Publication 4491

VITA/TCE **Training Guide**

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

Volume 11 of 16

2023 RETURNS

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What are examples of work-related expenses?

The following expenses count as work-related:

- Cost of care outside the home for dependents under age 13, for example, preschool or home day care, or before-school or after-school care for a child in kindergarten or higher grade
- Cost of care for any other qualifying person, for example, dependent care
- Household expenses that are paid at least partly for the well-being and protection of a qualifying person, for example, the services of a housekeeper or cook

If a taxpayer's qualifying child turned 13 during the tax year, their qualifying expenses include amounts incurred for the child while under age 13. For example, if the taxpayer's qualifying child *turns 13 on September 16, count only those expenses through September 15.*

What expenses do not qualify as work-related?

Expenses that do not qualify as work-related include amounts paid for food, clothing, education, or entertainment. However, small amounts paid for these items can be included if they are incidental to and cannot be separated from the cost of care. Examples of childcare expenses that do **not** qualify as work- related include:

- Education expenses to attend kindergarten or a higher grade
- The cost of sending a child to an overnight camp
- The cost of transportation not provided by a care provider

Roger takes his 10-year-old child to a private school. In addition to paying for the cost of the education, Roger also pays an extra fee so that his child can attend a before- and after-school program while he is at work. Roger can count the cost of the before- and after-school program when figuring the credit, but not the cost of the education.

Krista takes her 3-year-old child to a nursery school that provides lunch and educational activities as part of its preschool childcare service. She can count the total cost when she figures the credit.

What about taxes paid for household employees?

Taxpayers who paid someone to come into their home to provide care for their dependent or spouse may be required to pay household employment taxes. These taxes may be considered a work-related expense.

Generally, if the household employee earned less than a certain amount for the tax year, and the taxpayer did not withhold any income tax, the taxpayer is not required to pay employment taxes or provide the employee with Form W-2. Refer taxpayers who should pay employment taxes for their household employees, or are unsure about these requirements, to Publication 926, Household Employer's Tax Guide, and to a professional tax preparer.

What if the taxpayer makes payments to a relative?

Payments to relatives may qualify as work-related expenses if the taxpayer does not claim the relative as a dependent. Do not count amounts paid to:

- A dependent that the taxpayer (or spouse, if married) can claim on the tax return
- The taxpayer's child who is under age 19 at the end of the year, even if the child is not the taxpayer's dependent
- A person who was the taxpayer's spouse at any time during the year
- The other parent of the taxpayer's qualifying child who is under age 13

What questions should I ask?

Continue asking questions from the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, and the intake and interview sheet. Here is how a volunteer might interview a taxpayer about the work-related test.

Sample Interview

Volunteer Says…	Dorothy Responds…
Did the caregivers assist your daughter only when you and your husband were at work?	That's right. We couldn't afford any more help than that. All last year, they arrived just before we left for work and they left when my mother came at 2 p.m.
Do you pay your mother to care for your daughter?	No, we don't. She just does it because she loves her granddaughter.
That's wonderful. You're all very fortunate. So all your	Yes, exactly.

expenses were only to allow you to work – or in your husband’s case to go to school or look for work prior to becoming employed.	
No. That does not disqualify you.	

Dorothy passes the work-related expense test because the expenses are paid so that she and her husband can work and are not paid to a dependent relative.

What is the joint return test?

Generally, *married couples* who wish to take the child and dependent care credit must file a joint return. However, taxpayers can be considered unmarried if they file a separate return and:

- Are legally separated under a divorce or separate maintenance decree on the last day of the tax year or
- Lived apart from their spouse for the last 6 months of the year and paid more than half of the cost of providing a home that was also the main home of the qualifying person for more than half the year.

There is a checkbox required on Form 2441 for Married filing Separately taxpayers that meet the requirements to claim the credit.

Generally, married persons who are considered unmarried will use the filing status, Head of Household.

A taxpayer whose spouse died during the tax year, and who has not remarried, must generally file a joint return to claim the credit. The surviving spouse may, but is not required to, take into account the earned income of the spouse who died during the year.

At this point, you will have already determined the filing status and can rely on that to determine if the taxpayer passes the joint return test.

What is the provider identification test?

The provider identification test requires that taxpayers provide the name, address and Taxpayer Identification Number (TIN) of the person or organization who provided the care for their child or dependent.

If the care provider is an individual, the TIN is the same as the provider's Social Security number. If the provider is an organization, then it is the Employer Identification Number (EIN). Certain tax-exempt organizations are not required to have an EIN. See Publication 503 for more details.

Taxpayers who cannot provide all of the provider's information or who have incorrect information may still be able to take the credit if they can show that they used due diligence in trying to obtain the correct information. Refer to the sections titled Due Diligence and Provider Refusal in Publication 503, Child and Dependent Care Expenses, for more information. Returns that do not include the provider information cannot be filed electronically.

EXERCISES

Use the screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, to answer the following questions. The answers appear at the end of the lesson.

Question 1: Audrey is a stay-at-home mom. Her husband works and had earned income for the tax year They have a young son with autism who must be supervised at all times. Audrey volunteers at a local autism information hotline 12 hours a week. She and her husband pay a caregiver to stay with their son during those hours.

Do they qualify for the child and dependent care credit?

a. Yes

b. No

Question 2: Why don’t Audrey and her husband qualify for the credit? (Select all answers that apply.)

a. The caregiver expense is not work-related

b. Their son is not a qualifying person

c. The caregiver’s duties qualify as work-related

d. They do not pass the earned income test

Taxpayer Interview and Tax Law Application

Bill, 61, and Helen, 62, are married and have lived together for 20 years. Earlier in the interview with Bill, you learned that Helen is too sick to work and needs 24-hour care. Bill is claiming his granddaughter Lucy as

a dependent, as noted in the Marital Status and Household Information section of his intake and interview sheet. She is 18 and takes care of Helen. You wonder whether Bill can take the child and dependent care credit.

Apply the questions from the credit for child and dependent care expenses screening sheet in the Volunteer Resource Guide, Tab G, Nonrefundable Credits, to find out whether Bill can take the credit, as shown in the sample interview to follow.

