. \$18,200
- d. \$25,200

How Do I Convert Foreign Income to U.S. Dollars?

Exchange rates

All amounts on the U.S. tax return must be stated in U.S. dollars. Taxpayers may provide the U.S. dollar amount to report. If they don't, convert income that taxpayers received in foreign currency into U.S. dollars using the

appropriate exchange rate. U.S. exchange rates are stated in two ways:

- Units of foreign currency to one U.S. dollar: 0.74855 Euro = 1 U.S. dollar
- U.S. dollars to one unit of the foreign currency: 1.33592 U.S. dollar = 1 Euro



Exchange rates shown here are for example only. Use the exchange rates in effect when the income was received.

To convert a sum of money into U.S. dollars, **divide** the amount of foreign currency by the exchange rate for the foreign currency to one U.S. dollar.



Ryan received 3,000 Euros (€3000) on a day that the exchange rate was 0.74855 Euros to one U.S. dollar. Based on this exchange rate, the value of Ryan's €3000 is: $€3000 \div 0.74855 = \$4,007.75$

In other words:

$$\frac{\text{Amount of foreign currency}}{\text{Exchange rate of foreign currency to one U.S. dollar}} = \text{Amount in U.S. dollars}$$
$$\frac{3,000 \text{ Euros}}{0.74855} = \$4,007.75$$

Question 6: Caryn received 200 Euros on a day that the exchange rate was .75514 Euros to one U.S. dollar. In U.S. dollars, she would have __.

- a. \$264.85
- b. \$377.57
- c. \$115.03
- d. \$11.50

Question 7: Given an exchange rate of .7000, how much is 36,000 Euros worth in U.S. dollars?

- a. \$252.00
- b. \$25,200.00
- c. \$51,428.57
- d. \$61,614.00

Which exchange rate should I use?

The exchange rate for a particular currency is likely to change every day. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. The exchange rate is determined by the date of transaction, which is either the date on the check or the date the money is credited to the taxpayer's account. If there is more than one exchange rate, use the one that most properly reflects the income.

However, the taxpayer can use the average annual exchange rate if:

- Foreign income was received evenly throughout the year, and
- The foreign exchange rate was relatively stable during the year

Taxpayers may use the monthly average exchange rates if they earned foreign income evenly for one or more months, but less than twelve months.



Edward Hall worked in Dallas for Lubbock Incorporated from January until September. On September 29, he was transferred to Lubbock's Mexico City office, where he will be working for three more years. In Mexico, he is paid in Mexican pesos. Because he did not receive his salary in Mexican pesos evenly throughout the year, he cannot use the annual average exchange rate for Mexico source income. If he does not

know the exchange rate at the time he received the funds, he can use the monthly average exchange rate for October, November, and December.

Where to obtain exchange rates

In mid-January, the IRS distributes exchange rates for various currencies to its worldwide offices, including the prior year's average annual exchange rate information.

Exchange rates can be found at irs.gov by typing "foreign currency rates" in the search box. You may also contact banks that provide international currency exchange services.

Because taxpayers should use the rate that most closely reflects the value of the foreign currency at the time they receive the income, taxpayers may use an exchange rate that is different from the rates posted in IRS worldwide offices if they find it to be a true representation.

What is the foreign earned income exclusion?

Certain taxpayers can exclude income earned in, and while living in, foreign countries. The maximum amount of the foreign earned income exclusion is indexed to inflation annually. The current year amount can be found in the Important Changes lesson in this publication. The foreign earned income exclusion **does not** apply to wages and salaries of U.S. military members and civilian employees of the U.S. government. Use Form 2555 to claim the foreign earned income exclusion.

If the taxpayer qualifies to exclude foreign earned income, the excludable amount will be reported as a negative amount on the other income line of Form 1040, Schedule 1. Since the foreign earned income would have been reported on Form 1040 as taxable wages or as self-employment income, the exclusion (negative amount) will reduce the total

income calculated. The method of calculating the tax when the taxpayer elects the foreign earned income exclusion is based on the Foreign Earned Income Tax Worksheet. The tax software will do this calculation automatically.



If a taxpayer elects to exclude foreign earned income, he or she cannot claim the earned income credit and the refundable portion of the child tax credit. The child and dependent care credit does not include excluded foreign income as earned income when computing the credit.



To review information related to the software for the foreign earned income exclusion, go to the Volunteer Resource Guide, Tab D, Income.

When do I choose the exclusion?

