Publication 4491

VITA/TCE **Training Guide**

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

Volume 5 of 16

2023 RETURNS

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What are qualified dividends?

Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. See Publication 550, Investment Income, for a detailed definition of qualified dividends.

Taxpayers who have questions about why a dividend is qualified or not qualified should contact the company that paid the dividend.

What are capital gain distributions?

Capital gain distributions are also called capital gain dividends. They come from mutual funds and real estate investment trusts (REITs). They are taxed at the lower long-term capital gains rate, regardless of how long the taxpayer holds the shares. Capital gain distributions are reported to the taxpayer on Form 1099-DIV. While you may enter these distributions in the dividend section of the software, these distributions will appear as long-term capital gains on Form 1040 and on Schedule D if required.

Capital gains are not the same as capital gain distributions. A capital gain distribution is the owner's portion of the capital gains that were realized when the mutual fund or REIT sold assets. A volunteer with a Basic certification can prepare a return with this type of income.

A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than its cost. A volunteer must have Advanced certification to prepare a return for taxpayers who sold mutual fund shares or other shares of stock.

What are nondividend distributions?

Form 1099-DIV also shows nondividend distributions, which is the part of a distribution that is nontaxable because it is a return of the taxpayer's cost or other basis in a stock or security. Brokers will keep track of these and other basis adjustments for covered securities. Otherwise, taxpayers should keep this information with their tax records in order to calculate the adjusted basis of the stock when it is sold.

During the tax year, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. The following January she received Forms 1099-DIV listing these capital gain distributions.

Where do I get dividend information?

Taxpayers that hold their securities in a brokerage account will receive Form 1099-DIV from their broker. For stocks held directly, corporations use Form 1099-DIV to report dividend distributions to each shareholder. Ask the taxpayer for any Form(s) 1099-DIV. If the taxpayers did not receive a Form 1099-DIV for a dividend, they should contact the payer or their broker to get the needed forms.

What about Patronage dividends on Form 1099-PATR?

Form 1099-PATR, Box 1, shows patronage dividends paid to the taxpayer during the year in cash, qualified written notices of allocation (at stated dollar value), or other property (not including nonqualified allocations).

Any dividends paid on property bought for personal use are not taxable. Ask the taxpayer if the patronage dividends are only for personal consumption of goods. Only when the dividends are not taxable are they in scope. In this case, it is not necessary to enter the dividend into the software.

How do I report dividend information?

Generally, all dividend income is reported on Form 1040. Schedule B may be needed if the taxpayer's ordinary dividends exceed a specified amount, or if the taxpayer was the nominee for dividends that actually belong to someone else. If the taxpayer received income as a nominee or if Form 1099-DIV includes amounts in boxes labeled Unrecap. Sec. 1250 gain, Section 1202 gain, Collectibles (28%) gain, Section 897 ordinary dividends, Section 897 capital gain, Cash liquidation distributions, or Noncash liquidation distributions, the return is out of scope for the VITA/TCE programs. Refer taxpayers with amounts in these boxes to a professional tax preparer.

Any federal income tax withheld shown on a Form 1099-DIV is reported on the federal income tax withheld line of the return.

Foreign tax paid will be covered in the Foreign Tax Credit lesson.

Review the Volunteer Resource Guide, Tab D, Income, for guidance for entering dividend income. If the taxpayer has multiple accounts, the software will add all the dividends for you, preventing math errors.

Taxpayer Interview and Tax Law Application

Leonard and Gloria are filing a joint return. Leonard and the volunteer are discussing dividend income.

Sample Interview

Volunteer Says...	Leonard Responds...
Do you and your wife own shares of stock,	Yes, I have an IRA and I own shares in several mutual funds and a bond fund. My

mutual funds, or bond funds?	wife has an IRA. Here are the statements.
The earnings on the IRAs are tax deferred until you take a distribution. These 1099-DIVs are what we want right now. Are these the only Forms 1099-DIV that you received?	Yes
We will enter the information from each of these in the tax software. It will add everything up and display it properly on your tax return	

How do I report a refund of state or local income taxes?

Taxpayers who receive a refund of state or local income taxes may receive Form 1099-G reporting their refund amount(s). Only taxpayers who itemized and received a federal income tax benefit for deducting their state or local income taxes have to include their state/local tax refunds in income. Not everyone must include the refund in their taxable income.

- Taxpayers who claimed the standard deduction on the tax return for the year they received a refund of state or local income taxes do not have to include the refund in their taxable income.
- Taxpayers who itemized and deducted the state sales tax instead of the state income tax withheld or paid do not have to include the refund in their taxable income.

- Some taxpayers could not deduct all their state income taxes because of the annual cap on state and local taxes deduction. Refer to the Volunteer Resource Guide, Tab D, Income, for the State and Local Refund Worksheet in the software to determine the amount, if any, of the refund that is taxable.

Refer taxpayers who received a state or local income tax refund for a year other than the previous tax year to a professional tax preparer.

Nancy itemized her deductions on last year's federal return. She included the income taxes paid to her state on Schedule A. During the current tax year, she received a state refund on the overpaid portion of those taxes. When filing her current year tax return, she must use the state tax refund worksheet to see how much of the *refund to include in her federal taxable income.*

Form 1099-G may also report agriculture payments, market gain, or Box 8 indicating that the state payments are trade or business income. These situations are beyond the scope of the VITA/TCE programs and taxpayers with these items should be referred to a professional tax preparer.

What is alimony?

Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument. It may include payments on behalf of the spouse or former spouse, such as medical bills, housing costs, and other expenses. It does not include child support or voluntary payments outside the instrument.

Post-1984 and Pre-2019 Divorces

The person receiving alimony must include it as income. The person paying alimony can subtract it as an adjustment to income. Both items are reported on Form 1040, Schedule 1. The date of divorce or separation agreement must also be provided.

