



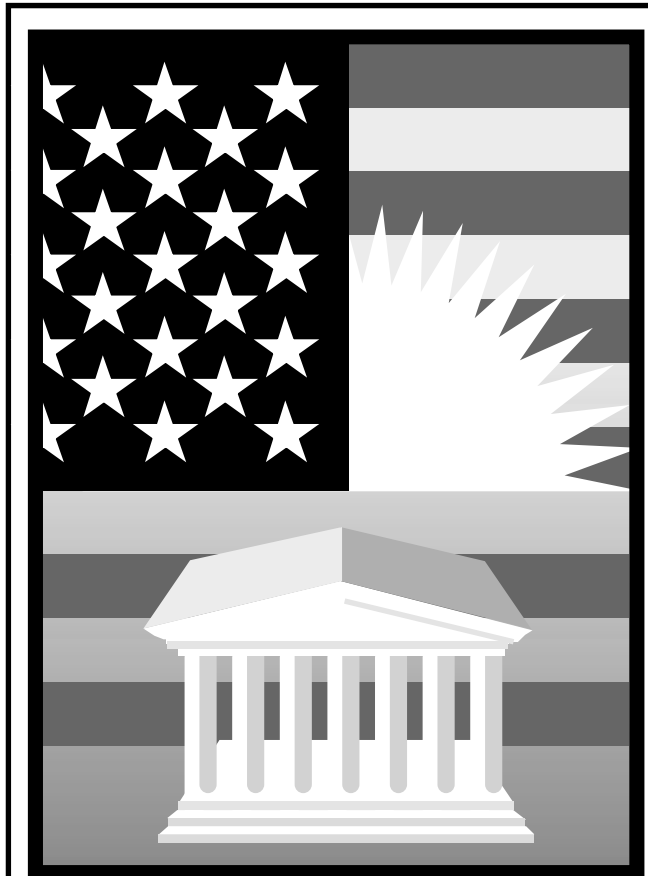
Department  
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Internal  
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# Taxable and Nontaxable Income

For use in preparing  
**1999** Returns



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## Important Change

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

## Important Reminder

**Foreign source income.** If you are a U.S. citizen, you must report income from sources outside the United States (foreign income) on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital

gains, pensions, rents, and royalties). This rule also applies to resident aliens.

If you reside outside the United States, you may be able to exclude part or all of your foreign source earned income. For details, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

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## Introduction

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

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

A valid check that you received or that was made available to you before the end of the tax year is considered income constructively received in that year, even if you do not cash the check or deposit it to your account until the next year. For example, if the postal service tries to deliver a check to you on the last day of the tax year but you are not at home to receive it, you must include the amount in your income for that tax year. If the check was mailed so that it could not possibly reach you until after the end of the tax year, and you could not otherwise get the funds before the end of the year, you include the amount in your income for the next tax year.

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

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

## Useful Items

You may want to see:

### Publications

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

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

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## Employee Compensation

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

You should receive a Form W-2, *Wage and Tax Statement*, from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

**Child-care services.** If you provide child care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you are not an employee, you are probably self-employed and must include payments for your services on Schedule C, *Profit or Loss from Business*, or Schedule C-EZ, *Net Profit or Loss from Business*, of Form 1040. You are generally not an employee unless you are subject to the will and control of the person who employs you as to what you are to do and how you are to do it.

**Babysitting.** If you babysit for relatives or neighborhood children, whether on a regular basis or only periodically, the rules for child-care providers apply to you.

## Miscellaneous Compensation

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

**Advance commissions and other earnings.** If you receive advance commissions or other amounts for services to be performed in the future and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

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

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

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

**Bonuses and awards.** Bonuses or awards you receive for outstanding work are included in your gross income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future

time, it is not taxable until you receive it or it is made available to you.

**Employee achievement award.** If you receive tangible personal property (other than cash, gift certificate, or equivalent item) as an award for length of service or safety achievement, you can exclude its value from your income to the extent of your employer's cost for all such awards you receive during the year up to \$1,600 (\$400 for awards that are not qualified plan awards). Your employer can tell you whether your award is a qualified plan award. Your employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay.

However, the exclusion does not apply to the following awards.

- A length-of-service award if you received it for fewer than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

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

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

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials. For more information, get Publication 516, *U.S. Government Civilian Employees Stationed Abroad*.

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

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

**Note received for services.** If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of

the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

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

**Retirement plan contributions.** You must include in income amounts you pay into a retirement plan through payroll deductions. You recover your contributions tax free when you retire and receive benefits from the plan. See Publication 575 for information about the tax treatment of retirement plan benefits.

**Employer's contributions to qualified plan.** Your employer's contributions to a qualified retirement plan for you are not included in income at the time contributed. (Your employer can tell you whether your retirement plan is qualified.) However, the cost of life insurance coverage included in the plan may have to be included. See *Group-Term Life Insurance*, later, under *Fringe Benefits*.

**Elective deferrals.** If you chose to set aside part of your pay for retirement under a qualified deferred compensation arrangement (for example, a section 401(k) plan), the amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan, subject to a limit. For 1999, this limit is \$10,000 for all elective deferrals. If you set aside more than \$10,000, you must include the excess in your income for that year. See Publication 575 for a discussion of the tax treatment of corrective distributions of excess deferrals.

Elective deferrals are not excluded from wages for social security and Medicare taxes and benefits.

If you are a federal employee, this treatment applies to your contributions to the Thrift Savings Plan.

**Employer's contributions to nonqualified plan.** If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. However, if your interest is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of the contribution, you do not have to include the value of your interest in your income until it is no longer subject to a substantial risk of forfeiture.

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

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

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

ment to explain the difference between the wages on your return and the wages on your Forms W-2.

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

However, you can deduct the value of these outplacement services (up to the difference between the severance pay included in income and the amount actually received) as a miscellaneous deduction (subject to the 2% limit) on Schedule A (Form 1040).

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

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

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

**Social security and Medicare taxes paid by employer.** If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. You must also treat the payment as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

**Stock appreciation rights.** Do not include a stock appreciation right granted by your employer in income until you exercise (use) the right. When you use the right, you are entitled to a cash payment equal to the fair market value of the corporation's stock on the date of use minus the fair market value on the date the right was granted. You include the cash payment in income in the year you use the right.

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

### Restricted Property Received for Services

Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you do not include the value of the property in your income until it

has been **substantially vested**. (You can choose to include the value of the property in your income in the year it is transferred to you, as discussed later, rather than the year it is substantially vested.)

Until the property becomes substantially vested, it is owned by the person who makes the transfer to you, usually your employer. However, any income from the property, or the right to use the property, is included in your income as wages in the year you receive the income or have the right to use the property.

When the property becomes substantially vested, you must include its fair market value, minus any amount you paid for it, in your income for that year.

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

**Substantially vested.** Property is substantially vested when:

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

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

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

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

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

appreciation in value is not included in your compensation when the property becomes substantially vested.



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

You make the choice by filing a written statement with the Internal Revenue Service Center where you file your return. You must file this statement no later than 30 days after the date the property was transferred. A copy of the statement must be attached to your tax return for the year the property was transferred. You also must give a copy of this statement to the person for whom you performed the services and, if someone other than you received the property, to that person.

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

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

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

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

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

**Sale of property not substantially vested.** These rules apply to the sale or other disposition of property that is not substantially

vested and not included in your income in the year transferred.

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

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

**Example.** In 1996, you paid your employer \$50 for a share of stock that had a fair market value of \$100 and was subject to forfeiture until 1999. In 1998, you sold the stock to your spouse for \$10 in a transaction not at arm's length. You had wage income of \$10 in 1998 from this transaction. In 1999, when the stock had a fair market value of \$120, it became substantially vested. For 1999, you must report additional wage income of \$60, figured as follows:

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

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

## Fringe Benefits

Fringe benefits you receive in connection with the performance of your services are included in your gross income as compensation unless you pay fair market value for them or they are specifically excluded by law from your income. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

See *Valuation of Fringe Benefits*, later in this discussion, for information on how to determine the amount to include in income.

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

You do not have to be an employee of the provider to be a recipient of a fringe benefit.

If you are a partner, director, or independent contractor, you can also be the recipient of a fringe benefit.

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

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

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

Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

You must use the same accounting period that you use to report the benefit to claim an employee business deduction (for use of a car, for example).

