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Taxable and Nontaxable Income

For use in preparing 2004 Returns

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What’s New

Education loan repayment assistance. Beginning in 2004, education loan repayments made to you by the National Health Service Corps Loan Repayment Program (NHSC Loan Repayment Program) or a state education loan repayment program eligible for funds under the Public Health Service Act are not taxable if you agree to provide primary health services in health professional shortage areas. For more information, see Publication 970, Tax Benefits for Education.
Unlawful discrimination claims. You may be able to take a deduction from gross income for attorney fees and court costs paid after October 22, 2004, for actions settled or decided after that date involving a claim of unlawful discrimination, a claim brought against the United States Government, or a claim made under section 1862(b)(3)(A) of the Social Security Act, but only up to the amount included in gross income for the tax year from such claim. See Court awards and damages, under Other Income.

Elective deferrals. The limits on the amount of your wages you can elect to defer into certain retirement plans (such as section 401(k) plans) increase each year through 2006. If you are age 50 or older, you may be able to make additional catch-up elective deferrals. See Elective Deferrals in the discussion on retirement plan contributions under Employee Compensation.

Health Savings Accounts (HSAs). Beginning in 2004, you may be able to make tax-deducible contributions to a health savings account to pay qualified medical expenses. Amounts from HSAs used for qualified medical expenses are not includible in gross income. Amounts from HSAs not used for qualified medical expenses are includible in income. HSAs are discussed in Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Smallpox vaccine injuries. If you are an eligible individual who receives benefits under the Smallpox Emergency Personnel Protection Act of 2003 for a covered injury resulting from a covered countermeasure, you can exclude the payment from your income (to the extent it is not allowed as a medical and dental expense deduction on Schedule A (Form 1040)). Eligible individuals include health care workers, emergency personnel, and first responders in a smallpox emergency, who have received a smallpox vaccination.


Reminders

Terrorist attacks. You can exclude from income certain disaster assistance, disability, and death payments received as a result of a terrorist or military action. For more information, see Publication 3920, Tax Relief for Victims of Terrorist Attacks and Astronauts.

Foreign income. If you are a U.S. citizen or resident, 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, Wage and Tax Statement, or Form 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). 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.

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.

Introduction

You can receive income in the form of money, property, or services. This publication discusses many kinds of income and explains whether they are taxable or nontaxable. It includes discussions on employee wages and fringe benefits, and income from bartering, partnerships, S corporations, and royalties. It also includes information on disability pensions, life insurance proceeds, and welfare and other public assistance benefits. Check the index for the location of a specific subject.

Generally, an amount included in your income is taxable unless it is specifically excluded by law. 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 taxable.

Constructively received income. 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 day after 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.

Assignment of 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 your income when the third party receives it.

Example. 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 your income when your former spouse receives it.

Prepaid income. Prepaid income, such as compensation for future services, is generally included in your income in the year you receive it. 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 include the payment in your income as you earn it by performing the services.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and Publications Branch
SE:W:CAR:MP:TT-1
1111 Constitution Ave. NW, IR-6406
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at "taxforms@irs.gov." (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit www.irs.gov or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and publications. Call 1-800-829-3676, or write to one of the three addresses shown under How To Get Tax Help in the back of this publication.

Useful Items

You may want to see:

Publication

523 Selling Your Home

527 Residential Rental Property (Including Rental of Vacation Homes)

550 Investment Income and Expenses (Including Capital Gains and Losses)

559 Survivors, Executors, and Administrators

564 Mutual Fund Distributions

575 Pension and Annuity Income

915 Social Security and Equivalent Railroad Retirement Benefits

970 Tax Benefits for Education

See How To Get Tax Help, near the end of this publication, for information about getting these publications.
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.

Childcare providers. If you provide childcare, 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 (Form 1040), Profit or Loss From Business, or Schedule C-EZ (Form 1040), Net Profit From Business. You generally are 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.

Baby-sitting. If you baby-sit for relatives or neighborhood children, whether on a regular basis or only periodically, the rules for childcare providers apply to you.

Miscellaneous Compensation

This section discusses many types of employee compensation. The subjects are arranged in alphabetical order.

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 included in your income by the repayment. If you repay them 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, see Publication 463, Travel, Entertainment, Gift, and Car Expenses. If you are reimbursed for moving expenses, see Publication 521, Moving Expenses.

Back pay awards. Include in income amounts you are awarded in a settlement or judgment for back pay. These include 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 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, a gift certificate, or an equivalent item) as an award for length-of-service or safety achievement, generally you can exclude its value from your income. However, the amount you can exclude is limited to your employer’s cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards you receive during the year. 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 disclaimed.

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

- A length-of-service award if you received it for less 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 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, Ben can exclude the award by itself would be excluded from income. However, because 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 generally are included in your income. However, they are 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, see Publication 516, U.S. Government Civilian Employees Stationed Abroad.

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 a nonnegotiable 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.

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

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 as wages 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. Attach to your tax return a copy of the receipt or statement given to you by the agency you repaid 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 résumé 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. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income any sick pay benefits received from any of the following payers:

- A welfare fund.
- A state sickness or disability fund.
- An association of employers or employ- ees.
- An insurance company, if your employer paid 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 enter into 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. The payment is also treated 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 em-
ployer 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 in-
come in the year you use the right.

Fringe Benefits

Fringe benefits received in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Abstaining from the perform-
ance 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 re-
cipient 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 you 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 con-
tractor, you can also be the recipient of a fringe benefit.

Provider of benefit. Your employer or an-
other 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 em-
ployer has the option to report taxable noncash fringe benefits by using either of the following rules.