If the taxpayer is unsure whether a payment is alimony or child support, ask if the payments will stop once the child is grown.

Alimony income received under a pre-2019 divorce or separation instrument is unearned income. However, it is considered compensation, which may allow the taxpayer receiving alimony income to make a deductible traditional IRA or nondeductible Roth IRA contribution.

If the agreement was executed before 1985, refer the taxpayer to a professional tax preparer.

Where do I get alimony information?

Ask if the taxpayer received alimony under a divorce or separation instrument. If so, explain that you need the exact amount, since it may also be reported as a deduction by the payor, and the two amounts must agree.

How do I report alimony income?

Enter any alimony income on the alimony received screen. The Social Security number of the person paying the alimony is not needed.

Post-2018 Divorces

The Tax Cuts and Jobs Act provides that alimony and separate maintenance payments are not deductible by the payor spouse and repeals the code provisions that specify that alimony and separate maintenance payments are included in income by the recipient of the payments.

This treatment is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by the Tax Cuts and Jobs Act, Section 11051, apply to such modification.

Summary

This lesson covered income reported on Form 1040, including how to differentiate taxable and nontaxable income, and earned or unearned income.

- Earned income is any income received for work, such as wages or business/self-employment income.

- Unearned income is any income produced by investments, such as interest on savings, dividends on stocks, or rental income.
- Wages from Form W-2 are generally included on Form 1040.
- Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, or U.S. government bonds. This interest is reported by the payer on Form 1099-INT and included in the taxpayer's income on Form 1040.
- Interest on certain bonds, such as from state political subdivisions, District of Columbia, or port authorities, are exempt from federal income tax but must be reported on Form 1040.
- Dividends are reported to the taxpayer on Form 1099-DIV. Ordinary dividends are corporate distributions paid out of the

earnings and profits of a corporation. Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. Capital gain distributions are reported on Form 1040 and Schedule D, if required.

- Taxpayers who itemized deductions in the previous year and received a tax benefit from deducting state or local income taxes may have to report part or all of their refund as income. Taxpayers generally receive Form 1099-G reporting their state or local tax refund.
- Alimony is income received from a spouse or former spouse under a separation or divorce instrument. If the alimony was paid pursuant to a divorce or separation instrument executed on or before December 31, 2018, it is taxable income and included on Form 1040, Schedule 1.

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.

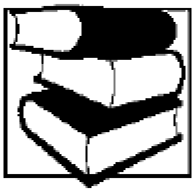
- Taxpayers with income from the following sources:
  - Other gains/losses
  - Farm income
- Taxpayers who must check “yes” to the digital asset question on Form 1040.
- Taxpayers subject to the Additional Medicare Tax, the Net Investment Income Tax, or the Alternative Minimum Tax
- Taxpayers who use the accrual method for reporting income
- Taxpayers who buy or sell noncovered bonds between interest payment dates

- Form 1099-INT amounts reported in the box labeled Specified private activity bond interest if AMT applies
- Form 1099-INT premium amount is greater than the respective amount of interest reported.
- Form 1099-DIV amounts reported in the boxes labeled Unrecap. Sec. 1250 gain, Section 1202 gain, Cash liquidation distributions, and Noncash liquidation distributions
- Adjustments needed for any of the amounts reported on Form 1099-OID, or if the taxpayer should have received Form 1099-OID but did not receive one
- State or local income tax refunds received during the current tax year for a year other than the previous tax year
- Alimony/divorce agreements executed before 1985

- Tax returns for ministers and members of the clergy because of unique tax issues
- The FATCA filing requirement box is checked on any 1099 form.
- The taxpayer is required to file form FINCEN 114 or received a distribution from, or was the grantor of, or transferor to, a foreign trust.
- Taxpayers whose Form 1099-G reports agriculture payments, market gain, or Box 8 indicates that the state payments are trade or business income.

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&LT.

Income – Business



Introduction

This lesson will help you prepare an accurate return for taxpayers who have business income, including self-employment income. Form 1040 is used to report income from a business or profession operated as a sole proprietor or independent contractor.

Preparation of tax returns with Schedule C, Profit or Loss From Business (Sole Proprietorship), are in scope for VITA/TCE under certain limited conditions and with expenses of $35,000 or less.

This lesson covers recordkeeping requirements for taxpayers with business income and expenses. Refer to Publication 334, Tax Guide for Small Business and

Publication 583, Starting a Business and Keeping Records, for more information. You will learn how business income is determined and how it affects eligibility for certain tax credits.

Objectives

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

- Determine how to report business income
- Determine what business expenses are within the scope for the VITA/TCE programs
- Identify “red flags” when preparing a Schedule C return with earned income credit (EIC)
- Determine what records should be maintained

What do I need?

- Form 13614-C
- Publication 4012
- Publication 334
- Publication 463
- Form 1099-K
- Form 1099-MISC
- Form 1099-NEC
- Schedule C
- Schedule C Instructions
- Schedule SE

Optional:

- Publication 583

Where do I get business income information?

Business income information may come from the following:

- Forms 1099-MISC, Miscellaneous Income
- Forms 1099-NEC, Nonemployee Compensation
- Forms W-2, Wage and Tax Statement, with Statutory Employee checked in Box 13
- Taxpayer’s books and records
- Forms 1099-K, Payment Card and Third Party Network Transactions

Based on your interview and the completion of the taxpayer’s intake and interview sheet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. These taxpayers may not have income statements for their business income and expenses. The information to prepare their tax return comes from their records.

Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor.