**Form W-2.** Your employer reports your taxable fringe benefits in box 1 (*Wages, tips, other compensation*) of Form W-2. The total value of your fringe benefits may also be noted in box 12. The value of your fringe benefits may be added to your other compensation on one Form W-2, or you may receive a separate Form W-2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

## Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan are generally taxable, as explained, later, under *Sickness and Injury Benefits*.

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

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

**Executive health program.** If your employer pays for a fitness program provided to you at an off-site resort hotel or athletic club, the value of the program is included in your compensation.

**Adoption Assistance**

You may be able to exclude from gross income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. The amounts must be paid or the expenses must be incurred before January 1, 2002, as part of an adoption assistance program. See Publication 968, *Tax Benefits for Adoption*, for more information.

Adoption benefits are reported by your employer in box 13 of Form W-2 with code T. They are also included as social security and Medicare wages in boxes 3 and 5. However, they are not included as wages in box 1. To determine the taxable and nontaxable amounts, you must complete Part III of Form 8839, *Qualified Adoption Expenses*. Attach the form to your return.

**Educational Assistance**

You can exclude from gross income up to \$5,250 of qualified employer-provided educational assistance. The exclusion applies to courses beginning before June 1, 2000. The exclusion does not apply to graduate-level courses. For more information, get Publication 508, *Tax Benefits for Work-Related Education*.

**Financial Counseling Fees**

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

**Group-Term Life Insurance**

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

For exceptions to this rule, see *Entire cost excluded* and *Entire cost taxed*, later.

If your employer provided more than \$50,000 of coverage, the amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 13 with code C.

**Former employer.** If your former employer provides more than \$50,000 of group-term life insurance coverage during the year, the amount included in your income is reported as wages in box 1 of Form W-2. It is also shown separately in box 13 with code C. Box 13 will also show the amount of uncollected social security and Medicare taxes on the excess coverage with codes M and N. You must pay these taxes with your income tax return. Include them in your total tax on line 56, Form 1040, and enter "UT" and the amount of the taxes on the dotted line next to line 56.

**Two or more employers.** Your exclusion for employer-provided group-term life insurance coverage cannot exceed the cost of \$50,000 of coverage, whether the insurance is provided by a single employer or multiple employers. If two or more employers provide insurance coverage that totals more than \$50,000, the amounts reported as wages on your Forms W-2 will not be correct. You must figure how much to include in your income. See *Figuring the taxable cost*, later. Reduce the amount you figure by any amount reported with code C in box 13 of your Forms W-2, add the result to the wages reported in box 1, and report the total on your return.

**Group-term life insurance.** This insurance is term life insurance protection (insurance for a fixed period of time) that:

- 1) Provides a general death benefit,
- 2) Is provided to a group of employees,
- 3) Is provided under a policy carried by the employer, and
- 4) Provides an amount of insurance to each employee based on a formula that prevents individual selection.

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

**Accidental death benefits.** Insurance that provides accidental or other death benefits but does not provide general death benefits (travel insurance, for example) is not group-term life insurance.

**Figuring the taxable cost.** You figure the taxable cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage for the month (figured to the nearest tenth), less 50, by the cost from the following table. Use your age on the last day of the tax year. You must prorate the cost from the table if less than a full month of coverage is involved.

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

<b>Insurance Provided Before July 1999:</b>	
Age	Cost
Under 30	\$.08
30 through 34	.09
35 through 39	.11
40 through 44	.17
45 through 49	.29
50 through 54	.48
55 through 59	.75
60 through 64	1.17
65 through 69	2.10
70 and older	3.76

<b>Insurance Provided After June 1999:</b>	
Age	Cost
Under 25	\$.05
25 through 29	\$.06
30 through 34	.08
35 through 39	.09
40 through 44	.10
45 through 49	.15
50 through 54	.23
55 through 59	.43
60 through 64	.66
65 through 69	1.27
70 and older	2.06

You figure the total taxable cost by multiplying the monthly taxable cost by the number of full months coverage at that cost.

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

- 1) Payments for coverage in a different tax year,
- 2) Payments for coverage through a cafeteria plan, unless the payments are after-tax contributions, or
- 3) Payments for coverage not taxed to you because of the exceptions discussed, later, under *Entire cost excluded*.

**Example.** You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you for the entire year. Your coverage is \$35,000 with employer A and \$45,000 with employer B. You pay premiums of \$4.15 a month under the employer B group plan. You figure the amount to include in your income for the insurance provided before July 1999 as follows:

Employer A coverage (in thousands)	.....	\$ 35
Employer B coverage (in thousands)	.....	+ 45
Total coverage (in thousands)	.....	\$ 80
Minus: Exclusion (in thousands)	.....	- 50
Excess amount (in thousands)	.....	\$ 30
Multiply by cost per \$1,000 per month, age 51 (from table)	.....	× .48
Cost of excess insurance for 1 month	.....	\$ 14.40
Multiply by number of full months coverage at this cost	.....	× 6
Cost of excess insurance provided before July 1999	.....	\$86.40
Minus: Premiums you paid	.....	-24.90
<b>Cost to include in income as wages</b>		<u>\$61.50</u>

You figure the amount to include in your income for the insurance provided after June 1999 as follows:

Excess amount (in thousands)	.....	\$ 30
Multiply by cost per \$1,000 per month, age 51 (from table)	.....	× .23
Cost of excess insurance for 1 month	.....	\$6.90
Multiply by number of full months coverage at this cost	.....	× 6
Cost of excess insurance provided after June 1999	.....	\$41.40
Minus: Premiums you paid	.....	-24.90
<b>Cost to include in income as wages</b>		<u>\$16.50</u>

The total amount to include in income for the cost of excess group-term life insurance is \$78 (\$61.50 + \$16.50). Because neither employer provided over \$50,000 insurance coverage, the wages shown on your Forms W-2 do not include any part of that \$78. You must add it to the wages shown on your Forms W-2 and include the total on your return.

**Entire cost excluded.** You are not taxed on the cost of group-term life insurance if any of the following apply.

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

- 4) The plan existed on January 1, 1984, and:
- You retired before January 2, 1984, and were covered by the plan when you retired, or
  - You reached age 55 before January 2, 1984, and were employed by the employer or its predecessor in 1983.

**Entire cost taxed.** You are taxed on the entire cost of group-term life insurance if either of the following apply.

- The insurance is provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.
- You are a key employee and your employer's plan discriminates in favor of key employees.

## Meals and Lodging

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

- The meals are:
  - Furnished on the business premises of your employer, and
  - Furnished for the convenience of your employer.
- The lodging is:
  - Furnished on the business premises of your employer,
  - Furnished for the convenience of your employer, and
  - A condition of your employment (you must accept it in order to be able to properly perform your duties).

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

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

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

**Qualified campus lodging.** Qualified campus lodging is lodging furnished to you, your spouse, or one of your dependents by, or on behalf of, the institution or center for use as a home. The lodging must be located on or near a campus of the educational institution or academic health center.

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

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

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

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

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

## Transportation

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

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

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

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

The exclusion for the qualified parking fringe benefit cannot be more than \$175 a month, regardless of its value.

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

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

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

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

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

## Tuition Reduction

You can exclude a qualified tuition reduction from your income. This is the amount of a reduction in tuition for education (below graduate level) furnished by an educational institution to an employee (or former employee) or his or her family. For more information, get Publication 520.

## Valuation of Fringe Benefits

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

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

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

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

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

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

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

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

**Flights on employer-provided aircraft.** Under the general valuation rules, if your flight on an employer-provided piloted aircraft is primarily personal and you control the use of

the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.

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

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

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

The special valuation rules are the following.

- 1) The automobile lease rule.
- 2) The vehicle cents-per-mile rule.
- 3) The commuting rule.
- 4) The unsafe conditions commuting rule.
- 5) The employer-operated eating-facility rule.

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

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

## Sickness and Injury Benefits

Generally, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. For information on nontaxable payments, see *Military and Government Disability Pensions* and *Other Sickness and Injury Benefits*, later, in this discussion.

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

**Cafeteria plans.** Generally, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and you must include

any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums and any benefits you receive are not taxable.

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.



*You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see Publication 524, Credit for the Elderly or the Disabled.*

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

**Retirement and profit-sharing plans.** If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity.

**Accrued leave payment.** If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your gross income in the tax year you receive it.

## Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

**Service-connected disability.** You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services.

- 1) The armed forces of any country.
- 2) The National Oceanic and Atmospheric Administration.
- 3) The Public Health Service.
- 4) The Foreign Service.