Sample Interview

Volunteer Says…	Bill Responds…
For the credit for child and dependent care, I’d like to ask you some questions about the care provided for your wife, Helen. You may qualify for the credit.	Oh, okay.
Why don’t you tell me about your wife’s illness and care?	Well, she has chronic lung disease; she can’t take care of herself at all. We need to have someone in the home 24 hours a day.
I’m sorry that she is so ill. That must be difficult for both of	Yes, it is … well, sometimes she has

you. [The volunteer has already determined earlier in the tax return preparation process that Bill has earned income from his full-time teaching job. So he skips these questions in the decision tree and moves ahead to the next relevant question.]	good days, and I'm thankful for that.
Did you pay someone to take care of your wife so that you could go to work?	Yes, I pay my granddaughter Lucy, who just graduated from high school, to take care of Helen.

Oh, I see. Well unfortunately, you won’t be able to take the credit for your wife because you are claiming Lucy as a dependent.	Oh, that’s okay. Thanks for looking into it for me.
You’re welcome. Just trying to help! [On the intake and interview sheet, indicate that the taxpayer doesn’t qualify for this credit, and why.]	

Bill does not pass the work-related expenses test because his expenses were paid to a dependent relative.

How do I determine the amount of the credit?

To determine the amount of the credit, multiply the work-related expenses (after applying the earned income and dollar limits) by a percentage. It is possible a qualifying person could have no expenses and a second qualifying person have expenses that exceed $3,000. In that case, list $0 for one person and the actual amount for the second person. The percentage depends on the taxpayer's adjusted gross income.

The tax software performs much of the credit computation for you. To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Form 2441, Credit for Child and Dependent Care Expenses.

How do I complete Form 2441?

Form 2441 is divided into three parts:

- Part I is for general information about the care provider
- Part II is where the child and dependent care credit is calculated
- Part III is where information is entered if the taxpayer reports employer-provided dependent care benefits All taxpayers complete Part I first.

Taxpayers who did not receive dependent care benefits from their employers then complete Part II. Taxpayers who did receive these benefits complete Part III and then Part II.

What about employer-provided dependent care benefits?

Some taxpayers receive dependent care benefits from their employers. Taxpayers may be able to exclude these benefits from their income. Dependent care benefits include amounts the employer pays either directly to the taxpayer or to the care provider. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, Box 10.

The taxpayer may still be able to claim a child and dependent care credit, but the amount of excluded benefits is not included in work-related expenses and also reduces the dollar limit for the credit. Taxpayers who receive dependent care benefits **must** complete Part III of Form 2441, even if they are not eligible for a child and dependent care credit.

Paula has one dependent child, Jenny, who is 6 years old. She paid $2,900 in qualified expenses. Paula's Form W-2, Box 10, shows she received $1,400 during the year from her employer's dependent care assistance program. Because she received dependent care benefits, Form

2441, Part III, must be completed before completing Part II.

To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, Form 2441, Credit for Child and Dependent Care Expenses.

What limits apply to this credit?

The taxpayer’s expenses are subject to an earned income limit. The amount of work-related expenses used to figure the credit cannot be more than:

- The taxpayer’s earned income for the year or
- If Married Filing Jointly, the smaller of the taxpayer or spouse’s earned income for the year

If the taxpayer files a return as a surviving spouse after the death of a spouse during the tax year, the taxpayer may, but is not required to, include the earned income of the spouse who died. If the decedent's earned income is less than the surviving spouse, use the surviving spouse's earned income only. See the Volunteer Resource Guide, Tab G, Miscellaneous Credits, for entries to adjust the decedent's earned income so the software will make the proper calculations.

In addition to the earned income limit, there is a dollar limit on the amount of work-related expenses that can be used to figure the credit. This limit is $3,000 for one qualifying person or $6,000 for two or more qualifying persons. If the taxpayer received dependent care benefits from an employer, the amount of the benefits excluded from income must be subtracted from the dollar limit.

Care expenses paid in the current tax year that were incurred in the prior tax year are subject to different rules as detailed on Form 2441 and its instructions. The taxpayer will need to provide a breakdown of the prior year care expenses paid during the current tax year.

Mary has three qualifying children. She received $4,800 in dependent care benefits through her employer. When Mary figures her credit, her work-related expenses will be limited to $1,200 ($6,000 – $4,800).

The tax software guides you through applying the limits and computing the credit. If the taxpayer received employer-paid benefits, enter the amounts in the Form W-2 section, and this amount is carried to Part III of Form 2441.

How do I avoid common errors?

When entering information into the software, double-check your entries for the provider’s name, ID number, and amounts paid. Be sure that qualified expenses are entered in step 2 of the software. If the taxpayer had an amount in any Form W-2, Box 10, the software will ask you to verify that the entry is correct, and to make sure Form 2441 is completed.

On the intake and interview sheet, make sure the box is checked to indicate that the taxpayer was eligible for the dependent care credit. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return.

Summary

The credit for child and dependent care expenses is a nonrefundable credit that allows taxpayers to reduce their tax liability by a portion of the expenses.

The maximum expense amounts are $3,000 for one qualifying person and $6,000 for two or more qualifying persons. This $6,000 limit does not need to be divided equally among them.

The maximum credit rate is 35% of the taxpayer's expenses. A taxpayer must satisfy the five eligibility tests to qualify for the credit. The tests are the:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

The credit is calculated on Form 2441.

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

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

- Taxpayers who need assistance in determining if employment taxes are owed for household employees

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: b, No. They do not qualify.

Answer 2: a and d. Audrey is not using the caregiver's services to look for work or to perform work. In addition, both spouses must have earned income during the year to qualify. Only the husband had earned income for the tax year.

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Education Credits

Introduction

This lesson covers tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of income tax. This lesson suggests probing questions you can ask based on the intake and interview sheet, the Volunteer Resource Guide, Tab J, Education Benefits, and on the rules for claiming education credits.

During the interview, ask taxpayers if they are aware of the education credits, and give a brief description. Next, gather information to determine if any credits can be claimed.