*Taxpayers who must answer **Yes** to the digital asset (virtual currency) question on Form 1040 should be referred to a professional tax preparer. Identify these situations as early in the interview as possible. Refer to Scope of Service in Publication 4012, VITA/TCE Resource Guide and Instructions for Form 1040 for details on digital assets.*

Income received from all sources in a self-employed taxpayer's business must be reported, unless excluded by law.

Cash Income

Some taxpayers may indicate that they received cash income for self-employment activity. This income must be reported, unless excluded by law.

If taxpayers do not have adequate records of the cash income they received, you may be able to assist them with simple record reconstruction. See the section on reconstructing records later in this lesson.

Form 1099-NEC, Nonemployee Compensation

Taxpayers who are independent contractors should receive Form 1099-NEC showing the income they earned from payers who are required to file Forms 1099. The amount from

Form(s) 1099-NEC, along with any other business income payments, are reported on their tax return.

A taxpayer does not have to conduct regular full-time business activities to be self-employed. Having a parttime business in addition to a regular job or business may be self-employment. Ask for any Form(s) 1099NEC that document this income. During the interview, confirm the taxpayer’s activities are a business and not a hobby.
Subcontractors or individuals (including for-hire drivers) who receive less than $600 may not receive Form 1099-NEC, but still must report all their income. Also ask for documentation of any business income that was not reported on Form W-2 or Form 1099-NEC (e.g., payments received from individual clients who do not need to file Form 1099).

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-NEC that shows he received $15,000 for the work he did for them. He also received cash payments of $4,000 from several different individuals for the work he completed. He did not receive Forms 1099-NEC for the $4,000. Tim must include the $4,000 cash payments as self-employment income along with the $15,000 from Form 1099-NEC.

Form 1099-MISC, Miscellaneous Income

Taxpayers may receive other business income on Form 1099-MISC, Boxes 2 and 3. Refer to Schedule C instructions for more information. Box 2 royalties from the taxpayer's own personal services are generally reported on Schedule C. Examples include authors and composers. If from another person's services, they are generally reported as other income in Box 3. An example is inherited royalties.

Bartering is an exchange of property or services. Bartering is beyond the scope of the VITA/TCE Programs.

Form 1099-K, Payment Card and Third Party Network Transactions

Form 1099-K is used by third-party networks (such as Visa, Mastercard, or others) to report transactions processed for taxpayers, including those who use their automobiles for hire or ride share services such as Uber, Lyft, Sidecar, etc., also known as the Gig Economy. Taxpayers may not receive the Form 1099-K if the amount is less than $600, but the amount received must still be reported. For additional information regarding Gig Economy, see Gig Economy Tax Center at **www.irs.gov/businesses/gig-economy-tax-center**.

Darryl used his car only for personal purposes during the first 6 months of the year. During the last 6 months of the year, he drove the car a total of 18,000 miles. Of those miles, 15,000 miles were driven providing transportation through a ride-sharing service. He received a Form 1099-K showing the income he received from the ride-sharing business. Darryl can deduct the 15,000 miles using the standard mileage rate as well as any other ordinary and necessary business expenses, such as supplies, a cell phone, food and drinks for passengers, parking fees, tolls, roadside assistance plans, business insurance, and taxes.

Volunteer sites may see more Forms 1099-K than in the past because the form filing threshold has been substantially reduced. Due diligence is needed *to ascertain the correct reporting of these proceeds, if any.*

Income from Covid-19 Related Grants

If a grant was awarded to a business, even a self-proprietor Schedule C business, the COVID grant must be declared and is taxable and subject to self-employment tax.

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 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.

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

How is business income reported?

Form 1040, Schedule C

Form 1040, Schedule C, is used to report income from a business operated or a profession practiced as a sole proprietor. Schedule C shows the income and expenses and the net income amount is carried to Form 1040. An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. A hobby is an activity typically undertaken for pleasure during leisure time.

To report income from an activity not for profit, see the instructions for Form 1040 and Publication 17, Other Income. This topic is out of scope. Refer any taxpayers with not-for-profit activity to a professional tax preparer.

Form 1040, Schedule C, is also used to report wages and expenses the taxpayer had as a statutory employee or certain income shown on Form 1099-MISC or Form 1099-NEC.

Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC or Form 1099-NEC. Taxpayers who believe they have been misclassified should contact the IRS and ask for help.

Volunteer tax preparers who have Advanced certification can assist with preparation of the limited Schedule C.

The tax software calculates net profit after income and expense entries are made. Next, the software transfers the net profit to the applicable line on Schedule SE, Self-Employment Tax, to compute the self-employment tax. The software will also transfer the net profit to Form 8995 to compute the qualified business income deduction. Amounts are then transferred to the applicable lines of Form 1040.

The following terms are used in the preparation of business returns:

Definition of Terms	
Business expenses	Business expenses are amounts that are ordinary and necessary to carry on the business.
Cash method of accounting	The cash method of accounting reports all income when received and deducts all expenses when paid.
Inventory	Inventory is the items the taxpayer buys or makes for resale to others. Taxpayers with inventories should be referred to a professional tax preparer.
Depreciation	The cost of items that are expected to last more than a year should be spread over a

	period of years rather than deducted in the year of purchase. If the taxpayers have such a cost, they should be referred to a professional tax preparer.
Election to expense business assets	An election is available to immediately expense qualifying business assets, known as a “179 deduction”. Taxpayers who wish to expense business assets should be referred to a professional tax preparer.

What is in scope for VITA/TCE?

Volunteers can assist taxpayers who have returns that require Schedule C with certain limits:

- Have less than $35,000 in business expenses
- Use the cash method of accounting

- Have no inventory at any time during the year
- Did not have a net loss from the business
- Have no employees during the year and did not pay contract labor for services (out of scope issue)
- Are not required to file Form 4562, Depreciation and Amortization, for this business (depreciation and the election to expense business assets are out of scope for the VITA/TCE programs), but see the de minimis expense election below
- Do not deduct expenses for business use of a home

During the interview, if you discover taxpayers have issues that fall outside the scope of the VITA/TCE programs, refer them to a professional tax preparer.