**Conditions for exclusion.** Do not include the disability payments in your income if any of the following conditions apply.

- 1) You were entitled to receive a disability payment before September 25, 1975.
- 2) You were a member of a listed government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
- 3) You receive the disability payments for a combat-related injury. This is a personal injury or sickness that:
  - a) Results directly from armed conflict,

- b) Takes place while you are engaged in extra-hazardous service,
  - c) Takes place under conditions simulating war, including training exercises such as maneuvers, or
  - d) Is caused by an instrumentality of war.
- 4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it. Your exclusion under this condition is equal to the amount you would be entitled to receive from the VA.

**Pension based on years of service.** If you receive a disability pension based on years of service, you generally must include it in your income. But if it is a result of active service in one of the listed government services and one of the listed conditions applies, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

**Retroactive VA determination.** If you retire from the armed services based on years of service and are later given a retroactive service-connected disability rating by the VA, your retirement pay for the retroactive period is excluded from income up to the amount of VA disability benefits you would have been entitled to receive. You can claim a refund of any tax paid on the excludable amount (subject to the statute of limitations) by filing an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return*, for each previous year during the retroactive period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, do not include in your income the portion of the severance payment equal to the VA benefit you would have been entitled to receive in that same year. However, you must include in your income any lump-sum readjustment or other non-disability severance payment you received on release from active duty, even if you are later given a retroactive disability rating by the VA.

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

## Other Sickness and Injury Benefits

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

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

**Workers' compensation.** Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature

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

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

of a workers' compensation act. The exemption also applies to your survivor(s). The exemption from tax, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

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

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

**Return to work.** If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

**Disability pension.** If your disability pension is paid under a statute that provides benefits only to employees with service-connected disabilities, part of it may be workers' compensation. That part is exempt from tax. The rest of your pension, based on years of service, is taxable as pension or annuity income. If you die, the part of your survivors' benefit that is a continuation of the workers' compensation is exempt from tax.

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

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

You can deduct the amount you spend to "buy back" sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you used it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

**Other compensation.** Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See *Court awards and damages* under *Miscellaneous Taxable Income*, later.

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

**Reimbursement for medical care.** A reimbursement for medical care is generally not taxable. However, it may reduce your medical expense deduction.

If you receive reimbursement for an expense you deducted in an earlier year, see *Recoveries*, later.

## Stock Options

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

## Nonstatutory Stock Options

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

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

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

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



from a decrease in the value of the property subject to the option.

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

**Option without readily determined value.** If the fair market value of the option is not readily determined at the time it is granted to you (even if it is determined later), you do not have income until you transfer or exercise the option. When you exercise this kind of option, the restricted property rules apply to the property received. The amount to include in your income is the difference between the amount you pay for the property and its fair market value when it becomes substantially vested. Your basis in the property you acquire under the option is the amount you pay for it plus any amount you must include in your gross income under this rule.

If you transfer this kind of option in an arm's-length transaction, you must include in your income the money or other property you received for the transfer, as if you had exercised the option. For more information on restricted property, see *Restricted Property Received for Services*, earlier.

## Statutory Stock Options

There are two kinds of statutory stock options:

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

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

If your option is a statutory stock option, do not include any amount in your income either when the option is granted or when you exercise it. You have taxable income or deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it on Schedule D (Form 1040), *Capital Gains and Losses*, for the year of the sale.

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

- You do not meet the **holding period requirement**. This situation applies only if you sell the stock within 1 year after its transfer to you or within 2 years after the option was granted.

- You meet the holding period requirement but the option was granted under an employee stock purchase plan for an option price that was less than the stock's fair market value at that time.

Report your ordinary income as wages on line 7, Form 1040, for the year of the sale.

**Incentive stock options.** If you sell stock acquired by exercising an incentive stock option and meet the holding period requirement, your gain or loss from the sale is capital gain or loss.

If you do not meet the holding period requirement and you have a gain from the sale, the gain is ordinary income up to the amount by which the stock's fair market value when you exercised the option exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss and you do not have any ordinary income.

**Example.** Your employer, X Corporation, granted you an incentive stock option on March 11, 1997, to buy 100 shares of X Corporation stock at \$10 a share, its fair market value at the time. You exercised the option on January 19, 1998, when the stock was selling on the open market for \$12 a share. On January 25, 1999, you sold the stock for \$15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 1999, you must report the difference between the option price (\$10) and the value of the stock when you exercised the option (\$12) as compensation. The rest of your gain is capital gain figured as follows:

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

**Alternative minimum tax.** For the alternative minimum tax, you must treat stock acquired through the exercise of an incentive stock option as if no special treatment applied. This means that, when your rights in the stock are transferable and no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price.

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

**Employee stock purchase plan.** If you sold stock acquired by exercising an option granted under an employee stock purchase plan, determine your ordinary income and your capital gain or loss as follows.

**Option granted at discount.** If you meet the holding period requirement and you have a gain from the sale, the gain is ordinary income up to the amount by which the stock's fair market value when the option was granted exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss, and you do not have any ordinary income.

**Example.** Your employer, Y Corporation, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Y Corporation for \$20 a share at a time when the stock had a value of \$22 a

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

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

**Holding period requirement not met.** If you do not meet the holding period requirement, your ordinary income is the amount by which the stock's fair market value when you exercised the option exceeded the option price. This ordinary income is **not** limited to your gain from the sale of the stock. Increase your basis in the stock by the amount of this ordinary income. The difference between your increased basis and the selling price of the stock is a capital gain or loss.

**Example.** The facts are the same as in the previous example, except that you sold the stock only 6 months after you exercised the option. Because you did not hold the stock long enough, your compensation is \$300 and your capital gain is \$700, figured as follows:

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

## Special Rules for Certain Employees

This part of the publication deals with special rules for people in certain types of employment: members of the clergy, people working for foreign employers, military personnel, veterans, and Peace Corps volunteers.

### Clergy

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. Get Publication 526, *Charitable Contributions*. Also, see *Members of religious orders*, later in this discussion.

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

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

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

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

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

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

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

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

**Example 1.** Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

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

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

**Example 2.** Gene Dennis is a member of a religious order who, as a condition of membership, has taken vows of poverty and obedience. All claims to his earnings are renounced. Gene received permission from the order to establish a private practice as a psychologist and counsels members of religious orders as well as nonmembers. Al-

though the order reviews Gene's budget annually, Gene controls not only the details of his practice but also the means by which his work as a psychologist is accomplished.

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

## Housing

Special rules for housing apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a housing allowance provided to you as part of your pay. The home or allowance must be provided as compensation for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040), *Self-Employment Tax*, if you are subject to the self-employment tax.

**Housing allowance.** The amount of a housing allowance you can exclude from your income cannot be more than either:

- The reasonable compensation for your services as a minister, or
- Your expenses, in the year the allowance is received, to provide a home or to pay utilities for a home you are provided.

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

**Designation requirement.** The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated. The amount of the housing allowance cannot be determined at a later date.

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

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

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

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



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

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

**Cantors.** If you are a cantor, you can exclude a housing allowance from gross income even if you are not ordained, provided you have a bona fide commission and are employed by a congregation on a full-time basis to perform substantially all religious functions.

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

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

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

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

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

## Foreign Employer

Special rules apply if you work for a foreign employer.

**U.S. citizen.** If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

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

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

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

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

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

## Military

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

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

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

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

**Veterans' benefits.** Veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs are not included in gross income. The following amounts paid to veterans or their families are not taxable.

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

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

## Volunteers

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

**Peace corps.** If you are a Peace Corps volunteer or volunteer leader, living allowances for housing, utilities, household supplies, food, and clothing are exempt from tax.

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

- 1) Allowances paid to the spouse and minor children of a volunteer leader while training in the United States.
- 2) Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- 3) Leave allowances.
- 4) Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

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

on a monthly basis as it is credited to his account.

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

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

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

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

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

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

## Miscellaneous Taxable Income

This section discusses various types of taxable income. You may have to include income from certain transactions even if no money changes hands. For example, if you lend at a below-market interest rate or have had a debt cancelled, you may have to include an amount in income.

See *Recoveries* for a discussion of when to include in your income amounts you receive that you deducted in an earlier year, such as a state income tax refund.

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



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

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

tion on whether an activity is considered carried on for a profit.

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



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

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

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

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

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

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

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

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

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

**Charitable gift annuities.** If you are the beneficiary of a charitable gift annuity, you are required to report the yearly annuity or fixed percentage payment in gross income.