Objectives

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

- Determine who qualifies for an education credit

- Determine which credit the taxpayer can claim

What do I need?

- Form 13614-C
- Publication 4012
- Publication 970
- Form 1098-T
- Form 8863 and Instructions

Optional:

- Form 1040 Instructions

What are education credits?

Education credits are amounts that will reduce the amount of tax due. The amount is based on qualified education expenses that the taxpayer paid during the tax year.

There are two different education credits: the American opportunity credit and the lifetime learning credit. The American opportunity credit allows 40% of the credit

to be refundable. There are general rules that apply to these credits, as well as specific rules for each credit.

For an overview of the various education tax benefits, review the Volunteer Resource Guide, Tab J, Education Benefits, Highlights of Education Tax Benefits.

Who can take an education credit?

Taxpayers can take education credits for themselves, their spouse, and/or dependents (claimed on the tax return) who were enrolled at or attended an eligible postsecondary educational institution during the tax year. The law requires that the student must generally receive a Form 1098-T, Tuition Statement, in order for the taxpayers to claim the education credit. However, if the student's educational institution is not required to furnish a Form 1098-T, the taxpayer may claim a credit if the student does not receive a Form 1098-T. The student is required to provide the information that would otherwise be included on the Form 1098-T.

Review the dependent section of the intake and interview sheet for children who are shown as full-time students. Ask the taxpayer if there are education expenses.

What basic requirements must the taxpayer meet?

To claim an education credit, verify that the following are true for the taxpayers:

- They cannot be claimed as a dependent on someone else’s tax return
- They are not filing as Married Filing Separately
- Their adjusted gross income (AGI) is below the limitations for their filing status ($180,000 if married filing jointly;

$90,000 if single, head of household, or qualifying surviving spouse)

- They were not nonresident aliens for any part of the tax year, or if they were, they elected to be treated as resident aliens

Taxpayers claiming the American opportunity credit must have a valid identification number (SSN or ITIN) by the due date of the tax return (including extensions). Further, the student claimed for the credit must also have a valid identification number (SSN, ATIN, or ITIN) by the due date (including extensions). Taxpayers cannot file an amended return to claim the credit for a year that the taxpayer and/or student did not originally have a required identification number by the return due date.

How do I handle dependents?

The taxpayer must claim the student as a dependent to receive the credit for the student's qualified expenses. If the taxpayer claims the student as a dependent, all qualified education expenses of the student are treated as being paid by the taxpayer.

Carol Marshall has a grandson named Gary. He is claimed as a dependent on his parent's joint return. Carol paid Gary's tuition directly to the university. For purposes of claiming an education credit, Gary is treated as receiving the money as a gift and paying for the qualified tuition and related expenses. Since his parents are claiming him on their return, they may be able to use the expenses to claim an education credit. Alternatively, if he is claiming himself on his return, he might be able to claim the expenses as if he paid them to the school.

What is an eligible institution?

An eligible institution is generally any accredited public, nonprofit, or private college, university, vocational school, or other postsecondary institution eligible to participate in a student aid program administered by the U.S. Department of Education. The school should be able to tell the student if it is an eligible education institution. A searchable database of all accredited postsecondary institutions and programs are available at: **https://ope.ed.gov/accreditation/**.

Taxpayers claiming the American opportunity credit are required to report the EIN of the educational institution the student attended on Form 8863, Education Credits (American Opportunity and Lifetime Learning Credits). The student can get the EIN from the school if they did not receive Form 1098-T.

What are qualifying expenses?

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. Qualified education expenses include nonacademic fees, such as student activity fees, athletic fees, or other expenses unrelated to the academic course of institution that must be paid to the institution as a condition of enrollment or attendance. However, for the American opportunity credit, the definition for "certain related expenses" is different from the lifetime learning credit. This will be discussed later in the lesson.

Ask to see documentation, such as Form 1098-T, issued by the school. The taxpayer can add other expenses that qualify for education credits, such as books or supplies not purchased through the school account.

EXAMPLE *When Janice enrolled for her freshman year of college, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students and is used solely to* *fund on- campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Janice's college enrollment and attendance; therefore, it is a qualified expense.*

Which expenses do not qualify?

Do **not** include expenses such as:

- Room and board, insurance, medical expenses (including student health fees), transportation costs, or other similar personal, living, or family expenses
- Any course of instruction or other education involving sports, games, or hobbies, unless the course is part of the student's degree program or (for the lifetime learning credit) helps the student to acquire or improve job skills

If expenses or scholarships are adjusted in a later year, the school will report the amount in Box 4 or Box 6 of Form 1098-T. Prior credits claimed may need to be recaptured. Refer taxpayers with adjustments to a professional tax preparer.

Jackie paid $3,000 for tuition and $5,000 for room and board at an eligible university. The $5,000 paid for room and board is not a qualified expense for the education credits.

Are any amounts excluded from qualified expenses?

Tuition or other education expenses that have been used to make scholarships, grants, 529 distributions or other amounts received tax-free cannot be used to figure the credit. Once you have identified each person claiming a credit and their qualified expenses, ask if the student received any of these untaxed educational benefits during the year:

- Tax-free part of Pell grants
- Tax-free employer-provided educational assistance (See the Volunteer Resource Guide, Tab J for maximum amount)
- Veterans’ educational assistance
- Tax-free parts of scholarships and fellowships
- Any other nontaxable payments received as educational assistance (other than gifts or inheritances). For example, distributions from a 529 plan reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530)
- Refunds of the year’s qualified expenses paid on behalf of a student (e.g., the student dropped a class and received a refund of tuition)

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return if the scholarship or fellowship grant (or any part of it) must be applied (by its terms) to expenses (such as room and board) other than qualified education expenses, or if the scholarship or fellowship grant (or any part of it) ***may*** *be applied (by its terms) to expenses (such as room and board) other than qualified education expenses. Some students may choose to pay non- qualifying expenses with scholarship/Pell grants funds, making the scholarship/Pell grants taxable. This is true even if the scholarship/grant was paid directly to the school.*

Higher education emergency financial aid grants are available through September 30, 2023. This grant is not includible in gross income. Further, the student's qualified education expenses are not *reduced for this nontaxable grant for purposes of an education benefit.*

Generally, any scholarship or fellowship grant is treated as tax-free educational assistance. However, a scholarship or fellowship grant is not treated as tax-free educational assistance to the extent the student includes it in gross income (the student may or may not be required to file a tax return) for the year the scholarship or fellowship grant is received. If the student includes the educational assistance in income, has a filing requirement and unearned income (including the taxable scholarship) over the ceiling amount, the student must file Form 8615, Tax for Certain Children Who Have Unearned Income (Kiddie Tax) to compute the tax. In this case, Form 8615 is out of scope. See the Volunteer Resource Guide, Tab J, Education Benefits for the ceiling amount.