More than one Schedule C can be prepared if the taxpayers have more than one business or to report each spouse's share of the business if it is jointly operated and filing a joint return.

The net profit or loss will be reported on Form 1040. The net profit will also need to be shown on Schedule SE in order to calculate the self-employment tax. Schedule SE will be covered in a later lesson.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

Sample Interview

Volunteer Says...	Jason Responds...
What kind of business do you have and were you the sole owner?	I install air conditioners and, yes, I own the business myself. No partners or employees.
Do you have a record of your business income and expenses for last year?	Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.
Do you use the cash method of accounting?	Yes. I have a printout of my year-end summary here.
And what were your expenses?	Well, I do the installations myself; I

	spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year were $2,212.

Sample Interview

Volunteer Says…	Jason Responds…
Do you keep any parts in inventory?	No, I purchase the parts when an order is placed with me.
And you say you had a good year? In other words, did you make a profit?	That’s correct.
Do you plan on deducting expenses	No, I don’t.

for the business use of your home?	
Okay, and how much business income did you have? [On page 2 of the intake and interview sheet, indicate Jason's responses to these questions.]	My gross totaled $30,762.

EXERCISE

Question 1: Based on the information in the sample interview, is Jason's return in scope for VITA/TCE?

a. Yes

b. No

How do you clarify taxpayers' business income and expenses?

All IRS-certified volunteers must exercise due diligence when preparing tax returns. Due diligence means doing your part to ensure tax returns are correct.

This means, as a volunteer, you must do your part when preparing or reviewing a tax return to ensure the information on the return is correct and complete. Generally, you can rely in good faith on information from a taxpayer without requiring documentation as verification.

However, when preparing a tax return with a Schedule C and the earned income credit (EIC), take additional steps to determine that the net self-employment income used to calculate the amount of, or eligibility for, EIC is correct and complete. Additional clarification or inquiries should be made if the information furnished by the taxpayer appears to be incorrect, incomplete, or inconsistent. Taxpayers sometimes want to over report or under report their income to qualify for or maximize the amount of EIC.

Ask sufficient questions of taxpayers claiming self-employment income to be satisfied that:

- The taxpayer actually conducts a business
- The taxpayer has records to support income and expenses, or can reasonably reconstruct income and expense records
- All income and related expenses have been included on the taxpayer’s Schedule C

Emphasize to taxpayers that in the event of an IRS audit, they would need to provide receipts to support their reported income and expenses.

What Schedule C situations raise a "red flag"?

As a volunteer preparing a tax return with Schedule C, watch for examples of incorrect, incomplete, or inconsistent information, such as:

- Schedule C income reported in round numbers
- Schedule C cash businesses as the only source of income on a return claiming EIC
- Schedule C with little or no expenses when expenses would be expected
- Schedule C taxpayers with little or no records for income and expenses
- Any Schedule C income that qualifies the taxpayer for the maximum EIC
- Schedule C without a Form 1099

Taxpayer Interview and Tax Law Application

A taxpayer, Dana, comes in to have her tax return prepared. She tells you she runs her own babysitting business and wants to claim the EIC. To assist the taxpayer in completing an accurate return, you need to ask more questions to determine if Dana did incur allowable business expenses and that the income she reported is correct.

Sample Interview

Volunteer Says…	Dana Responds…
Tell me about your business, and were you the sole owner?	I have a babysitting service that I handle all by myself.
Do you have a record of your business	Well, I'm not very good at keeping records, but I can tell you that I made

income and expenses for last year?	$14,000 over the course of the year. I didn't have any expenses.
How did you determine that you made a net profit of $14,000?	I based my income on deposits to my checking account.
I see. We may be able to reconstruct your business income based on your deposits. Did you bring any bank statements or your checkbook record with you today?	No, I'm sorry.
How many children did you care for, and was this a full-time or parttime job for you?	Babysitting is just part-time. I watch several of my neighbors' children

	along with my own kids who are 8 and 10 years old.
What is your fee for babysitting?	It averages about $10 an hour.
Do you have a calendar or schedule of the children present each day?	No, but I may be able to come up with one.
Do you have a business license or permit, and do you watch the children in your own home or in a daycare facility or in the client’s home?	My home and sometimes at my neighbors’ homes. I don’t need a permit.
Do you buy any supplies such as food, diapers, toys, or other	Sometimes I need to buy supplies. But I

items necessary for the business?	didn’t bring receipts with me.
Did you intend to deduct expenses for the business use of your home?	No, I don’t think so.
Be aware that the IRS requires that you report all income and allowable expenses on your tax return. In the event of an IRS audit, you will be responsible for providing support for the income and expenses claimed on your return. Before we can proceed, you’ll need to	OK – thanks. I’ll see what I can pull together.

gather some additional facts and records. I'll write down a list of items that could help us more accurately calculate your net profit from your business.	

The information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

1. Has no business expenses. Most businesses have expenses, even if it is just a few dollars here and there.

2. Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EIC.

The volunteer cannot complete a return based on information provided, but gives Dana the chance to gather materials to document her business.

What business expenses are within scope for the VITA/TCE programs?

Taxpayers deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer’s industry. A necessary expense is one that is helpful and appropriate for the taxpayer’s trade or business. All ordinary and necessary expenses incurred in a self-employed taxpayer’s business must be reported. See the Instructions for Schedule C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Advertising

Advertising expenses are the costs associated with promoting the business through various means including internet ads, newspapers, magazines, billboards, racing sponsors, and television spots.