The payer will report the types of income you received on Form 1099-R. Report the gross distribution from box 1 on Form 1040, line 16a, and the portion taxed as ordinary income (box 2a minus box 3) on Form 1040, line 16b. Report the portion taxed as capital gain on Schedule D, line 8, in column (f), and identify it in column (a).

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

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

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

**Example 3.** You specify in the contract for the sale of your property that a third party is to be paid part of the proceeds from the sale equal to your gain. You have constructively received the proceeds and must include the gain in your income. It is the same as if you had received the proceeds and paid them to the third party.

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

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

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

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

**Court awards and damages.** To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. Include the following as ordinary income.

- 1) Interest on any award.

- 2) Compensation for lost wages or lost profits in most cases.
- 3) Punitive damages. See *Punitive damages*, later in this discussion.
- 4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
- 5) Damages for:
  - a) Patent or copyright infringement,
  - b) Breach of contract, or
  - c) Interference with business operations.
- 6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

**Emotional distress.** Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

**Punitive damages.** Punitive damages generally are taxable. It does not matter if they relate to a physical injury or physical sickness.

**Pre-existing agreement.** If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued on or before) September 13, 1995, you do not have to include in income any of those damages received on account of personal injuries or sickness.

**Credit card insurance.** Generally, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you receive during the year that is more than the amount of the premiums you paid during the year.

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

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

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

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

up to the amount of your share of distributable net income.

**How to report.** Treat each item of income the same way that the estate or trust would treat it. For example, if a trust's dividend income is distributed to you, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains.

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


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

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

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

**Fees for services.** Include all fees for your services in your gross income. Examples of these fees are amounts you receive for services you perform as:

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

 **TIP** If you are not an employee and the fees for your services from the same payer total \$600 or more for the year, you may receive a Form 1099-MISC.

**Corporate director.** Corporate director fees are self-employment income. Report these payments on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

**Executor or administrator of an estate.** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on line 21 of Form 1040. If you provide the services as a trade or business, report them as self-employment income on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

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

**Election precinct official.** You should receive a Form W-2 showing payments for services performed as an election official or

election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

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


**Gambling winnings.** You must include your gambling winnings in your income on line 21 of Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings.

**Lotteries and raffles.** Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes.

**Installment payments.** Generally, if you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amounts you receive designated as "interest" on the unpaid installments.

**Form W-2G.** You may have received a Form W-2G, *Certain Gambling Winnings*, showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 57 of Form 1040.

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

 **CAUTION** If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. However, if you sell items from your collection at a loss, you cannot deduct the loss.

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

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

**Jury duty.** Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to income. Include the amount you repay your employer on line 32 of Form 1040. Write "Jury pay" and the amount on the dotted line next to line 32.

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

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

**Manufacturer incentive payments.** You must include as other income on Form 1040, line 21 (or Schedule C or C-EZ if you are self-employed) incentive payments from a manufacturer that you receive as a salesperson. This is true whether you receive the payment directly from the manufacturer or through your employer.

**Example.** You sell cars for an automobile dealership and receive incentive payments from the automobile manufacturer every time you sell a particular model of car. You report the incentive payments on line 21 of Form 1040.

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

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

**Prizes and awards.** If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a \$50 prize in a photography contest, you must report this income on line 21 of Form 1040. If you refuse to accept a prize, do not include its value in your income.

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

**Employee awards or bonuses.** Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income. See *Bonuses and awards* under *Miscellaneous Compensation*, earlier.

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

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

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

These rules do not apply to scholarship or fellowship awards. For information, see Publication 520.

**Railroad retirement annuities.** The following types of payments are treated as pension or annuity income and are taxable under the rules explained in Publication 575.

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

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

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

**Social security and equivalent railroad retirement benefits.** Social security or equivalent railroad retirement benefits, if taxable,

must be included in the income of the person who has the legal right to receive the benefits. Whether any of your benefits are taxable, and the amount that is taxable, depends on the amount of the benefits and your other income.

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

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

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

**Form RRB-1099.** If you received equivalent railroad retirement or special guaranty benefits during the year, you will receive Form RRB-1099, *Payments by the Railroad Retirement Board*.

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

If you received other railroad retirement benefits, see *Railroad retirement annuities*, earlier.

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

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

- You received a lump-sum benefit payment during the year that is for one or more earlier years.
- You exclude qualified adoption expenses, interest from qualified U.S. savings bonds, or interest paid on a student loan.
- You take the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from U.S. possessions, or the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

**Benefits may affect your IRA deduction.** You must use the special worksheets in Appendix B of Publication 590, *Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)*, to figure your taxable benefits and your IRA deduction if all of the following conditions apply.

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

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

**State tuition programs.** If you receive distributions from a qualified state tuition program, only the amount that is more than the amount contributed to the program is taxable.

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

- 1) Allows a person to:
  - a) Buy tuition credits or certificates for a designated beneficiary who would then be entitled to a waiver or payment of qualified higher educational expenses, or
  - b) Make contributions to an account that is set up to meet the qualified higher educational expenses of a designated beneficiary of the account,
- 2) Requires all purchases or contributions to be made only in cash,
- 3) Prohibits the contributor and the beneficiary from directing the amount invested,
- 4) Allows a rollover or a change of beneficiary to be made only between members of the same family, and
- 5) Imposes a penalty on any refund of earnings that does not meet at least one of the following conditions.
  - a) The amount is used for qualified higher educational expenses of the beneficiary.
  - b) The refund is made because of the death or disability of the beneficiary.
  - c) The refund is made because the beneficiary received (and the refund is not more than) a scholarship, a veteran's educational assistance allowance, or another nontaxable payment (other than a gift, bequest, or inheritance) received for educational expenses.

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

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

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

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

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

**Supplemental unemployment benefits.** Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax and social security and Medicare taxes. Report these payments on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

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

Deduct the repayment in the later year as an adjustment to gross income on Form 1040. (You cannot use Form 1040A or Form 1040EZ.) Include the repayment on line 32 of Form 1040, and put "Sub-Pay TRA" and the amount on the dotted line next to line 32. If the amount you repay in a later year is more than \$3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For information on this, see *Repayments*, later.

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

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

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

**State employees.** Payments similar to a state's unemployment benefits may be made by the state to its employees who are not

covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment benefits. Report these payments on line 21 of Form 1040.

**Repayment of unemployment compensation benefits.** If you repaid in 1999 unemployment compensation benefits you received in 1999, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 12 of Form 1040A, or line 3 of Form 1040EZ. Also, enter "Repaid" and the amount you repaid on the dotted line next to line 19, line 12, or line 3. If, in 1999, you repaid unemployment compensation that you included in your gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. See *Repayments*, later.

**Tax withholding.** You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 15% of your payment.



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

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

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

**Strike and lockout benefits.** Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

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

## Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Generally, you report this income on Schedule C or Schedule C-EZ (Form 1040). But if the barter involves exchange of some-

thing other than services, such as in *Example 4* below, you may have to use another form or schedule instead.

**Example 1.** You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in your income on Schedule C or Schedule C-EZ (Form 1040) in the year you receive them.

**Example 2.** You are a self-employed accountant. You and a house painter are members of a barter club. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services you provided, the house painter painted your home. You must report as your income on Schedule C or Schedule C-EZ (Form 1040) the fair market value of the house painting services you received. The house painter must include in income the fair market value of the accounting services you provided.

**Example 3.** You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods or services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in your income the value of the credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

**Example 4.** You own a small apartment building. In return for 6 months' rent-free use of an apartment, an artist gives you a work of art she created. You must report as rental income on Schedule E (Form 1040), *Supplemental Income and Loss*, the fair market value of the artwork, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

**Form 1099-B from barter exchange.** If you exchanged property or services through a barter exchange, you should receive Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange by January 31, 2000. It should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also receive a copy of Form 1099-B.

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

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

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

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

The barter exchange will withhold tax only to the extent of any cash paid to you or deposited in your account or any scrip or credit issued to you (and converted to cash).



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

## Canceled Debts

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

If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040. If it is a business debt, report the amount on Schedule C or C-EZ (Form 1040) (or on Schedule F (Form 1040), *Profit or Loss From Farming*, if you are a farmer).

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

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

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

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

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

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

## Exceptions

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

**Nonrecourse debt.** If you are not personally liable for the debt (nonrecourse debt), different rules apply. You may have a gain or loss if a nonrecourse debt is canceled or forgiven in conjunction with the foreclosure or repossession of property to which the debt attaches. See Publication 544, *Sales and Other Dispositions of Assets*, for more information.