Most students should receive Form 1098-T from the educational institution. The form should show the amounts the student paid for tuition and related expenses, the amounts of scholarships and grants received are shown in Box 5, and whether the student was at least a half-time student or a graduate student. Verify with the taxpayer that the amount in Form 1098-T, Box 1, is actually the amount paid in the current tax year for qualified expenses. Also ask about qualified education expenses paid outside the school, such as from a bookstore.

Form 1098-T may have incomplete information. Question the taxpayer to determine the amount of qualified expenses actually paid and adjust this amount by any non-taxable items, such as tax-free scholarships and tuition program distributions.

Joan Smith received Form 1098-T from the college she attends. It shows her tuition was $9,500 (Box 1) and that she received a $1,500 (Box 5) scholarship. She had no other scholarships or nontaxable payments. Her maximum qualifying expenses for the education credit would be $8,000 ($9,500 - $1,500).

Juan, a student, receives a grant equal to his qualifying education expenses. He otherwise has no filing requirement. He earned $10,600 from a summer job which is less than the cost of half of his support, had $4,000 in education expenses and a $4,000 Pell grant. Juan's parents file a return claiming Juan as a dependent and reported income that is within the allowable range for the American opportunity credit (AOC).

Scenario 1: *Juan uses the grant to pay the education expenses. Juan has no filing requirement and files only to get his withholding (from his summer job) back. His parents qualified education expenses would be zero.*

Gross income = $10,600, no filing requirement, tax = 0.

Scenario 2: *Juan chooses to declare $2,000 of the grant as income on his return and his parents use the education expenses toward the AOC. Juan's gross income is $10,600 + $2,000 = $12,600. As a dependent, Juan has no filing requirement and he has no tax. His parents claim $2,000 as qualified education expenses.*

Scenario 3: *Juan chooses to include the entire grant as income on his return. Juan's parents can claim the entire $4,000 education expenses toward the AOC. Juan's gross income is $10,600 + $4,000 = $14,600. Since Juan's income is over the dependent's* *filing requirement income, the kiddie tax applies and his tax return is out of scope. His parents claim an AOC of $2,500.*

It may be better to forgo some portion of the AOC when other issues, such as the kiddie tax or premium tax credits, could be adversely affected by Juan having a filing requirement.

What about payments for the next academic year?

The taxpayers can claim payments prepaid for the academic period that begins in the first three months of the next calendar year (Box 7 of Form 1098-T will be checked). Refer to the Volunteer Resource Guide, Tab J, Education Benefits.

Thomas pays $1,500 in December for qualified tuition for the winter semester that begins in January. He can use the $1,500 paid in December to *compute his credit for the current tax year. He cannot count it again next tax year.*

What rules apply to each credit?

American Opportunity Tax Credit

Taxpayers can take the American opportunity credit for a student if they can answer all of these questions as indicated below:

- As of the beginning of the tax year, was the student still in the first four years of postsecondary education (generally, the freshman, sophomore, junior, and senior years)? *Yes*
- As of the beginning of the tax year, has the American opportunity credit been claimed for this student for four years? *No*
- Was the student enrolled in a program that leads to a degree, certificate, or other credential? *Yes*
- Was the student taking at least one-half the normal full-time workload for the

course of study, for at least one academic period beginning in the current tax year? *Yes*

- Has the student been convicted of a felony for possessing or distributing a controlled substance as of year end? *No*
- Did the taxpayer and student have a taxpayer identification number (TIN) by the due date of the return (including extensions)? *Yes*

If the student does not meet all of the requirements for the American opportunity credit, the taxpayer may be able to take other education benefits for part or all of the student's qualified expenses.

Mindy's brother, Jim, started college in 2017. He was eligible for the American opportunity credit for 2017, 2018, 2019 and 2020. His parents claimed the American opportunity credit on their 2017, *2018 and 2019 returns. Jim claimed the credit on his 2020 tax return. Since the credit has been claimed for four years, the credit can't be claimed on any additional returns based on Jim's expenses.*

Qualified expenses include tuition, required enrollment fees, and course materials that the student needs for a course of study whether or not the materials are bought at the educational institution as a condition of enrollment or attendance.

The American opportunity credit can be up to $2,500 per eligible student, depending on the amount of eligible expenses and the amount of tax on the return.

- The credit is 100% of the first $2,000 in eligible expenses and 25% of the second $2,000 in eligible expenses per student, up to the amount of tax

- 40% of the credit is a refundable credit, which means the taxpayer can receive up to $1,000 even if no taxes are owed
- Taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met

Refer to Volunteer Resource Guide, Tab J, Education Benefits, Student Under Age 24 Claiming American Opportunity Credit, for details.

Toby has receipts for books and supplies for his first year at college. He spent $1,291 for required books, lab supplies, and rock-hunting equipment he needed for his introductory chemistry and geology courses. The school has no policy requiring that these books and equipment be purchased from the college in order to enroll. These are qualified expenses for the American opportunity credit.