The foreign earned income exclusion is voluntary. It is not always an advantage to claim the exclusion. If taxpayers wish to claim the exclusion, they must file Form 2555 with a timely return (including extensions). If the taxpayer is not eligible for, or chooses to not claim, the foreign earned income exclusion, any taxes paid on this income to a foreign government may be eligible for the foreign tax credit. See the Foreign Tax Credit lesson for more information.

Once the taxpayer chooses to exclude foreign earned income, that choice remains in effect for that year and all later years until revoked. The taxpayer may revoke the exclusion for any tax year by attaching a statement to the return. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

What are the eligibility requirements?

To claim the foreign earned income exclusion, taxpayers must:

- Demonstrate that their tax home is in a foreign country
- Meet either the bona fide residence test or the physical presence test
- Have income that qualifies as foreign earned income

The requirements are applied separately to each individual. If a married couple is working overseas, each spouse must meet all requirements to qualify for the exclusion. If they do qualify, each is entitled to an exclusion of up to the maximum amount for the current year.



The terms foreign, abroad, and overseas do not include Puerto Rico, U.S. Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Marianas, Wake Island, the Midway Islands, and Johnston Island.

Question 8: Miranda has lived in Puerto Rico since 2003. Is she eligible for the foreign earned income exclusion?

- a. Yes
- b. No

How do I determine the tax home?

To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country. The tax home is defined as the country in which the taxpayer is permanently or indefinitely engaged to work as an employee or a self-employed individual, regardless of where the family home is maintained.

For taxpayers who work abroad but do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live. The tax home for members of the U.S. Armed Forces is the permanent duty station, either land-based or on a ship.



John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2007. Their tax home for the current year is Germany.

Question 9: Alan has lived and worked in China since August 16, 2005. China is his tax home.

- a. True
- b. False

What is a regular place of abode?

For purposes of the foreign earned income exclusion, if taxpayers work overseas for an indefinite period of time, and their regular place of abode is the U.S., the taxpayers cannot designate the foreign country as the tax home.

“Regular place of abode” is defined as one’s home, habitation, domicile, or place of dwelling. It does not necessarily include one’s principal place of business.

If the taxpayer maintains a place of business, or is assigned to overseas employment in a foreign country for an indefinite period, *and does not maintain a regular place of abode in the U.S.*, the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

How do I determine whether the U.S. is the taxpayer's regular place of abode?

Ask three questions to determine whether a U.S. home is the taxpayer's regular place of abode:

1. Did you use your home in the U.S. as a residence while you worked at your job in the U.S. just before going abroad to your new job, and did you continue to maintain work (e.g., contacts, job seeking, leave of absence, ongoing business) in that area in the U.S. during the time you worked abroad?
2. Are your living expenses duplicated at your U.S. and foreign homes because your work requires you to be away from your U.S. home?
3. Do you have a family member or members living at your U.S. home, or

did you frequently use your U.S. home for lodging during the period you worked abroad?

If the answer to two of the questions is “no,” the taxpayer is considered to be indefinitely assigned to the new location abroad and is eligible for the foreign earned income exclusion.

If the answer to all three questions is “yes” and the job duration is for less than one year with the taxpayer returning to the U.S. home, the taxpayer is considered “temporarily away” from home. In this case, the taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct *away-from-home expenses*.

If the answer to two of the three questions is “yes,” with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on the facts and circumstances.



Henry is a member of the Armed Forces. He was assigned to a post in Japan last year. This assignment was for an indefinite period that exceeds one year. Margaret, his wife, accompanied him to Japan and has foreign earned income. They have not used their home in the U.S. as a place of residence for over a year. Therefore, their tax home for this year is Japan.

Question 10: Stan is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the U.S. during his off periods. Does Stan's employment satisfy the tax home test?

- a. Yes
- b. No

What is the period of stay requirement?

The period of stay is the amount of time the taxpayer stays in the foreign country. To meet the period of stay requirement, the taxpayer must be either:

- A U.S. citizen or U.S. resident alien from a tax treaty country who is a **bona fide** resident of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
- A U.S. citizen or U.S. resident alien who is **physically present** in a foreign country or countries for at least 330 full days during any period of 12 consecutive months

What is the bona fide residence test?

To meet the bona fide residence test, taxpayers must show that they have set up permanent quarters in a foreign country for

an entire, uninterrupted tax year (even though they intend to eventually return to the U.S.). Simply going to another country to work for a year or more is not enough to meet the bona fide residence test. A taxpayer must establish a residence in the foreign country.

A brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention to return to the foreign country is clear.



Charles is a military spouse who has lived and worked in England since 2006. His mother still lives in the U.S. Charles came to the U.S. for two weeks this year to be with his mother after she had surgery. Charles' trip to the U.S. does not affect his status as a bona fide resident of a foreign country.

Question 11: Zach, a U.S. citizen, has homes in the U.S. and in Spain, where he has worked for the last two years. Zach's spouse, who is also a U.S. citizen, lives with him in Spain. Zach visits the U.S. occasionally.

Does Zach meet the bona fide residence test in Spain?

- a. Yes
- b. No

What is the physical presence test?

If the taxpayers do not meet the bona fide residence test, then they may qualify under the physical presence test rules. To qualify, the taxpayers must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is

spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country or to another foreign country without losing full days. If any part of the taxpayer's travel is not in any foreign country and takes less than 24 hours, you are considered to be in a foreign country during that part of travel. See Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, physical presence test section for additional information.



If a taxpayer left England by ship at 10:00 p.m. on July 6 and arrived in Lisbon at 6:00 a.m. on July 8, the taxpayer would lose July 6, 7, and 8 as full days because the trip took more than 24 hours. In this example, if the taxpayer remained in Lisbon, the first full day would be July 9.

Figuring the 12-Month Period

Any 12-month period may be used if the 330 full days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. See Publication 54 for clarification on the physical presence rules.

What is qualifying income?

To qualify for the exclusion, income must be earned income.

How does earned income qualify for the exclusion?

To qualify for the exclusion, the earned income must be for services performed in a foreign country. Amounts paid by the United States or its agencies to its employees **do not** qualify for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Earned income does not include:

- Dividends
- Social Security benefits
- Interest
- Pensions
- Capital gains
- Annuities
- Alimony



Alisa, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2010. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Tokyo. The income from her self-employment may qualify for the exclusion.

What are sources of foreign earned income?

To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in determining the *source* of the income.

If a taxpayer works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total foreign earned income.



Earl works and lives in the Bahamas. During the tax year, he worked 49 weeks in the Bahamas. He attended a business meeting in Florida for one week, and was on vacation for two weeks. One-fiftieth or 2% of his wages are not foreign earned income because of the week spent working in Florida.



Ron and his wife Amy, both U.S. citizens, have lived in England for two years. Ron is in the military and Amy works in a pastry shop in a nearby town.

Ron's military income does not qualify for the foreign earned income exclusion but Amy's wages from the company in England does qualify. The source of Amy's income is England.

Question 12: Juanita lives in Scotland. She is retired and her income consists of U.S. Social Security, a pension, and several stock dividends. Does she qualify for the foreign earned income exclusion?

- a. Yes
- b. No

How do I complete Form 2555?

Use the following guidelines when completing Form 2555.

- Part I is completed by all taxpayers
- Part II is completed by taxpayers who qualify under the bona fide residence test
- Part III is completed by all taxpayers who qualify under the physical presence test
- Part IV is completed by all taxpayers – list all foreign earned income
- Part V is completed by all taxpayers
- Part VI is completed by taxpayers claiming the housing exclusion and/or housing deduction
- Part VII is completed by taxpayers claiming the foreign earned income exclusion

- Part VIII is completed by taxpayers claiming the foreign income exclusion, the foreign housing exclusion, or both.
- Part IX is completed by taxpayers claiming the housing deduction if line 33 is more than line 36, and line 27 is more than line 43



To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Form 2555.

Taxpayer Interview and Tax Law Application

Look at the following sample interview for taxpayers Hudson and Hope Howard.

Sample Interview

| Volunteer Says... | Hope Responds... |
|---|--|
| | <p>Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made \$24,000 in U.S. dollars. I heard that you don't have to pay taxes on income earned in a foreign country and I've never done this before.</p> |
| <p>That is possible. First, we will have to determine if you meet the requirements. Were you working as a</p> | <p>No, Bavaria Advertising is a foreign company owned by a family right there in Munich.</p> |

| | |
|--|-------------------------------------|
| military or civilian employee of the U.S. government? | |
| <p>Great. That would qualify, but Hudson's military pay won't.</p> <p>Let's see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than the maximum amount. You have no self-employment income or business/moving expenses and since you lived on base, you won't have a foreign housing exclusion.</p> | <p>Yeah, that all sounds right.</p> |