Every self-employed taxpayer must claim all allowable deductions in computing net earnings from self-employment.

Car and Truck Expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. This is true even if the taxpayer used the vehicle for hire. Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation. The calculation of depreciation is outside the scope of the VITA/TCE programs. If the taxpayers have used actual expenses in the past, or wish to use actual expenses in the current year, they must be referred to a professional tax preparer.

For the standard mileage deduction, the current standard mileage rate is multiplied by the number of business miles.

Self-employed taxpayers can also deduct the business part of interest on a car loan, state and local personal property tax on the car, parking fees, and tolls, whether or not they claim the standard mileage rate. For-hire drivers may have other deductible car expenses such as cellular service, fees, and ride-sharing insurance in addition to using the standard mileage rate. Commuting and other personal automobile expenses such as depreciation, lease payments, maintenance and repairs, gasoline (including gasoline taxes), oil, insurance, parking tickets, traffic fines, or vehicle registration fees are not deductible.

Wendy is a self-employed masseuse and does not maintain an office in her home. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Wendy drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.

For-hire drivers who have mileage in between customer pick-ups can claim the mileage as a business expense.

Commissions and Fees

Commissions or fees are paid to both individuals and businesses. If payments to a single individual are $600 or more, the taxpayer must report the payments on Form 1099-MISC or Form 1099-NEC. In this case, the taxpayer's return is out of scope for the VITA/TCE programs.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property and business liability insurance.

If the standard mileage rate is used, no deduction is allowed for regular automobile insurance premiums.

A for-hire driver's cost of extra liability coverage can be added to the standard mileage rate if separate from the main policy.

Health insurance for the sole proprietor and his or her family is not deductible as a business expense on Schedule C. However, these medical premiums may be deducted on Form 1040 as an adjustment to gross income, subject to qualifications, and is discussed in the Adjustments to Income lesson.

Other Interest

This category can include interest paid on business operating loans, but not mortgage interest. Business interest includes the business portion of interest on a car loan – it can be added to the standard mileage rate.

Legal and Professional Services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., tax returns, wills, or estates) and are not deductible as business expenses.

Payments over $600 may require a Form 1099-MISC or 1099-NEC to be filed, which makes the return out of scope.

Office Expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or Lease – Vehicle, Machinery, and Equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Vehicle leases of more than 30 days are out of scope. If the taxpayer uses the standard mileage rate method for business miles of a leased vehicle, the return remains in scope.

Repairs and Maintenance

Repairs on equipment, office space, and buildings are some possible expenditures reflected in this category. Expenses that should *not* be reflected are:

- Capital equipment that is improperly expensed (see Cost Recovery in Publication 535, Business Expenses).
- Repairs that substantially improve a facility or equipment that should be capitalized.

Also see the de minimis expense election below under Other Expenses.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Business Meal Expenses

A business owner can deduct a percentage, generally 50%, of the actual cost of a meal if the following conditions are met:

- The meal expense was an ordinary and necessary expense in carrying on the taxpayer's trade or business;
- The expense was not lavish or extravagant under the circumstances;
- The taxpayer was present at the meal;
- The meal was provided to a current or potential business customer, client, consultant, or similar business contact; and
- In the case of food or beverages provided during or at an entertainment event, the food and beverages were purchased separately from the entertainment, or the cost of the food and beverages was stated separately from the cost of the

entertainment on one or more bills, invoices, or receipts.

Taxes and Licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

Travel Expenses

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel expenses are in the Volunteer Resource Guide, Income tab.

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses incurred for the business. There should be no deduction for personal expenses or expenses for a home office in this category.

Kiana runs a small business from her home. She has only one phone line and frequently makes long-distance calls for business. The cost of the phone line cannot be deducted, but Kiana can deduct the long-distance charges for her business calls.

Other Expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Schedule C.

Taxpayers can deduct the cost of their education expenses (including certain related travel) related to the trade or business. Taxpayers must be able to show the education maintains or improves skills required in their trade or business, or that it is required by law or regulations, for keeping license to practice, status, or job. See Form Schedule C Instructions (Part V – Other Expenses) for more information.

Taxpayers may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property used in the taxpayer’s trade or business. They may use this safe harbor to deduct amounts paid for tangible property up to $2,500 per invoice or item (substantiated by invoice) if they have accounting procedures in place whereby they deduct amounts paid for business property if the costs of such property are under a certain de minimis amount.

The de minimis safe harbor election does not include amounts paid for inventory and land. The election applies for the taxable year and, if made, applies to each expenditure meeting the criteria for the election in the taxable year. Make the election by attaching a statement titled “Section 1.263(a)-1(f) de minimis safe harbor election” to a timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include the taxpayer’s name, address, and Taxpayer Identification Number, as well as a statement that the taxpayer is making the de minimis safe harbor election.

EXAMPLE *Barry makes his living as a handyman and earned $17,438 during the tax year. In the same year, Barry bought a new ladder for $450 and uses it exclusively in his business. In keeping his books and records, Barry uses an accounting procedure whereby he deducts amounts he pays for business equipment if the cost of the equipment is $1,000 or less. Under the de* *minimis safe harbor, Barry can deduct the full cost of the ladder as a business expense, as well as any other equipment purchases for $1,000 or less, by attaching the required statement to his timely filed tax return.*

How do I complete Schedule C?

On Schedule C, business expenses are broken down by category.

General Information Section

Using the Volunteer Resource Guide, Tab D, Income, complete the questions about your business in TaxSlayer.

In general, taxpayers who seek assistance through the VITA/TCE programs may be required to file Form 1099-MISC or Form 1099-NEC for payments in the amount of $600 or more for services performed for a trade or business by people not treated as its employees or for rent paid. The taxpayer must file Form 1099NEC or Form 1099-MISC to report contract labor or rent payments. For a complete listing of Forms 1099 and the requirements for filing each one, refer to the chart in the General Form 1099 Instructions.