Lifetime Learning Credit

The lifetime learning credit can be taken if the taxpayer and the expenses meet the requirements described under “What basic requirements must the taxpayer meet?”, above. Additional criteria for the lifetime learning credit include:

- Student doesn’t need to be pursuing a program leading to a degree or other recognized education credential
- Felony drug conviction doesn’t make the student ineligible
- Up to $2,000 non-refundable credit per return (20% of up to $10,000 in eligible expenses)
- Available for an unlimited number of tax years
- Available for all years of postsecondary education and for courses to acquire or

improve job skills (no minimum amount of course workload)

- Course-related books, supplies, fees, and equipment are included in qualified education expenses only if they must be paid to the institution as a condition of enrollment or attendance

Jill attends Wanda's School of Beauty, an eligible institution. She pays $4,400 for the course of study, which includes tuition, equipment, and books required for the course. The school requires that students pay for the books and equipment when registering for the course. The entire $4,400 would be an eligible educational expense.

Jack attends a culinary school on Saturdays. He pays $4,400 for the course of study and qualifies for the lifetime learning credit. The school *provides a list of equipment that he needs to bring to class. The $4,400 is an eligible educational expense, but the cost of the equipment and supplies is not.*

EXERCISES

Use the Volunteer Resource Guide, Tab J, Education Benefits, and Publication 17, Comparison of Education Credits, to answer the following questions. Answers are at the end of the lesson summary.

Question 1: Bob was a full-time student and a fifth-year senior. He has only claimed the American opportunity credit for three earlier years. Does he qualify for the American opportunity credit?

a. Yes

b. No

Question 2: Janice works full time and takes one course a month at night school. Some of the courses are not for credit, but they are meant to advance her career. Which credit is appropriate for her?

a. American opportunity

b. Lifetime Learning

Question 3: Clark is an older student who has gone back to college half time after serving 18 months in prison for felony drug possession. Which credit is appropriate for him?

a. American opportunity

b. Lifetime Learning

Can a taxpayer take multiple education benefits?

Education expenses can be taken in any of several areas on the tax return. They can be used toward one of these credits, as a business expense on Schedule C, or to reduce the taxable portion of scholarships, fellowships, grants and distributions from education savings accounts. The definition of a qualifying expense varies among these different benefits, but in general, each expense can be used only once. For example, do **not**:

- Figure the education credits based on expenses that have already been taken on Schedule C
- Take both an American opportunity credit and a lifetime learning credit for the same student in the same year

A taxpayer who has taken an early distribution from an IRA may take an exception to the 10% additional tax for an amount equal to the adjusted qualified education expenses including room and board costs if enrolled at least half-time.

To review information related to software entries, go to the Volunteer Resource Guide, Tab J, Education Benefits.

To determine the most beneficial way to claim education expenses, do not compare them until both federal and state tax returns have been otherwise completed.

How do I determine the amount of the credit?

Here are the general steps in figuring the amount of education credits:

1. Review the list of qualifying students and expenses and decide if the American opportunity credit or lifetime learning credit is more suitable (see the requirements discussed earlier).

2. Form 8863, Part III, page 2, requests information about the student, the

student's eligibility for the credit, and the educational institution(s). Taxpayers must complete Part III for each eligible student for whom they are claiming an education credit before completing Parts I and II.

3. Enter each student's qualified expenses. Be sure that these:

   - Include only qualified expenses paid during the tax year
   - Are reduced by untaxed benefits
   - Do not exceed the limit for the credit

4. Find the totals for each section and apply the limits, then transfer the amounts to Parts I and II to determine the refundable and nonrefundable credits. Apply the income test and do the calculations. (Tax software does this step for you.)

To determine the amount of qualified expenses, please review Form 1098-T and have a discussion with the taxpayer to determine the qualified education expenses paid.

When entering qualified expenses, the software allows you to select an education benefit. At this point, you can make changes to determine the most beneficial education benefit to claim for the taxpayer.

If you find taxpayers claimed an education credit in a prior year and they were refunded part or all of the expenses they used to claim the American opportunity or lifetime learning credit, they may have to repay (recapture) all or part of the credit. Information can be found in Publication 970, Tax Benefits for Education, but this is beyond the scope of the VITA/TCE programs. Advise the taxpayer to consult a professional tax preparer.

Taxpayer Interview and Tax Law Application

Here is how our volunteer helped a taxpayer, Barbara Smith, determine which education credits applied to her family.

Sample Interview

Volunteer Says...	Barbara Responds...
Barbara, are you familiar with education credits?	They have something to do with tuition.
Yes, they apply to certain expenses for postsecondary education. Did anyone in the family attend college or vocational school during the tax year?	My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.

There are two kinds of credits – here’s a chart comparing the two education credits. [Explains the differences.]	Looks like American opportunity for Carla and lifetime learning for me!
I think you’re right. You both meet the basic requirements, since you are both on the return and meet the income limits. Do you have your student account information showing the expenses paid?	Yes, these are for Carla’s tuition, fees, and books for the tax year. These are for extracurricular field hockey.
The books will qualify but her field hockey costs will not. Did she receive any money	Only $5,000 from her grandfather.

from an employer, a scholarship, Pell grant, anything like that?	
We don’t need to count the gift. The American opportunity credit is available for a student’s first four years of college, so that might be the best for you to claim. Now let’s look at your expenses.	All I have are tuition and fees for two classes in accounting, spring and fall semesters.
Are these to improve your job skills?	Yes, but my boss doesn’t reimburse me.
Are all of these fees required for your courses?	Yes.

You'll be eligible for the lifetime learning credit. [On the intake and interview sheet, indicate that you've addressed education benefits.]	I'm so glad you were here to help me!

Which education benefit is better for the taxpayer?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- American opportunity credit or lifetime learning credit
- Business expenses on Schedule C if the expenses qualify
- Make an unrestricted scholarship or grant tax free

Generally, taxpayers will benefit the most from claiming the education credits. The American opportunity credit will always be greater than the lifetime learning credit. However, you should compute any of the other benefits for which taxpayers are eligible to determine which gives them the lowest tax. Do not claim multiple credits for the same education expense; use the education credit that is most advantageous to the taxpayer.

Refer to the Volunteer Resource Guide, Tab J, Education Benefits for a comparison chart of some of the tax benefits for education.

How can I avoid common errors?