| | |
|---|---|
| Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country. | It sounds complicated to me. |
| Don't worry, I just need to ask you a few questions. How long did you say you were in Germany? | We moved on base in Germany on March 3, 2011 and just returned to the states on January 10 this year. |
| No problem then. You were living in Germany for the entire year so you are considered a bona fide resident this tax year. Since your home and | 1567 Albion Street, Munich. |

| | |
|--|---|
| place of employment were both in Germany, you meet the tax home test. Now, what was your address while you were living in Germany? | |
| What did you do for Bavaria Advertising? | I was a copywriter. |
| Do you have Bavaria Advertising's address? | I sure do; it is right here on this statement. |
| Were you present in the U.S. during this tax year? I have to enter the dates on this form. | Not this year. But we did come home for the holidays last year. |

Summary

Total taxable income from all sources is entered on Form 1040.

Taxpayers are sometimes alarmed at how high their total income is. If this happens, reassure the taxpayer that the return is not finished yet! It is very likely that adjustments, deductions, and credits will considerably reduce the total tax owed.

Other income includes any taxable income for which there is not a specific line identified on Form 1040. This income is reported on the other income line of Form 1040, Schedule 1.

If a taxpayer receives Form 1099-C for canceled credit card debt and was solvent immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

U.S. citizens and resident aliens are taxed on worldwide income. They must file a U.S. tax

return even if all the income is from foreign sources, and even if they pay taxes to another country.

When taxpayers living abroad receive income in foreign currency, the amounts reported on the return must be converted into U.S. dollars. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. If there is more than one exchange rate, use the one that most properly reflects the income.

If the taxpayers are eligible to exclude some or all of their foreign earned income, then Form 2555 must be completed. The excludable amount will be entered as a negative number on Schedule 1 to offset income reported as wages or self-employment income.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Distributions from an ABLE account in which the funds were not fully used for qualified disability expenses
- Distributions from Educational Savings Accounts in which the:
 - Funds were not used for qualified education expenses, or
 - Distribution was more than the amount of the qualified expenses
- Taxpayers who are insolvent and had debt canceled



To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L<.



EXERCISE Answers

Answer 1: b. Greg is fairly certain that he has more debt than he has assets, which means he is insolvent. This situation is beyond the scope of the VITA/TCE programs.

Answer 2: Yes. Kay was solvent and not in bankruptcy, and the credit card company issued her a Form 1099-C.

Answer 3: d. Kay would report \$7,500 on her Schedule 1.

Answer 4: b. Marta's gross income includes her wages and interest, both of which should be reported on her tax return.

Answer 5: c. Mary's gross income includes her wages, interest, and gambling winnings, all of which should be reported on her tax return. Her child support payments are her only nontaxable income.

Answer 6: a. Dividing 200 Euros by the .75514 exchange rate comes to \$264.85.

Answer 7: c. Dividing 36,000 Euros by the .7000 exchange rate comes to \$51,428.57.

Answer 8: b, No. Miranda is not eligible for the foreign earned income exclusion because Puerto Rico is not a foreign country.

Answer 9: a, True. Generally, the tax home is the country in which taxpayers maintain their place of business. Because Alan works in China, it is considered to be his tax home. For taxpayers who do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Answer 10: b, No. Stan is considered to have a residence in the United States and does not satisfy the tax home test in the foreign country. He is not eligible for the foreign earned income exclusion.

Answer 11: a, Yes. Since Zach went to Spain to work and has established a permanent residence there with his spouse, he meets the bona fide residence test.

Answer 12: b, No. Social Security benefits, pension, and dividends do not qualify as earned income; therefore, Juanita does not qualify for the foreign earned income exclusion.

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Military Income



Introduction

This lesson will help you determine which income items received by current and former members of the U.S. Armed Forces are reportable on the return, and the status of any medical separation pay or pay related to service in a combat zone.

Community property laws may impact the income reported by some military members on their returns.

Objectives

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

- Which income items received by members of the U.S. Armed Forces are reportable on the tax return and
- The status of any medical separation pay or pay related to service in a combat zone

What do I need?

- Form 13614-C
- Publication 4012
- Publication 3
- Publication 525
- Publication 555

What are the types of income?

U.S. Armed Forces members receive many different types of pay and allowances. Some are includible in gross income while others are excludable from gross income.

Refer to the Volunteer Resource Guide, Tab D, Income, Armed Forces Gross Income chart, for detailed lists of these types of military pay and to determine if they are included in gross income or excluded.

What income is includible?