**Student loans.** Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers.

You do not have income if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

- 1) The government — federal, state, or local, or an instrumentality, agency, or subdivision thereof,
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
- 3) An educational institution:
  - a) Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
  - b) As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A loan to refinance a qualified student loan will also qualify if it was made by an educational institution or a tax-exempt section 501(a) organization under its program designed as described in (3)(b) above.

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

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

- Charitable.
- Religious.
- Educational.
- Scientific.
- Literary.
- Testing for public safety.
- Fostering national or international amateur sports competition (but only if none of the organization's activities involve providing athletic facilities or equipment).
- Preventing cruelty to children or animals.

**Exception.** You do not have income if your student loan was made by an educational institution and is canceled because of services you performed for the institution or other organization that provided the funds.

**Deductible debt.** You do not have income from the cancellation of a debt if your payment of the debt would be deductible. This exception applies only if you use the cash method of accounting. For more information, see chapter 5 of Publication 334, *Tax Guide for Small Business*.

**Price reduced after purchase.** Generally, if the seller reduces the amount of debt you owe for property you purchased, you do not have income from the reduction. The reduction of the debt is treated as a purchase price adjustment and reduces your basis in the property.

**Excluded debt.** Do not include a canceled debt in your gross income in the following situations.

- 1) The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, *Bankruptcy Tax Guide*.
- 2) The debt is canceled when you are insolvent. However, this does not apply to the extent the debt exceeds the amount by which you are insolvent. See Publication 908.
- 3) The debt is qualified farm debt and is canceled by a qualified person. See chapter 4 of Publication 225, *Farmer's Tax Guide*.
- 4) The debt is qualified real property business debt. See chapter 5 of Publication 334.

## Partnership Income

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

**Partner's distributive share.** Your distributive share of partnership income, gains, losses, deductions, or credits is generally based on the partnership agreement. You must report your distributive share of these items on your return whether or not they are actually distributed to you. However, your distributive share of the partnership losses is limited to the adjusted basis of your partnership interest at the end of the partnership year in which the losses took place.

**Partnership agreement.** The partnership agreement usually covers the distribution of profits, losses, and other items. However, if the agreement does not state how a specific item of gain or loss will be shared, or the allocation stated in the agreement does not have substantial economic effect, your distributive share is figured according to your interest in the partnership.


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

**Schedule K-1 (Form 1065).** You should receive from each partnership in which you are a member a copy of Schedule K-1 (Form



1065), *Partner's Share of Income, Credits, Deductions, etc.*, showing your share of income, deductions, credits, and tax preference items of the partnership for the tax year.

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

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

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


## S Corporation Income

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

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

**Schedule K-1 (Form 1120S).** You should receive from the S corporation in which you are a shareholder a copy of Schedule K-1 (Form 1120S), *Shareholder's Share of Income, Credits, Deductions, etc.*, showing your share of income, losses, deductions, and credits, of the S corporation for the tax year.

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

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

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

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

## Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

**Tax benefit rule.** You must include a recovery in your income in the year you receive it to the extent that the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

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

**State income tax refund.** If you received a state or local income tax refund (or credit or offset) in 1999, you should receive a statement, Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, from the payer by January 31, 2000. The IRS will also receive a copy of the Form 1099-G.

**Mortgage interest refund.** If you received a refund or credit in 1999 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, *Mortgage Interest Statement*. Do not subtract the refund amount from the interest you paid in 1999. You may have to include it in your income under the rules explained in the following discussions.

**Interest on recovery.** Interest on any of the amounts you recover must be reported as interest income in the year received. For example, report any interest you received on state or local income tax refunds on line 8a of Form 1040.

**Recovery and expense in same year.** If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

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

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

**Example.** You paid 1998 estimated state income tax of \$4,000 in four equal payments. You made your fourth payment in January 1999. You had no state income tax withheld during 1998. In 1999, you received a \$400 tax refund based on your 1998 state income tax return. You claimed itemized deductions each year on your federal income tax return.

You must allocate the \$400 refund between 1998 and 1999, the years in which you

paid the tax on which the refund is based. Since you paid 75% ( $\$3,000 \div \$4,000$ ) of the estimated tax in 1998, 75% of the \$400 refund, or \$300, is for amounts you paid in 1998 and is a recovery item. If all of the \$300 is a taxable recovery item, you will include \$300 on line 10, Form 1040, for 1999, and attach a copy of your computation showing why that amount is less than the amount shown on the Form 1099-G you received from the state.


The balance (\$100) of the \$400 refund is for your January 1999 estimated tax payment. When you figure your deduction for state and local income taxes paid during 1999, you will reduce the \$1,000 paid in January by \$100. Your deduction for state and local income taxes paid during 1999 will include the January net amount of \$900 ( $\$1,000 - \$100$ ), plus any estimated state income taxes paid in 1999 for 1999, and any state income tax withheld during 1999.

**Deductions not itemized.** If you did not itemize deductions for the year for which you received the recovery of an expense that was deductible only if you itemized, do not include any of the recovery amount in your income.

**Example.** You filed your 1998 federal income tax return on Form 1040A. In 1999 you received a refund of your 1998 state income tax. Do not report any of the refund as income because you did not itemize deductions for 1998.

## Itemized Deduction Recoveries

The following discussion explains how to determine the amount to include in your income from a recovery of an amount deducted in an earlier year as an itemized deduction.

 **CAUTION** If you also recovered an amount deducted as a non-itemized deduction, include that recovery in your taxable income before applying the rules explained here. See Non-Itemized Deduction Recoveries, later.

**Total recovery included in income.** If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must generally include the full amount of the recovery in your income in the year you receive it. This rule applies if, for the earlier year, all of the following statements are true.

- 1) Your itemized deductions exceeded the standard deduction by at least the amount of the recovery. (If your itemized deductions did not exceed the standard deduction by at least the amount of the recovery, see *Standard deduction limit*, later.)
- 2) You had taxable income. (If you had no taxable income, see *Negative taxable income*, later.)
- 3) Your deduction for the item recovered equals or exceeds the amount recovered. (If your deduction was less than the amount recovered, see *Recovery limited to deduction*, later.)
- 4) Your itemized deductions were not subject to the limit on itemized deductions. (If your deductions were limited, see *Itemized deductions limited*, later.)
- 5) You had no unused tax credits. (If you had unused tax credits, see *Unused tax credits*, later.)

6) You were not subject to alternative minimum tax. (If you were subject to alternative minimum tax, see *Subject to alternative minimum tax*, later.)

If any of the above statements is **not** true, see *Total recovery not included in income*, later.

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

**Example.** For 1998, you filed a joint return. Your taxable income was \$20,000 and you were not entitled to any tax credits. Your standard deduction was \$7,100, and you had itemized deductions of \$9,000. In 1999, you received the following recoveries for amounts deducted on your 1998 return:

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

None of the recoveries were more than the deductions taken for 1998.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction (\$9,000 – \$7,100 = \$1,900), you must include your total recoveries in your income for 1999. Report the state and local income tax refund of \$400 on line 10 of Form 1040, and the balance of your recoveries, \$525, on line 21 of Form 1040.

**Total recovery not included in income.** If one or more of the six statements listed in the preceding discussion is not true, you may be able to exclude at least part of the recovery from your income. If (4), (5), and (6) are true (your itemized deductions were not limited, you had no tax credits, and you were not subject to the alternative minimum tax) you can use *Table 5* at the end of this publication to determine the amount of your recovery of amounts deducted after 1986 to include in your income.

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

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

**Example.** In 1999 you recovered \$2,500 of your 1998 itemized deductions, but the recoveries you must include in your 1999 income are only \$1,500. Of the \$2,500 you recovered, \$500 was due to your state income tax refund. The amount you report as a tax refund on line 10 of Form 1040 is \$300 [(500

+ \$2,500) × \$1,500]. The balance of the taxable recoveries, \$1,200, is reported as other income on line 21 of Form 1040.

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

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

**Standard deduction for earlier years.**

To determine if amounts recovered in 1999 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. The standard deduction tables for 1998, 1997, and 1996 are at the end of this publication (*Tables 2, 3, and 4.*) If you need the standard deduction amounts for years before 1996, see the copy of your return for that year. For information on the standard deduction, get Publication 501, *Exemptions, Standard Deduction, and Filing Information.*

**Example.** You filed a joint return for 1998 with a taxable income of \$25,000. Your itemized deductions were \$8,700. The standard deduction that you could have claimed was \$7,100. In 1999, you recover \$2,400 of your 1998 itemized deductions. None of the recoveries were more than the actual deductions for 1997. Include \$1,600 of the recoveries in your 1999 income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction (\$8,700 – \$7,100 = \$1,600).