If the taxpayer responds Yes to making payments that would require the filing of Form(s) 1099, the income tax return and any related Form 1099 preparation are both out of scope for the VITA/TCE programs. The taxpayer must be referred to a professional tax preparer even if the taxpayer indicates they have already filed the Forms 1099.

Part I: Income

Enter each Form 1099-MISC or 1099-NEC that the taxpayer received. Also enter income that was not reported on a Form. The combined total represents the gross receipts from the taxpayer's trade or business. Refer to the Volunteer Resource Guide for the software entries, including when the income was reported on Form W-2 and the "Statutory Employee" box on that form is checked.

Determine if the taxpayer received business income that was not reported on Form 1099-NEC. For example, tips received by self-employed hair stylists or manicurists are to be included in gross receipts on Schedule C.

Statutory Employees

A "Statutory employee" can report the income and claim expenses related to that income on Schedule C. Enter the statutory employee income from Form W-2, Box 1, on line 1 of Schedule C. Social Security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self-employment tax on these earnings. Be sure to indicate that this is a statutory employee on the input screen so that the self-employment tax is not computed by the software. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Self-employment income and statutory employee income cannot be reported on the same Schedule C. The taxpayer must file two separate Schedules C.

Part II: Expenses

On Schedule C there is a separate line for the most common expenses that are incurred in a business. Review the taxpayer's business expense information. The taxpayer will decide whether a particular expense is ordinary and necessary for their business. Your role is to inform the taxpayer of the rules and ask probing interview questions to resolve incomplete or inconsistent data.

Part III: Cost of Goods Sold

This relates to inventory and is out of scope for the VITA/TCE programs.

Part IV: Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Schedule C. Report the cost of purchases as other expenses and not as cost of goods sold for a small business using the cash method of accounting.

Question 2: Daniel has his own business. He received Form 1099-NEC for $13,000 for work he completed as an independent contractor. He also received cash payments that total $2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of $2,500 on his return?

a. Yes

b. No

Question 3: Ellen has a small business. The gross income from her business is $40,000, her business expenses total $11,500, and she must file a Schedule C. Is Ellen’s tax return in scope for the VITA/TCE programs?

a. Yes

b. No

Taxpayers who report a profit on Schedule C may be able to deduct up to 20% of their qualified business income on Form 1040 as a qualified business income deduction. For more information, see the Standard Deduction and Tax Computation Lesson or the instructions for Form 1040.

Recordkeeping

Why keep records?

Everyone in business must keep records. Good records will help the taxpayer do the following:

- Monitor the progress of their business

- Prepare their financial statements
- Identify source of receipts
- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books and records (for example, accounting journals and ledgers). The books and records must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books and records. In addition, supporting documents must be kept.

Supporting documents

Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, bank or credit card statements and canceled checks. These documents contain information that must be recorded in the business books and records.

When a business involves the use of a vehicle, a mileage log would be a supporting document.

It is important to keep these documents organized and in a safe place because they support the entries in the business books and records, and on the tax return. For instance, organize them by year and type of income or expense.

Records include electronic records. Taxpayers should retain paper and electronic records that support their tax return data.

Reconstructing records

Make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

You may help a taxpayer with simple record reconstruction. Assisting the taxpayer in reconstruction will help teach the taxpayer about recordkeeping. Extensive record reconstruction should be performed by the taxpayer or a paid preparer. If you are not satisfied with the accuracy of the reconstructed records, you have the right to decline to prepare the return. See your Coordinator for guidance in these situations.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. When reconstructing records, you can use such tools as:

- Appointment books or calendars
- Online map tools or apps that track business miles
- IRS standard allowances
- Checkbooks and canceled checks
- Cash apps and accounting software
- Bank or credit card statements
- Lists of regular clients
- Partial receipts or sales tax records
- Cell phone records, call history, or computer logs
- Prior year returns

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the statute of limitations for that return runs out.

The statute of limitations is the time period in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Publication 583, Starting a Business and Keeping Records.

Taxpayer Interview and Tax Law Application

Remember our taxpayer, Dana, with a babysitting business? She said she made $14,000 in net profit from her business, and wants to claim the EIC. After careful interviewing, the volunteer has determined the return cannot be completed without record reconstruction. The volunteer asked

Dana to go home and return with some documentation to support her claims.

Based on the taxpayer's materials and additional questions, you can now determine if Dana should be claiming expenses for the business use of her home. If she can, refer the taxpayer to a professional tax preparer.

Sample Interview

Volunteer Says...	Dana Responds...
Nice to see you again, and I see you have some additional materials. What kind of documentation were you able to put together?	As you suggested, I completed a calendar that shows the number of children that I cared for on each date.
That sounds great. First, let's multiply the number of children	Yes, I have some grocery store receipts, canceled checks, bank

that you cared for by the corresponding charged rate to confirm your income figure. Did you also bring documents to support your business expenses?	statements, and credit card statements. I have highlighted the regular purchases I made for my business.
OK, then we'll calculate a reasonable estimate of expenses incurred.	Good. I'm sure my first estimate of $14,000 business income is not accurate after all. I appreciate learning what I need to do to keep track of my income and expenses.

What about self-employment tax?

A taxpayer must file Schedule SE if he or she has net earnings from self-employment of

$400 or more. The tax is computed on Schedule SE and transferred to Form 1040, and is added to other taxes owed. The Schedule SE is attached to Form 1040, and is discussed in the Other Taxes lesson.

Self-employed taxpayers may claim an adjustment to income for part of their Social Security and Medicare taxes.