Make sure that you have entered the names, SSNs, and education expense amounts correctly. Check that you have not claimed more than one tax benefit for the same taxpayer or taken a credit or deduction for expenses paid with a tax-free benefit like a scholarship.

On the intake and interview sheet, make sure that the appropriate box is checked to indicate that the taxpayer had education expenses. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return. For example, you could note if some expenses were paid with a nontaxable scholarship.

What if the American opportunity credit was disallowed in a prior year?

The intake and interview sheet asks if the taxpayer was previously disallowed the American opportunity credit in a prior year. If the taxpayer answers “yes” to this question, refer to the Volunteer Resource Guide, Tab I, Earned Income Credit, Disallowance of Certain Credits.

Summary

You are now ready to help taxpayers determine which education tax benefits are best for them. When you get to this section of the return, always check the intake and interview sheet and ask probing questions based on the taxpayer’s information and on the rules for claiming education credits.

There are two education credits that may reduce a taxpayer’s tax:

- American opportunity credit
- Lifetime learning credit

These are some requirements for the credits:

- Taxpayers and students must have a TIN by the due date of the return, including extensions, to claim the American opportunity credit
- A taxpayer who claims the American opportunity credit and is not eligible can

be banned up to 10 years from claiming the credit

- 40% of the American opportunity credit is refundable (up to $1,000)
- Taxpayers can claim the American opportunity credit for up to four years
- Lifetime learning credit can be claimed for an unlimited number of years
- Lifetime learning credit is a non-refundable credit of up to $2,000 (20% of up to $10,000 in expenses)
- Education expenses can be applied to those credits or deducted as business expenses on Schedule C if they qualify
- Students that include tax-free scholarships and grants in income and have a filing requirement may be required to file Form 8615, Tax for Certain Children Who Have Unearned Income, which is out of scope for the VITA/TCE programs

Other education benefits are listed in the Volunteer Resource Guide, Tab J.

One of your roles as a volunteer is to help taxpayers maximize the benefits that they are entitled to under the tax law. Stay alert to ways they can use their education expenses to lower their tax.

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

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

- Taxpayers who must repay (recapture) part or all of an education credit claimed in a prior year.
- Taxpayers who are subject to the kiddie tax on their taxable scholarships or grants.

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

Question 1: a, Yes. Bob qualifies for the American opportunity credit because he only claimed the credit in three previous tax years.

Question 2: b, Lifetime learning

Question 3: b, Lifetime learning

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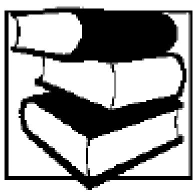
Foreign Tax Credit

Introduction

This lesson will show you how to help taxpayers claim the foreign tax credit. This credit applies to those who have paid or accrued taxes to a foreign country on foreign-sourced income and who are subject to U.S. tax on the same income.

To help these taxpayers, you must determine which taxes and types of foreign income are eligible for the foreign tax credit and accurately compute the credit using Form 1116, Foreign Tax Credit. Form 1116 is in scope only with International certification.

If the foreign tax paid is reported on a Form 1099-INT, Form 1099-DIV, or Schedule K-1 completion of the entire Form 1116 may not be required.

If the foreign tax paid is a result of living and working outside the U.S., then all the questions on Form 1116 need to be addressed.

Although the foreign tax credit is not specifically listed on Form 13614-C, Intake/Interview and Quality Review Sheet, ask taxpayers if they paid any tax to a foreign country.

Objectives

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

- Determine which taxes and types of foreign income are eligible for the foreign tax credit
- Determine whether Form 1116 is needed, and if so to accurately compute the credit

- Calculate and report the foreign tax credit as a nonrefundable credit

What do I need?

- Form 13614-C
- Publication 4012
- Publication 514
- Form 1116
- Form 1116 Instructions

What is the foreign tax credit?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens having to pay tax twice on the same income — first to the government of the foreign country where the income was earned and again to the U.S. government.

Taxpayers can choose whether to take the amount of any qualified foreign income taxes paid during the *year as a foreign tax credit or as an itemized deduction. Taxpayers may change their choice each year.*

As a general rule, taxpayers must choose to take either a credit or a deduction for all qualified foreign taxes. For exceptions to this general rule, see Publication 514, Foreign Tax Credit for Individuals.

The foreign tax credit was created to help taxpayers avoid this double taxation. Taxpayers who paid income, war profits, or excess profits taxes to a foreign country or U.S. territory may be entitled to a credit on their U.S. taxes. Like other nonrefundable credits, the foreign tax credit allows taxpayers to take a dollar-for- dollar reduction in the amount of U.S. tax owed. However, in some cases, not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit.

Four tests must be met to qualify for the credit:

1. The tax must be imposed on the taxpayer
2. The taxpayer must have paid or accrued the tax
3. The tax must be a legal and actual foreign tax liability, and
4. The tax must be an income tax

Some foreign taxes, such as foreign real property tax, are not income taxes.

What if the foreign tax credit is reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1?

Taxpayers who receive Form 1099-INT, Form 1099-DIV, or Schedule K-1 may have amounts indicating that foreign taxes have been paid on their behalf by the issuer of the document.

Taxpayers can elect to report foreign tax on Form 1040, Schedule 3 without filing Form 1116 as long as the following conditions are met:

- All of the gross foreign source income was from interest and dividends and all of that income and the foreign tax paid on it were reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1 (or substitute statement).
- If the tax relates to dividend income from shares of stock, those shares were held for at least 16 days.
- The taxpayer is not filing Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa, or excluding income from sources within Puerto Rico.

- The total foreign taxes shown on the forms was not more than $300 (not more than $600 if married filing jointly). If the total foreign tax amount shown exceeds these amounts, Form 1116 is required to claim any foreign tax credit.
- All foreign taxes were:
  - Legally owed and not eligible for a refund, and
  - Paid to countries that are recognized by the United States and do not support terrorism.

Taxpayers who must complete Form 1116 because they cannot qualify to claim the foreign tax credit without filing Form 1116 must be referred to a volunteer with an International certification or a professional tax preparer. If Schedule K-1 shows foreign taxes were paid or accrued, Schedule K-3 is needed to properly complete Form 1116.