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

**Example.** The facts are the same as in the previous example except you had a negative taxable income of \$200 in 1998. You would include \$1,400 in your 1999 income, rather than \$1,600.

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

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

**Example.** During 1998, you paid \$1,700 for medical expenses. From this amount you subtracted \$1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was \$200. In 1999, you received a \$500 reimbursement from your medical insurance for your 1998 expenses. The only amount of the \$500 reimbursement that must be included in your income in 1999 is \$200 — the amount actually deducted.

**Itemized deductions limited.** You were subject to the limit on itemized deductions in the earlier year if your adjusted gross income (AGI) was more than a base amount. For example, this amount was:

- For 1998, \$124,500 (\$62,250 if married filing separately),
- For 1997, \$121,200 (\$60,600 if married filing separately), and
- For 1996, \$117,950 (\$58,975 if married filing separately).

If the limit applied, your itemized deductions were reduced by the smaller of the following amounts.

- 1) 3% of the amount by which your AGI exceeded the base amount.
- 2) 80% of your otherwise allowable deductions other than medical and dental expenses, investment interest expense, nonbusiness casualty and theft losses, and gambling losses.

If the amount you recovered was deducted in a year in which your itemized deductions were limited, you must include it in income up to the difference between the amount of itemized deductions actually allowed that year and the amount you would have been allowed (the greater of your itemized deductions or your standard deduction) if you had figured your deductions using only the net amount of the recovery item.

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

- 1) If your taxable income for the earlier year was a negative amount, reduce your recovery by the negative amount.
- 2) If your tax for the earlier year was reduced to zero by a tax credit that was not fully used in that year, and if reducing your deduction for that year by the recovery would result in tax for that year, reduce your recovery to an amount equal to your recovery multiplied by the following fraction:

- a) Your tax for the earlier year, determined after reducing your deductions by the recovery and applying the credit; over
- b) The total increase in your tax for the earlier year, determined by subtracting your actual tax before applying the credit from the tax in (a) before applying the credit.

3) Figure the greater of:

- a) The standard deduction for the earlier year, or
- b) Your itemized deductions for the earlier year figured as you **would have claimed them** (after taking into account the limit on itemized deductions) if you had paid the proper amount of the item for which you later received a refund or recovery. The proper amount is the amount you actually paid reduced by the recovery amount (as reduced by the recovery amount (as reduced in *steps 1* and *2*, if they apply). For example, if you paid \$12,000 in state income taxes in 1998 and in

1999 you received a \$2,000 refund of 1998 state income taxes, \$10,000 is the proper amount, and you would figure your itemized deductions for 1998 as though you had paid only \$10,000 in state income taxes in 1998.

**Note.** If you were required to itemize your deductions in the earlier year, use *step 3(b)* and not *step 3(a)*.

- 4) Subtract the amount in *step 3* from the amount of itemized deductions you **actually claimed** in the earlier year after applying the limit on itemized deductions. The difference is the amount of the refund or recovery to include in your gross income in the year you receive the refund or recovery.

If you need more information, see Revenue Ruling 93-75. This ruling is in Cumulative Bulletin 1993-2.

**Example.** Eileen Martin is single. She had an AGI of \$1,124,500 and itemized her deductions on her federal income tax return for 1998. She was not subject to alternative minimum tax and was not entitled to any credit against income tax. Her only allowable deduction was \$40,000 of state income taxes. However, Eileen deducted only \$10,000 in 1998 because her otherwise allowable deductions of \$40,000 were reduced by \$30,000. In 1999, she received a \$5,000 refund of her state income taxes for 1998.

The following table shows how Eileen calculated the \$30,000 reduction and other amounts from the *Itemized Deduction Worksheet* in her 1998 Form 1040 package. These amounts are needed to figure the portion of the \$5,000 refund that Eileen must include in her income for 1999.

AGI for 1998 .....	\$1,124,500
State income taxes paid in 1998 .....	\$40,000
3% reduction (amount on line 8 of 1998 <i>Itemized Deduction Worksheet</i> ) [(\$1,124,500 - \$124,500) × 3%] .....	\$30,000
80% reduction not applied (amount on line 4 of 1998 <i>Itemized Deduction Worksheet</i> ) (\$40,000 × 80%) .....	\$32,000
1998 deduction (amount on line 10 of 1998 <i>Itemized Deduction Worksheet</i> ) (\$40,000 - \$30,000) .....	\$10,000
Refund received in 1999 of 1998 state income taxes .....	\$5,000
Proper amount of 1998 state income taxes (\$40,000 - \$5,000) .....	\$35,000

If Eileen had paid only \$35,000 in state income taxes in 1998, her otherwise allowable itemized deductions of \$35,000 would have been reduced by \$28,000 (\$35,000 × 80%). This is the amount that would have been entered on line 4 and on line 9 of the 1998 *Itemized Deduction Worksheet*. Further, \$28,000 is less than the amount that would have been entered on line 8 (\$30,000). She would have claimed a deduction in 1998 of \$7,000 (\$35,000 - \$28,000). She derived a tax benefit of the \$3,000 difference between her deduction for 1998 (\$10,000) and the deduction for 1998 that she would have claimed (\$7,000) had she paid the proper amount of state income taxes in 1998 and not received a state income tax refund in 1999. Only \$3,000 (\$10,000 - \$7,000) of the \$5,000 state income tax refund that Eileen received in 1999 is includible in her gross income in 1999.

**Unused tax credits.** If you recover an item deducted in an earlier year in which you had unused tax credits, you must refigure the earlier year's tax to determine if you must include the recovery in your income. To do this, add the amount of the recovery to your earlier year's taxable income and refigure the tax and the credits on the recomputed amount. If the recomputed tax, after application of the credits, is more than the actual tax in the earlier year, include the recovery in your income to the extent it reduced the tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from deducting the recovered amount in the earlier year is considered to have reduced your tax in the earlier year. If the recovery is for an itemized deduction claimed in a year in which the deductions were limited, see *Itemized deductions limited*, earlier.

If your tax, after application of the credits, does not change, you did not have a tax benefit from the deduction. Do not include the recovery in your income.

**Example.** In 1998, Jean Black filed as head of household and itemized her deductions. Her taxable income was \$5,260 and her tax was \$791. She claimed a child care credit of \$1,200. The credit reduced her tax to zero and she had an unused tax credit of \$409 (\$1,200 - \$791). In 1999, Jean recovered \$1,000 of her itemized deductions. She reduces her 1998 itemized deductions by \$1,000 and recomputes that year's tax on taxable income of \$6,260. However, the child care credit exceeds the recomputed tax of \$941. Jean's tax liability for 1998 is not changed by reducing her deductions by the recovery. She did not have a tax benefit from the recovered deduction and does not include any of the recovery in her income for 1999.

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

### Non-Itemized Deduction Recoveries

This section discusses recovery of deductions other than those deducted on Schedule A (Form 1040).

**Total recovery included in income.** If you recover an amount that you deducted in an earlier year in figuring your adjusted gross income, you must generally include the full amount of the recovery in your income in the year received.

**Total recovery not included in income.** If any part of the deduction you took for the recovered amount did not reduce your tax, you may be able to exclude at least part of the recovery from your income. You must include the recovery in your income only to the extent

the deduction reduced your tax in the year of the deduction. (See *Tax benefit rule*, earlier.)

**Negative taxable income.** If your taxable income was a negative amount, reduce the recovery by that negative amount. Include this reduced recovery in your income.

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

- 1) Figure your non-itemized deduction recoveries.
- 2) Add the non-itemized deduction recoveries to your adjusted gross income.
- 3) Figure your itemized deduction recoveries.

This order is required because your adjusted gross income will change and you may have to use adjusted gross income to figure your itemized deduction recoveries.

### Amounts Recovered for Credits

If you received a recovery in 1999 for an item for which you claimed a tax credit in an earlier year, you must increase your 1999 tax to the extent the credit reduced your tax in the earlier year. You have a recovery if there is a downward price adjustment or similar adjustment on the item for which you claimed a credit.