Taxpayers who file Schedule C may be able to take a deduction for self-employment health insurance. For more information, see the Adjustments to Income lesson.

Self-employment tax and the deductible part of self-employment tax are automatically calculated. The software then enters these amounts on the applicable lines of Form 1040.

Summary

This lesson explained:

- Where to get business income and expense information
- Cash income must be reported
- Subcontractors or individuals who receive less than $600 may not receive Form 1099-MISC, Form 1099NEC, or Form 1099-K, but still must report all cash income
- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- Certain situations involving Schedule C and EIC should raise "red flags"
- How business income or loss is reported (a loss would make the return out of scope)

- What business expenses are within scope for the VITA/TCE programs
- How to complete Schedule C
- The records that should be maintained
- How to complete a simple record reconstruction

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.

Schedule C with:

- Hobby income or not-for-profit activity
- Bartering income
- Expenses over $35,000
- Returns and allowances
- Cost of goods sold (inventory)

- Expenses for employees
- Business use of home
- Contract labor
- Casualty losses
- Vehicle expenses reported as actual expenses
- Depreciation or the election to expense business assets (other than the de minimis expense safe harbor election)
- Rental or lease expenses – vehicle leases of more than 30 days (other than leased vehicles for which the standard mileage method is used)
- Accounting methods other than the cash method
- Net losses
- A “No” response that indicates the taxpayer does not meet any of the tests for material participation, or is uncertain

about materially participating in a business

- A “Yes” response indicating there is a requirement to file Form(s) 1099
- Income from the manufacture, distribution, or trafficking of controlled substances (such as marijuana)
- Taxpayers who must answer **Yes** to the digital asset question on Form 1040

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&LT.

EXERCISE Answers

Answer 1: a, Yes. Jason meets all requirements to be considered in scope for the VITA/TCE programs.

Answer 2: a, Yes. The cash payments must be included in Daniel's gross receipts the same as the $13,000 reported on Form 1099-NEC. Cash payments are compensation for his services and must be reported on his Schedule C.

Answer 3: a, Yes. Ellen's business expenses are under $35,000.

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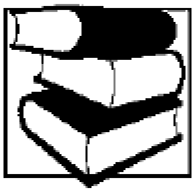
Income – Capital Gain or Loss



Introduction

This lesson will help you assist taxpayers who must use Form 8949, Sales and Other Dispositions of Capital Assets, in conjunction with Form 1040, Schedule D, Capital Gains and Losses, to report capital gains and/or losses on the sale of assets. This lesson includes topics on the sale of stock, mutual funds, and the sale of a personal residence. If the taxpayers have sold any other assets, refer them to a professional tax preparer.

This lesson will help you identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, the tax liability, and the amount of any capital loss carryover.

The intake and interview sheet asks about income from the sale of property such as stock, bonds, digital assets, or real estate. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year. It is important to ensure that all income is accurately reported on the return.

Transactions using a digital asset (virtual currency) or buying and selling a digital assets are out of scope. However, the tax return in in scope if the taxpayer can check the "No" box on Form 1040. Refer to Scope of Service in Publication 4012, VITA/TCE Resource Guide, and Instructions for Form 1040 for details on digital assets.

Information on the topics discussed in this lesson are in Publication 544, Sales and Other Dispositions of Assets, Publication 551, Basis of Assets, Publication 550, Investment

Income and Expenses, and Publication 523, Selling Your Home.

Objectives

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

- Determine the adjusted basis of capital assets
- Determine if the asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss from the sale of capital assets
- Determine whether a home is the taxpayer's main home
- Determine if a taxpayer meets the ownership and use tests
- Determine when the 5-year ownership/use test period is suspended

What do I need?

- Form 13614-C
- Publication 4012
- Publication 523
- Publication 544
- Publication 550
- Publication 551

Optional:

- Form 1040 Instructions
- Form 1040, Schedule D and Instructions
- Form 1099-B
- Form 1099-DIV
- Form 1099-S
- Form 8949

What information must I have to report a capital gain or loss?

To report capital gain or loss, you will need to identify:

- Basis and/or Adjusted Basis:
  - Basis is the original cost of the asset
  - Adjusted basis includes original cost plus any increases or decreases to that cost (such as commissions, fees, depreciation, deductible casualty losses, insurance reimbursements or major improvements)
  - Brokers must report cost or other basis on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, unless the securities sold were noncovered securities. Taxpayers will have to provide the information for noncovered securities not reported on Form 1099-B.

    - Taxpayers must use codes to report if Form 1099-B was received and whether or not it showed basis reported to the IRS

- Holding period (when acquired and when disposed):
    - Short-term property is held one year or less
    - Long-term property is held more than one year
    - Long-term capital gains are taxed at a lower rate than short-term gains and ordinary income
    - Brokers must report whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities. Taxpayers will have to provide the information for noncovered securities not reported on Form 1099-B.

- Proceeds from the sale:
  - Form 1099-B reflects gross or net proceeds for a stock or mutual fund
  - Form 1099-S usually reflects gross proceeds of real estate transactions
  - Other evidence in the absence of the above

Taxpayers will have to provide the information for noncovered securities not reported on Form 1099-B. Noncovered securities are defined in Instructions for Form 1099-B.

To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Schedule D, Capital Gain or Loss.

What is the basis of stock?

Basis

In order to compute gain or loss on a sale, taxpayers must provide their basis in the sold property. The basis of property is usually its cost.

- If taxpayers need help determining their basis and do not have the original purchase documents, refer them to Publication 551 and their stockbroker.
- If taxpayers cannot provide their basis in the property, the IRS will deem it to be zero.