A credit for foreign taxes can be claimed only for foreign tax imposed by a foreign country or U.S. territory.

Additional information can be found in the Form 1040 Instructions, Form 1116 Instructions and Publication 514.

To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Ryan, who is single, received Form 1099-DIV showing $29 of foreign taxes paid. According to Ryan, he received no other foreign source income and paid no other foreign taxes. The dividends were paid on shares of a mutual fund that he owned all year. He is eligible to claim the foreign tax credit on Form 1040, Schedule 3 and does not have to complete Form 1116.

EXERCISES

Answers are after the lesson summary.

Question 1: To claim the foreign tax credit without filing Form 1116, a taxpayer who is filing Single must have paid foreign taxes as shown on Form 1099-DIV, Form 1099-INT, or Schedule K-1 that are equal to or less than $300.

a. True

b. False

Question 2: Clyde comes to your site seeking help with his foreign tax credit. He is single and his Forms 1099-DIV show a total of $324 of foreign tax paid. Can Clyde claim the foreign tax credit without filing Form 1116?

a. Yes

b. No

Question 3: Judy and Mark are married and will file a joint return. Their Forms 1099-DIV show a foreign tax paid of $590. Can they claim the foreign tax credit without filing Form 1116?

a. Yes

b. No

The remaining sections of this lesson are directed to volunteers seeking an International certification. All others may proceed to the next lesson.

What are the rules for claiming the foreign tax credit on Form 1116?

If the foreign tax paid is more than $300 ($600 for Married Filing Jointly) or they do not meet the other conditions to make the election to claim the foreign tax credit without filing Form 1116, taxpayers must file Form

1116 to claim the foreign tax credit. See Publication 514 for details.

The foreign earned income exclusion differs from the foreign tax credit; try both methods for taxpayers and choose the approach that results in the lowest tax.

- *The exclusion allows a portion of the foreign earned income to be excluded from taxable income.*
- *The credit adds the foreign income to the taxable income and then reduces the U.S. tax due by some portion of taxes paid to the foreign government(s).*

What qualifies taxpayers for the credit?

To qualify for the credit, the following requirements must be met. A taxpayer must:

- Have income from a foreign country

- Have paid taxes on that income to the same foreign country
- Not have claimed the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of the Income – Other Income lesson)

In addition, the foreign tax must:

- Be paid to a foreign country on income derived from that country
- Be similar to the U.S. income tax
- Provide no economic benefit to the taxpayer paying the tax

Foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties

- Annuities

Foreign taxes for which an individual may *not* take a credit include taxes:

- On excluded income
- On foreign mineral income
- On combined foreign oil and gas income for which the taxpayer can take only an itemized deduction
- From international boycott operations
- Of U.S. persons controlling foreign corporations and partnerships
- Taxes paid to a foreign country that a taxpayer does not legally owe, including amounts eligible for refund by the foreign country

Taxpayers cannot take the foreign tax credit for foreign income taxes paid on income excluded under the foreign earned income exclusion.

Robb and his wife, Nina, are U.S. citizens who reside in France. Their Form 1040, Schedule B, Interest and Ordinary Dividends, lists $2,000 interest from a U.S. bank and $600 interest from a French bank. They paid income taxes on both amounts to both countries. On their U.S. tax return, they can compute a foreign tax credit to offset the taxes they owe to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return to offset the taxes paid to the U.S. on the interest income earned in the U.S.

Eva is a U.S. citizen who lives in Hong Kong. Eva owns her home in Hong Kong and paid $2,000 in real estate taxes and $1,000 in personal property taxes. She also paid $3,000 in income taxes to the *government of Hong Kong. She cannot claim a foreign tax credit for either the real estate taxes or the personal property taxes because they are not income taxes. Eva can compute a foreign tax credit on the $3,000 in income taxes paid to Hong Kong.*

For more detailed information, see Publication 514 and the Form 1116 Instructions.

Question 4: Anne is a U.S. citizen living in Japan. She listed wages, interest income, and dividend income on her U.S. tax return. She paid taxes on each of these types of income to Japan. Anne can claim a foreign tax credit for taxes paid on which of the following sources of income?

a. Wages from her job in the U.S.

b. Interest income from a U.S. bank

c. Interest income from a Japanese bank

d. Dividend income from a U.S. corporation

Question 5: Jean, a U.S. citizen, received an inheritance upon the death of an uncle in Spain and paid an inheritance tax to the Spanish government. Can Jean claim a foreign tax credit to offset the inheritance tax she paid in Spain?

a. Yes

b. No

What is "economic benefit"?

As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:

- Goods
- Services

- Fees or other payments
- The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
- Discharges of contractual obligations

Taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.

Lawrence is a business owner who lives in China, which has a two-tier income tax system:

- *Everyone is taxed according to their income*

- *Business owners pay additional tax on their profits*

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return.

However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

What are Sanctioned Country Restrictions and Section 901(j) Income?

Taxes paid to or accrued by certain countries do not qualify for the foreign tax credit.

These are countries:

- That have been designated by the Secretary of State as repeatedly providing support for acts of international terrorism,
- With which the U.S. has severed or does not conduct diplomatic relations, or
- Whose government the U.S. does not recognize, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act

See Publication 514 for the current list of sanctioned countries.

Foreign income earned in sanctioned countries is subject to U.S. tax. A separate Form 1116 must be completed for foreign income from a sanctioned country, using the "Section 901(j) income" category. This is beyond the scope of the VITA/TCE programs; refer taxpayers to a professional tax preparer.

Question 6: Adele lived and worked in a sanctioned country until August of this tax year, when she was transferred to Italy. She paid taxes to each country on the income earned in that country. Can Adele take a foreign tax credit on her U.S. tax return for the taxes paid on income she earned in the sanctioned country?

a. Yes

b. No

Question 7: Assume the taxpayer is a U.S. citizen or resident living in a nonsanctioned foreign country and that the tax is being paid to a foreign government on foreign-sourced income. For each listed item determine if the tax qualifies for the foreign tax credit (Q) or does not qualify for the foreign tax credit (NQ).