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

### Rental of Personal Property

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

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

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

### Reporting business income and expenses.

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

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

**Reporting nonbusiness expenses.** If you rent personal property for a profit, report your rental expenses on line 32 of Form 1040.

Enter the amount and "PPR" on the dotted line to the left and include the amount of your deductible expenses in the total amount you enter on line 32.

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

## Repayments

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income in the year in which you repaid it. Or, if the amount you repaid is more than \$3,000, you may be able to take a credit against your tax in the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

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

If you repaid social security or equivalent railroad retirement benefits, get Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*. If you repaid other railroad retirement benefits, get Publication 575.

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

**Repayment—over \$3,000.** If the amount you repaid was more than \$3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if, you included the income under a **claim of right**. This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

**Method 1.** Figure your tax for 1999 claiming a deduction for the repaid amount.

**Method 2.** Follow these steps.

- 1) Figure your tax for 1999 **without** deducting the repaid amount.
- 2) Refigure your tax from the earlier year without including in income the amount you repaid in 1999.
- 3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
- 4) Subtract the answer in (3) from the tax for 1999 figured without the deduction (step 1).

If the amount from method 1 is less tax, deduct the amount repaid on the same form or schedule on which you previously reported

it. For example, if you reported it as self-employment income, deduct it as a business deduction on Schedule C or Schedule C-EZ (Form 1040). If you reported it as wages, deduct it as an itemized deduction on line 27 of Schedule A (Form 1040).

If using method 2 results in less tax, claim the credit on line 63 of Form 1040, and write "I.R.C. 1341" next to line 63.

**Example.** For 1998 you filed a return and reported your income on the cash method. In 1999 you repaid \$5,000 included in your 1998 gross income under a claim of right. Your filing status in 1999 and 1998 is single. Your income and tax for both years are as follows:

	1998 <u>With Income</u>	1998 <u>Without Income</u>
Taxable Income	\$15,000	\$10,000
Tax Liability	\$ 2,254	\$ 1,504

	1999 <u>Without Deduction</u>	1999 <u>With Deduction</u>
Taxable Income	\$49,950	\$44,950
Tax Liability	\$10,646	\$ 9,246

Your tax under method 1 is \$9,246. Your tax under method 2 is \$9,896, figured as follows:

Tax previously determined for 1998 .....	\$2,254
Less: Tax as refigured .....	- 1,504
Decrease in 1998 tax .....	\$750
Regular tax liability for 1999 .....	\$10,646
Less: Decrease in 1998 tax .....	- 750
Refigured tax for 1999 .....	<u>\$9,896</u>

Because you pay less tax under method 1, you should take a deduction for the repayment in 1999.

**Repayment rules do not apply.** This discussion does not apply to:

- 1) Deductions for bad debts,
- 2) Deductions from sales to customers, such as returns and allowances, and similar items, or
- 3) Deductions for legal and other expenses of contesting the repayment.

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

## Royalties

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

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

**Copyrights and patents.** Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period

of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

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

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

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

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

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

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

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

## Income Not Taxed

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

### Accident and health insurance proceeds

#### "Black lung" benefits

**Casualty insurance and other reimbursements** (get Publication 547, *Casualties, Disasters, and Thefts (Business and Non-business)*)

**Child support payments** (get Publication 504)

**Compensatory damages awarded for physical injury or physical sickness**

**Federal Employees' Compensation Act payments**

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

**Housing allowance for members of the clergy**

**Interest on state or local obligations** (get Publication 550)

**Meals and lodging provided by employer**

**Military allowances** (get Publication 3)

**Moving expense reimbursements** (get Publication 521)

**Scholarship and fellowship grants** (get Publication 520)

**Supplemental security income (SSI)**

**Veterans' benefits**

**Welfare benefits**

**Workers' compensation**

**Campaign contributions.** These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*. Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21 of Form 1040 in the year transferred.

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

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

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

**Energy conservation subsidies.** You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit. If the property is not a dwelling unit (nonresidential property), you can exclude 50% of the subsidy, but only for amounts received under a written contract in effect on September 13, 1995, and at all times thereafter.

**Energy conservation measure.** This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

**Dwelling unit.** This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

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

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

A qualified foster individual is a person who:

- 1) Is living in a foster family home, and
- 2) Was placed there by:
  - a) An agency of a state or one of its political subdivisions, or
  - b) If the individual is under age 19, a tax-exempt placement agency licensed by a state or one of its political subdivisions.

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

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

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

**Maintaining space in home.** If you are paid to maintain space in your home for emergency foster-care, you must include the payment in your income.

**Reporting taxable payments.** If you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. Report the payments on Schedule C or Schedule C-EZ (Form 1040). Get Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers)*, to help you determine the amount you can deduct for the use of your home.

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

**Inherited pension or IRA.** If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income.

See *Survivors and Beneficiaries* in Publication 575 if you inherited a pension. See *Inherited IRAs* in Publication 590 if you inherited an IRA.

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

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

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

**Interest on frozen deposits.** In general, you exclude from your income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of the calendar year, you cannot withdraw any part of the deposit because:

- 1) The financial institution is bankrupt or insolvent, or
- 2) The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

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

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

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

**Interest on qualified savings bonds.** You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. "Qualified higher educational expenses" are those you pay for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A "qualified U.S. savings bond" is a series EE bond issued after 1989 or a series I bond. The bond must have been issued to you when you were 24 years of age or older. For more information on this exclusion, see *Education Savings Bond Program* in chapter 1 of Publication 550.

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

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

**Living expenses paid by insurance.** Do not include in your income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home due to a fire, storm, or other casualty. The amount you can exclude is limited to your actual expenses to keep the standard of living your family had before the casualty, minus the normal living expenses you would have had.

**Medical savings accounts (MSAs).** You do not generally include in income amounts you withdraw from your MSA or Medicare+Choice MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040). For more information about MSAs or Medicare+Choice MSAs, see Publication 969, *Medical Savings Accounts (MSAs)*.

**Sale of home.** You may be able to exclude from income all or part of any gain from the sale or exchange of a personal residence. Get Publication 523, *Selling Your Home*.

**Scholarships and fellowships.** A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- 1) Tuition and fees to enroll at or attend an educational organization, or
- 2) Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board **do not** qualify. Get Publication 520 for more information on qualified scholarships and fellowship grants.

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

For information about the exclusion for a qualified tuition reduction provided to employees and their families by an educational institution, see Publication 520.

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

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

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

**Transporting school children.** Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

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

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

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

## Life Insurance Proceeds

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

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

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

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

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

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

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

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

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

**Surrender of policy for cash.** If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In general, your cost (or investment in the contract) is the total of premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends or unrepaid loans that were not included in your income.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A.

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

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

## Survivor Benefits

Generally, payments made by or for an employer because of an employee's death must be included in income.

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

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

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

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

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

**Governmental plan annuity.** If you receive a survivor annuity as the child or spouse (or former spouse) of a public safety officer who was killed in the line of duty after 1996, you generally do not have to include it in income. The annuity is excluded to the extent it is based on the officer's service as a public safety officer.

For this purpose, the term "public safety officer" includes police and law enforcement officers, firefighters and rescue squad and ambulance crew members.

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

## Accelerated Death Benefits

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

In addition, if any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual is sold or assigned to a viatical settlement provider, the amount received is also excluded from income. Generally, a viatical settlement provider is one who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill.

To claim an exclusion for accelerated death benefits made on a per diem or other periodic basis, you must file Form 8853, *Medical Savings Accounts and Long-Term Care Insurance Contracts*, with your return.

**Terminally or chronically ill defined.** A terminally ill person is one who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification. A chronically ill person is one who is not terminally ill but has been certified by a licensed health care practitioner as meeting either of the following conditions.

- 1) The person is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity.
- 2) The person requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

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

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

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

- 1) They are paid on account of chronic illness, and
- 2) They are received as periodic payments.

For 1999, the most you can exclude on account of chronic illness is \$190 per day (\$69,350 a year).

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

## Long-Term Care Insurance Contracts

Long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. To claim an exclusion for payments made on a per diem or other periodic basis under a long-term care insurance contract, you must file Form 8853 with your return.

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

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

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

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

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

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

to health and safety due to severe cognitive impairment.

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

**Limit on exclusion.** You can generally exclude from gross income up to \$190 a day (\$69,350 a year) for 1999.

## Welfare and Other Public Assistance Benefits

Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare payments obtained fraudulently.