Includible items are subject to tax and must be reported on the tax return. The items listed in Publication 3, Armed Forces' Tax Guide, Table 1, and the Volunteer Resource Guide, Tab D, Income, are included in gross income, unless the pay is for service in a combat zone or in a qualified hazardous duty area. All includible military income will generally be shown on Form W-2, Box 1, and reported on Form 1040 as wages.



If the amount shown on Form W-2, Box 1, differs from the last Leave and Earnings Statement for the current tax year, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

What income is excludable?

Excludable income does not have to be reported as income on the tax return. The exclusion applies whether the item is furnished in kind, or is a reimbursement or an allowance.

For example, the Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) can be excluded from gross income as a qualified military benefit. Excludable income will not be included in the amount on Form W-2, Box 1.



If U.S. Armed Forces members were provided a commuter highway vehicle (such as a van) by their

employer, refer them to Publication 525, Taxable and Nontaxable Income, and to a professional tax preparer.



EXERCISES

Answers follow the lesson summary. Use the Armed Forces Gross Income chart in the Volunteer Resource Guide, Tab D, to answer these questions.

Question 1: Enlistment and reenlistment bonuses are excluded from a service member's income.

- a. True
- b. False

Question 2: Which of the following items is excludable from U.S. Armed Forces members' income?

- a. Hazardous duty pay

- b. Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) income
- c. Basic pay
- d. Hardship duty pay

Homeowners Assistance Program (HAP)

HAP was created to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market or when they were required to permanently relocate during the home mortgage crisis. These payments for qualified military base realignments and closures are generally excluded from income. For additional information go to **Publication 3**.

What is military separation with disability severance pay?

Disability severance pay has varying effects on a service member's income and taxes.

What is severance pay?

U.S. Armed Forces members who have been separated from the military after years of service or for medical reasons are given severance pay, which is generally taxable as wages. If the member receives disability severance pay and is later awarded Veteran's Affairs (VA) disability benefits, 100% of the disability severance benefit may be excluded from income. The VA makes the determination that the member is entitled to medical disability benefits, and the determination process can take several months, and sometimes years.

What is VA disability compensation?

VA disability compensation is a monetary benefit paid to veterans who are disabled because of injury or disease incurred or aggravated during active military service. The veteran's service must have been terminated through separation or discharge under honorable conditions. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax. The VA does not issue Form W-2, Form 1099-R, nor any other document for nontaxed veteran's disability benefits.

What happens after a service member receives a letter of determination?

Once the VA sends a letter of determination, all future pension payments from the government are offset by the disability amount paid directly from the VA. Disability

payments received directly from the VA are not taxable and are not included on Form W-2 or Form 1099-R.

Although pension payments made before the letter of determination was issued have already been taxed, the letter exempts from taxes the same amount of previous pension payments. U.S. Armed Forces members who have already filed a tax return and reported that pension income should file Form 1040-X, Amended U.S. Individual Income Tax Return, and attach a copy of the letter of determination.

Question 3: Disability payments sent directly from the VA to the discharged service member _____.

- a. Are taxable
- b. Appear on the taxpayer's Form W-2 or 1099-R
- c. Are not included on the taxpayer's Form W-2 or 1099-R

- d. May begin before the VA issues the letter of determination



Anita Zapata was an active duty service member who was separated due to a medical condition, and began receiving her military pension in February of the previous tax year. Here are the payments she reported on that year's tax return:

| <i>Payments</i> | <i>Amount</i> |
|--------------------------|----------------------|
| • <i>Service pension</i> | <i>\$33,000</i> |
| • <i>Active duty pay</i> | <i>\$ 5,000</i> |

In the current tax year, the VA determined that she was retroactively entitled to a VA disability pension of \$837 each month from the date of her discharge (February of the previous tax year). She can amend her tax return to exclude \$9,207 (\$837 x 11 months) of the pension she received.

She must attach a copy of her letter of determination to the amended return. Her current tax year Form 1099R will not include the nontaxable VA disability retirement payments received during that year.

What is a combat zone?

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Publication 3 lists the specific areas and dates.

A taxpayer serving in a combat zone may qualify for relief from certain IRS compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may notify the IRS directly of their status through a special e-mail address: **combatzone@irs.gov**. They should provide name, stateside address, date of birth and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative. For more information visit **www.irs.gov**.

Hazardous duty areas are determined by Congress. Members of the Armed Forces deployed overseas, away from their permanent duty station, in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone for federal income tax purposes.

What is the combat zone exclusion?