___ Dividend taxes

___ Foreign oil related income tax

___ Interest income tax

___ Real estate taxes

___ Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

___ Taxes paid that are returned to the taxpayer in the form of a subsidy

What categories of income qualify for the credit?

At the top of Form 1116, Part I, taxpayers are asked to indicate the type of foreign income they received. Two of these income categories fall within the scope of the VITA/TCE programs:

- Passive category income
- General category income

A separate Form 1116 must be completed for each type of income; each Form 1116 can include income earned in as many as three foreign countries.

Passive Category Income

This category includes passive income and specified passive category income. Passive income generally includes the following:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

For example, a taxpayer who lives in a foreign country and pays taxes on interest income could claim the foreign tax credit and check the Passive category income box on Form 1116.

Wages and salaries are considered to be general category income, which is discussed later in this topic. Passive category income may qualify as general category income if the foreign government taxes it at a rate higher than the highest U.S. tax rate; see High-Taxed Income later in this lesson.

For additional information on passive income and specified passive category income, see Publication 514.

General Category Income

General category income consists of income earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion. Additionally, foreign income that does not come under any of the other categories on

Form 1116 can typically be included as general category income.

Robert paid taxes to Spain for earned income and did not claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain.

What is high-taxed income?

Some passive category income can be included in general category income if it is taxed by a foreign government at a rate higher than the highest U.S. income tax rate. Therefore, if taxpayers pay more than the highest U.S. income tax rate on the foreign-sourced passive income for which they claimed the credit, the credit is computed under general category income.

Brenda is a U.S. citizen who lives in a foreign country and pays 45% income tax on her interest income in that country. She lists this as "General Category Income" on Form 1116, since the tax rate paid on this passive income is higher than the highest U.S. income tax rate.

Question 8: Regina lives in a foreign country and is a U.S. citizen. She has both dividend income and interest income from foreign countries. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income, at a rate of 45%. For the purposes of Form 1116, how should the following types of income be classified?

Interest Income: ___ Dividend Income: _____

a. Passive category income

b. General category income

Question 9: Bernard is a U.S. citizen who lives in Barbados. This year, he paid 17% income tax on interest income from his bank account in Barbados. For the purposes of Form 1116, Bernard's foreign interest income should be classified as:

a. Passive category income

b. General category income

Tax Law Application

There are several factors to consider when determining if taxes paid to a foreign government are eligible for the foreign tax credit. Ask the taxpayer:

- Was the income foreign-sourced?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

How do I complete Form 1116?

If the taxpayer does not qualify for the election to claim the foreign tax credit without filing Form 1116, the form must be completed. The amount of the foreign tax credit is the portion of U.S. income tax liability based on gross taxable foreign income. Certain expenses reduce foreign gross income. Some of these situations are complicated and beyond the scope of the VITA/TCE programs, such as:

- Expenses directly related to the foreign income
- Investment interest expense
- Foreign losses, such as those from selling foreign assets or a loss from a business or partnership

If taxpayers have any of these types of deductions or if they have excess foreign tax credits that can be carried back to a prior year or forward to a later year, refer them to a professional tax preparer.

For step-by-step instructions on completing Form 1116, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Summary

Taxpayers who paid taxes to a foreign country or U.S. territory may be able to take a nonrefundable foreign tax credit. Generally, to claim the credit, taxpayers are required to file Form 1116.

Taxpayers do not have to file Form 1116 if they meet certain requirements and can elect to claim the foreign tax credit directly on Form 1040, Schedule 3. This election is in scope for the Advanced certification. VITA/ TCE volunteers must have International certification to help taxpayers who are required to file Form 1116.

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The credit is computed and reported on Form 1116. A separate Form 1116 must be completed for each category of income.

The foreign tax credit is different from the foreign earned income exclusion. If the taxpayer uses the foreign earned income exclusion, foreign tax paid on the excluded income cannot be used to claim the foreign tax credit. Taxpayers can choose the approach that results in the lowest tax.

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 who must complete Form 1116 because they cannot elect to report foreign tax on Form 1040 Schedule 3, unless your site has a volunteer and a reviewer with an International certification

- Taxpayers who may deduct a foreign income tax that is not allowed as a credit in certain circumstances
- Certain expenses deducted to reduce foreign gross income
- Taxpayers who must report a carryback or carryover on Form 1116
- Taxpayers who must file a separate Form 1116 required for foreign income from a sanctioned country, using the "Section 901(j) income" category
- 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.

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, True. Form 1116 is not required if the total foreign taxes paid are less than or equal to $300 ($600 if Married Filing Jointly).

Answer 2: b, No. Clyde is not eligible for the election to not use Form 1116 once his creditable foreign taxes exceed $300. Clyde will need to be referred to a volunteer with an International certification or seek the assistance of a professional tax preparer.

Answer 3: a, Yes. Judy and Mark do not have to complete Form 1116 because they file jointly and their foreign taxes are less than $600.

Answer 4: c. On Anne's tax return, she can claim a foreign tax credit to offset taxes she paid to Japan on interest received from the Japanese bank.

Answer 5: b, No. An inheritance does not qualify as income from a foreign country. Under U.S. tax law, inheritances are not taxable to the beneficiaries. Jean is not eligible to claim a foreign tax credit for the inheritance taxes she pays to the Spanish government.

Answer 6: b, No. Adele cannot take a foreign tax credit for the taxes paid on income she earned in the sanctioned country. However, this income is taxable in the U.S. since she is a U.S. citizen.

Answer 7:

Q – Dividend taxes

NQ – Foreign oil–related income tax Q – Interest income tax

NQ – Real estate taxes

Q – Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

NQ – Taxes paid that are returned to the taxpayer in the form of a subsidy.

Answer 8: Interest Income – a, passive category income; Dividend Income – b, general category income because it is high taxed income.

Answer 9: a. Since 17% (the tax rate Bernard paid) is not more than the highest U.S. income tax rate, Bernard's income falls under passive category income.

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