Special rules apply to inherited property; these rules are covered in this lesson in the topic, "Basis Other Than Cost." If the taxpayer acquired the stock by means other than a purchase or inheritance, such as a gift or an employee stock option plan (ESOP), and does not know the basis of the stock, refer them to a professional tax preparer. The determination of basis in these situations is beyond the scope of the VITA/TCE programs.

Adjusted Basis

An adjustment to basis may include additional commissions or fees paid to the broker at the time of purchase or sale.

Stock is bought and sold in various quantities. It is important for the taxpayer to keep track of the basis per share of all stock bought and sold. Events that occur after the purchase of the stock can require adjustments (increases or decreases) to the “per share” basis of stock. The original basis per share can be changed by events such as stock dividends and stock splits.

- Stock dividends are issued in lieu of cash dividends. These additional shares increase the taxpayer’s ownership (number of shares). The adjusted basis of the original stock shares is split among the new total of shares, including the new stocks issued as a dividend. This lowers the taxpayer's basis per share.

- A stock split is a method used by corporations to lower the market price of stock. A two for one stock split will decrease the basis per share by half. For example, the original basis of $200 for 100 shares becomes
- $200 for 200 shares.
- DRP (dividend reinvestment plan) accounts leave cash dividends with the company for the purchase of additional shares. Even though these shares are from the same company, they retain their own individual basis separate from the original purchase. Each new purchased share could have a different basis.

Brokers or mutual fund companies will track the basis of mutual fund shares for covered securities. Still, taxpayers should keep track of their basis in mutual fund shares.

- The original basis of mutual fund shares bought is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.
- The cost basis of mutual fund shares acquired by reinvesting distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution was an exempt-interest dividend that was not reported as income.
- The basis in mutual fund shares may need to be increased or reduced. For more information, refer to Publication 550.

EXAMPLE

Alice paid $1,100 for 100 shares of ABC, Inc. stock (which included the broker's commission of $25). The *original basis per share was $11 ($1,100 ÷ 100). She received 10 additional shares as a tax-free stock dividend. Her $1,100 basis must be allocated to the 110 shares (100 original shares plus the 10-share stock dividend). This results in an adjusted basis of $10 per share ($1,100 ÷ 110).*

Basis Other than Cost

There are times when cost alone cannot be used as basis. In some cases, the fair market value (FMV) or adjusted basis is used.

- Property Received as a Gift – To determine the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. Taxpayers also need to know the FMV at the time of the donation and the amount of any gift tax paid on the donation. Determination of the adjusted basis of property received as a gift can be very complex and is beyond the scope of the VITA/TCE programs.

- Inherited Property
  - Before 2010 and after 2010: the basis of property inherited during this time is generally the FMV of the property on the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date or other acceptable method. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a professional tax preparer.
  - During 2010 (after December 31, 2009, and before January 1, 2011): special rules may apply to property inherited from a decedent who died in 2010. Determining the basis of such property can be complex. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a

professional tax preparer for determination of basis issues. For more information on the special rules, refer to Publication 4895, Tax Treatment of a Property Acquired from a Decedent Dying in 2010 (Rev. October 2011). Download Publication 4895 under Prior Year Forms and Instructions on IRS.gov.

- Wash Sales
  - The reporting of wash sales is in scope only if reported on Form 1099-B (Box 1g) or on a brokerage or mutual fund statement. Report the wash sale as an adjustment on Form 8949, line 1, columns (f) and (g).
  - A wash sale is the sale of securities at a loss and the acquisition of the same (substantially identical) securities within 30 days of the sale date (before or after).

- Taxpayers cannot deduct losses from sales or trades of stock or securities in a wash sale unless the loss was incurred in the ordinary course of business as a dealer in stock or securities (out of scope).
- The disallowed loss is added to the cost of the new stock or securities. The result is an increase to the basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities.
- The holding period for the new stock or securities includes the holding period of the stock or securities sold.

The taxpayer buys 100 shares of X stock for $1,000. The taxpayer sells these shares for $750 and within 30 days from the sale buys 100 shares of the same stock for $800. Because the taxpayer *bought substantially identical stock, the taxpayer cannot deduct the loss of $250 on the sale. However, the taxpayer adds the disallowed loss of $250 to the cost of the new stock, $800, to obtain the basis in the new stock, which is $1,050.*

For additional information on how to figure the basis, refer to Publication 551.

If the taxpayer knows the basis of property that was inherited or received as a gift, you can provide assistance. If they do not know the basis of the property, refer the taxpayer to a professional tax preparer.

How do I determine the holding period?

Long-Term or Short-Term

Brokerage firms report sales of securities, the acquisition cost, the dates of sale and acquisition, if there is a wash sale adjustment, and whether the cost basis was reported to the IRS on Form 1099-B.

Taxpayers will have to provide any information not reported on Form 1099-B or when their records disagree with the amount reported by the brokerage.

Form 1099-B will also indicate the date the stock was sold. The purchase and sell dates will determine the holding period. Capital gains and losses are either long-term or short-term, depending on how long the taxpayer owned the stock. Stock held for:

- One year or less has a short-term holding period
- More than one year has a long-term holding period

If a taxpayer acquired property by gift or inheritance, the taxpayer must provide the basis and acquisition date. Determining these tax items *is complex and outside the scope of the VITA/TCE programs.*

The holding period begins the day after the shares were purchased and includes the day the shares were sold. If investment property is inherited, the capital gain or loss is treated as long-term. This is true regardless of how long the property is held.

Determining the correct holding period is important because short-term gains are taxed at regular income tax rates and long-term gains are taxed at a lower rate than the other income reported on the return.

Stock acquired as a nontaxable stock dividend or stock split has the same holding period as the original stock owned. They are considered to have been acquired on the same day as the original stock. Stock acquired in a DRP has its own purchase date. The holding period for stock received as a taxable stock dividend begins on the date of distribution.