Members of the U.S. Armed Forces who serve in a combat zone may exclude certain pay from their income. The entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized due to wounds, disease, or injury incurred while serving in the combat zone. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone.

The following section is to help you understand when pay is considered excludable as combat pay. You will not be making any decisions about what is excludable. The information on the military member's Form W-2 indicates the amount of combat pay with a code Q. If military members feel the amount is incorrect, refer them to the local accounting and finance or payroll office for clarification. Do not change

any amounts on Form W-2 when entering them in the tax software.

What qualifies as service in a combat zone?

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

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

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

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

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

What is nonqualifying presence in a combat zone?

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

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



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



U.S. service members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.

Question 4: Which of the following may qualify as service in a combat zone?

- a. Temporary duty in a combat zone
- b. Traveling through a combat zone between two points outside of the combat zone
- c. Presence in a combat zone while on leave from a duty station located outside the combat zone

- d. Direct support of a qualified hazardous duty area but not entitled to hostile fire/imminent danger pay

What is the amount of the combat zone exclusion?

- Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month (even one day) can exclude all of that month's military pay, including awards and reenlistment bonuses for which the member becomes eligible while in the combat zone. Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded.
- Commissioned officers (including limited duty officers) may exclude pay according to the rules for enlisted members. However, the amount of the exclusion is limited to the highest rate of enlisted pay

plus the amount of imminent danger/hostile fire pay received for each month during any part of which they served in a combat zone or were hospitalized as a result of their combat zone service.

Combat pay is not included in Box 1 wages on the service member's Form W-2, but the amount is shown in Box 12, with code Q. If service members believe the taxable wages on Form W-2 are incorrect, they should contact the local accounting and finance or payroll office to request a corrected Form W-2.

Nontaxable combat pay may increase the Child Tax Credit or Earned Income Tax Credit. Enter all fields from Form W-2 when preparing the tax return. The software will determine what is most beneficial to the taxpayer.

Taxpayer Interview and Tax Law Application

Here's how a volunteer might help taxpayers with combat pay:

Sample Interview

| Volunteer Says... | Mrs. Fannin Responds... |
|---|--|
| Let's talk for a minute about where your husband was stationed. | My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything? |
| The combat pay is not taxable, but it's shown on your husband's W-2, here in Box 12, with code Q. I will enter that into the system with the rest of the W- | That's right. |

| | |
|---|--|
| <p>2 information, because combat pay can increase some tax credits. I can show on the tax return that he was in the combat zone, but I don't need to know the exact dates. Is he serving in Iraq?</p> | |
|---|--|

What are the laws regarding community property?

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. The states of Tennessee and South Dakota have passed elective Community Property Laws. The states of Tennessee and South Dakota have passed elective Community Property Laws. Special rules apply to married taxpayers who file separately or who were

divorced during the tax year and their **domicile** is in a community property state. For military members residing in these states, the key word is domicile, which describes someone's legal, permanent residence. It is not always where the person presently lives.

Married taxpayers who choose to file separately, when subject to community property rules, have to figure community income and separate income for state and federal income tax purposes.

How do community property laws affect Armed Forces pay?

State community property laws apply to active military pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the service member was/is in active military service.

Whether an item is subject to community property laws depends on whether the

payment is classified as active pay or retired/retainer pay:

- State community property laws apply to active military pay. Generally, the character of the pay as separate from community income is determined by the marital status and/or domicile of the service member and spouse while the member is on active military service.
- Armed Forces retired or retainer payments may be subject to community property laws. For more information see Publication 555, Community Property.

Summary

Special rules may govern whether certain income received by members of the U.S. Armed Forces is includible or excludable from taxable income reported on the return:

- Homeowners Assistance Program (HAP)

- Medical separation with disability severance pay
- Combat zone exclusion
- Community property laws

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- U.S. Armed Forces members who were provided a commuter highway vehicle (such as a van) by their employer



To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L<.



EXERCISE Answers

Answer 1: b, False. The payments and withholdings for the enlistment and reenlistment bonuses are reflected on the service member's Form W-2.

Answer 2: b. The Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) are both nontaxable income.

Answer 3: c. Once the VA sends the letter of determination, all pension payments are offset by the disability amount paid directly from the VA, which is not taxable and not included on any Form W-2.

Answer 4: a. Military members are considered to be serving in a combat zone if they are either assigned on official duty to a combat zone or they qualify for hostile fire/imminent danger pay while serving in direct support of a combat zone.

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