**Alaska residents.** Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in gross income on line 21 of Form 1040.

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

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

**Disaster relief grants.** Grants made under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* under *Miscellaneous Taxable Income*, earlier.

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

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

**Nutrition Program for the Elderly.** Food benefits you receive under the Nutrition Program for the Elderly are not taxable. If you prepare and serve free meals for the pro-

gram, include in your income as wages the cash pay you receive, even if you are also eligible for food benefits.



Table 2. **1998 Standard Deduction Tables and Worksheets** (For use in figuring the taxable part of recovered itemized deductions. See "Recoveries.")

Check correct boxes for yourself:  
 65 or older  Blind

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

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

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>your 1998 standard deduction was:</b>
Single	0	\$4,250
	1	5,300
	2	6,350
Married filing jointly	0	\$7,100
	1	7,950
	2	8,800
	3	9,650
	4	10,500
Married filing separately	0	\$3,550*
	1	4,400*
	2	5,250*
	3	6,100*
	4	6,950*
Head of household	0	\$6,250
	1	7,300
	2	8,350
Qualifying widow(er)	0	\$7,100
	1	7,950
	2	8,800

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

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>your 1998 standard deduction was:</b>
Single	0	\$ 700
	1	1,750
	2	2,800
Married filing separately	0	700*
	1	1,550*
	2	2,400*

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

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line B:</b>
Single	0	-0-
	1	1,050
	2	2,100
Married filing separately	0	-0-
	1	850
	2	1,700

C. Add lines **A** and **B** and enter total . . . . . \_\_\_\_\_

D. Enter correct amount from following table . . . . . \_\_\_\_\_

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line D:</b>
Single	0	4,250
	1	5,300
	2	6,350
Married filing separately	0	3,550*
	1	4,400*
	2	5,250*

E. Compare lines **C** and **D** and enter the smaller amount.  
 This was your standard deduction for 1998 . . . . . \_\_\_\_\_

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

Table 3. **1997 Standard Deduction Tables and Worksheets** (For use in figuring the taxable part of recovered itemized deductions. See "Recoveries.")

Check correct boxes for yourself:  
 65 or older  Blind

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

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

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>your 1997 standard deduction was:</b>
Single	0	\$4,150
	1	5,150
	2	6,150
Married filing jointly	0	\$6,900
	1	7,700
	2	8,500
	3	9,300
Married filing separately	0	\$3,450*
	1	4,250*
	2	5,050*
	3	5,850*
Head of household	0	\$6,050
	1	7,050
	2	8,050
	Qualifying widow(er)	0
1		7,700
2		8,500

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

<b>Table II — For Dependents Who Have Earned Income of \$650 or Less</b>		
<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>your 1997 standard deduction was:</b>
Single	0	\$ 650
	1	1,650
	2	2,650
Married filing separately	0	650*
	1	1,450*
	2	2,250*

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

<b>Worksheet For Dependents Who Have Earned Income of More Than \$650</b>		
A. Enter your earned income for 1997 . . . . . _____		
B. Enter correct amount from following table . . . . . _____		
<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line B:</b>
Single	0	\$ -0-
	1	1,000
	2	2,000
Married filing separately	0	-0-
	1	800
	2	1,600
C. Add lines <b>A</b> and <b>B</b> and enter total . . . . . _____		
D. Enter correct amount from following table . . . . . _____		
<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line D:</b>
Single	0	\$4,150
	1	5,150
	2	6,150
Married filing separately	0	3,450*
	1	4,250*
	2	5,050*
E. Compare lines <b>C</b> and <b>D</b> and enter the smaller amount. This was your standard deduction for 1997 . . . . . _____		

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

Table 4. **1996 Standard Deduction Tables and Worksheets** (For use in figuring the taxable part of recovered itemized deductions. See "Recoveries.")

Check correct boxes for yourself:  
 65 or older  Blind

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

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

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

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

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

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

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line B:</b>
Single	0	\$ -0-
	1	1,000
	2	2,000
Married filing separately	0	-0-
	1	800
	2	1,600

C. Add lines **A** and **B** and enter total . . . . . \_\_\_\_\_

D. Enter correct amount from following table . . . . . \_\_\_\_\_

<b>If your filing status was:</b>	<b>and number of boxes you checked was:</b>	<b>enter on line D:</b>
Single	0	\$4,000
	1	5,000
	2	6,000
Married filing separately	0	3,350*
	1	4,150*
	2	4,950*

E. Compare lines **C** and **D** and enter the smaller amount.  
 This was your standard deduction for 1996 . . . . . \_\_\_\_\_

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



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

If you received refunds, rebates, or reimbursements for any expense you deducted on Schedule A (Form 1040) after 1986, complete this worksheet to figure the amount to include in income on your 1999 Form 1040. If you recovered amounts from more than one year, such as a state income tax refund from 1997 and a casualty loss reimbursement from 1996, complete a separate worksheet for each year. Use information from Schedule A (Form 1040) for the year the expense was deducted.

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

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

- 1. State/local income tax refund or credit. 1) \_\_\_\_\_
2. Enter the total of all other Schedule A refunds or reimbursements (excluding the amount you entered on line 1). 2) \_\_\_\_\_
3. Add lines 1 and 2. 3) \_\_\_\_\_
4. Itemized deductions for prior year (for example, line 28, Sch. A for 1998). 4) \_\_\_\_\_
5. Enter any amount previously refunded to you (do not enter an amount from line 1 or line 2). 5) \_\_\_\_\_
6. Subtract line 5 from line 4. 6) \_\_\_\_\_
7. Standard deduction for prior year. 7) \_\_\_\_\_
8. Subtract line 7 from line 6. If the result is zero or less, stop here. The amounts on lines 1 and 2 are not taxable. 8) \_\_\_\_\_
9. Enter the smaller of line 3 or line 8. 9) \_\_\_\_\_
10. Taxable income for prior year (for example, line 39, Form 1040 for 1998). 10) \_\_\_\_\_
11. Enter the following amount to include in income— 11) \_\_\_\_\_
If line 10 is:
• -0- or more, enter the amount from line 9.
• A negative amount, add lines 9 and 10 and enter net amount (but not less than zero).

Where To Include In Income For 1999

If line 11 equals line 3—

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

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

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

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

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

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

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

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


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

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

## How To Get More Information


You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Free tax services.** To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

 **Personal computer.** With your personal computer and modem, you can access the IRS on the Internet at [www.irs.gov](http://www.irs.gov). While visiting our web site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed*) to find answers to questions you may have.
- *Forms & Pubs* to download forms and publications or search for forms and publications by topic or keyword.
- *Fill-in Forms* (located under *Forms & Pubs*) to enter information while the form is displayed and then print the completed form.
- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)*).
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business*) to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business*) to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](http://ftp.irs.gov).

 **TaxFax Service.** Using the phone attached to your fax machine, you can receive forms and instructions by

calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

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

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



**Walk-in.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Also, some libraries and IRS offices have:

- An extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.

- The Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



**Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**  
Western Area Distribution Center  
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**  
Central Area Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**  
Eastern Area Distribution Center  
P.O. Box 85074  
Richmond, VA 23261-5074



**CD-ROM.** You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at [www.irs.gov/cdorders](http://www.irs.gov/cdorders). The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676**.



## Tax Publications for Individual Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

### General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 2000
- 553 Highlights of 1999 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

### Specialized Publications

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

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

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

### Spanish Language Publications

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

## Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A & B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Unreimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch D-1 Continuation Sheet for Schedule D	10424	3903 Moving Expenses	12490
Sch E Supplemental Income and Loss	11344	4562 Depreciation and Amortization	12906
Sch EIC Earned Income Credit	13339	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
Sch F Profit or Loss From Farming	11346	4952 Investment Interest Expense Deduction	13177
Sch H Household Employment Taxes	12187	5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs	13329
Sch J Farm Income Averaging	25513	6251 Alternative Minimum Tax-Individuals	13600
Sch R Credit for the Elderly or the Disabled	11359	8283 Noncash Charitable Contributions	62299
Sch SE Self-Employment Tax	11358	8582 Passive Activity Loss Limitations	63704
1040A U.S. Individual Income Tax Return	11327	8606 Nondeductible IRAs	63966
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8812 Additional Child Tax Credit	10644
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8822 Change of Address	12081
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8829 Expenses for Business Use of Your Home	13232
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8863 Education Credits	25379
1040-ES Estimated Tax for Individuals	11340		
1040X Amended U.S. Individual Income Tax Return	11360		