• The general rule: benefits are reported for a full calendar year (January 1 – Decem-
ber 31).

• The special accounting period rule: bene-
fits 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 benef-
its 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.

If your employer pays you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, the value is not included in your income. Generally, the value of benefits such as dis-
counts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income. Also see Em-
ployee Discounts, later.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not include the value of that 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 in-
volved.

Dependent Care Benefits

If your employer provides dependent care bene-
fits under a qualified plan, you may be able to exclude these benefits from your income. De-
pendent care benefits include:

• Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work,

• The fair market value of care in a daycare facility provided or sponsored by your em-
ployer.

The amount you can exclude is limited to the lesser of:

• The total amount of dependent care bene-
fits you received during the year,

• The total amount of qualified expenses you incurred during the year,

• Your earned income,

• Your spouse’s earned income, or

• $5,000 ($2,500 if married filing sepa-
rate).

Your employer must show the total amount of dependent care benefits provided to you during the year under a qualified plan in box 10 of your Form W-2. Your employer also will include any dependent care benefits over $5,000 in your wages shown in box 1 of your Form W-2.

To claim the exclusion, you must complete either Part III of Form 2441, Child and Depen-
dent Care Expenses, or Part III of Schedule 2 (Form 1040A), Child and Dependent Care Ex-
penses for Form 1040A Filers. (You cannot use Form 1040EZ.)

See the instructions for Form 2441 or Sched-
ule 2 (Form 1040A) for more information.
Educational Assistance
You can exclude from your income up to $5,250 of qualified employer-provided educational assistance. The exclusion applies to undergraduate and graduate-level courses. For more information, see Publication 970.

Employee Discounts
If your employer sells you property or services at a discount, you may be able to exclude the amount of the discount from your income. The exclusion applies to discounts on property or services offered to customers in the ordinary course of the line of business in which you work. However, it does not apply to discounts on real property or property commonly held for investment (such as stocks or bonds).

The exclusion is limited to the price charged to nonemployee customers multiplied by the following percentage:

- For a discount on property, your employer’s gross profit percentage (gross profit divided by gross sales) on all property sold during the employer’s previous tax year. (Ask your employer for this percentage.)
- For a discount on services, 20%.

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

Qualified retirement planning services paid for you by your employer may be excluded from your income. For more information, see Retirement Planning Services, later.

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 that is more than the cost of $50,000 of coverage reduced by any amount you pay toward 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 wages in box 1 of Form W-2. Also, it is shown separately in box 12 with code C. Box 12 also will 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 62, Form 1040, and subtract "UT" from the amount of the taxes on the dotted line next to line 62.

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. Reduce the amount you figure by any amount reported with code C in box 12 of your Forms W-2, add the result to the wages reported in box 1, and report the total on your return.

Figuring the taxable cost. Use the following worksheet to figure the amount to include in your income.

Worksheet 1. Figuring the Cost of Group-Term Life Insurance To Include in Income

1. Enter the total amount of your insurance coverage............. 1.
2. Limit an exclusion for employer-provided group-term life insurance coverage...................... 2. 50,000
3. Subtract line 2 from line 1 3.
4. Divide line 3 by $1,000. Figure to the nearest tenth. 4.
5. Go to Table 1. Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group. 5.
6. Multiply line 4 by line 5 .... 6.
7. Enter the number of full months of coverage at this cost .................. 7. 
8. Multiply line 6 by line 7 . 8.
9. Enter the premiums you paid per month 9.
10. Enter the number of months you paid the premiums 10.
11. Multiply line 9 by line 10 . . . . 11.
12. Subtract line 11 from line 8. Include this amount in your income as wages .... 12.

Table 1. Cost of $1,000 of Group-Term Life Insurance for One Month

<table>
<thead>
<tr>
<th>Age</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 25</td>
<td>$ .05</td>
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<tr>
<td>25 through 29</td>
<td>.06</td>
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<tr>
<td>30 through 34</td>
<td>.08</td>
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<tr>
<td>35 through 39</td>
<td>.09</td>
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<td>60 through 64</td>
<td>.66</td>
</tr>
<tr>
<td>65 through 69</td>
<td>1.27</td>
</tr>
<tr>
<td>70 and older</td>
<td>2.06</td>
</tr>
</tbody>
</table>

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:

- Payments for coverage in a different tax year,
- Payments for coverage through a cafeteria plan, unless the payments are after-tax contributions, or
- 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 as follows.
Worksheet 1. Figuring the Cost of Group-Term Life Insurance To Include in Income—Illustrated

1. Enter the total amount of your insurance coverage from your employer(s) . . . . 1. $80,000
2. Limit on exclusion for employer-provided group-term life insurance coverage . . . . 2. $50,000
3. Subtract line 2 from line 1 . . . . 3. $30,000
4. Divide line 3 by $1,000. Figure to the nearest tenth . . . . 4. .300
5. Go to Table 1. Using your age on the last day of the tax year, find your age group in the left column, and enter the cost from the column on the right for your age group . . . . 5. $23
6. Multiply line 4 by line 5 . . . . 6. $6.90
7. Enter the number of full months of coverage at this cost. . . . . 7. 12
8. Multiply line 6 by line 7 . . . . 8. $82.80
9. Enter the premiums you paid per month . . . . 9. $4.15
10. Enter the number of months you paid the premiums . . . . 10. 12
11. Multiply line 9 by line 10 . . . . 11. $49.80
12. Subtract line 11 from line 8 . . . . 12. $33.00

The total amount to include in income for the cost of excess group-term life insurance is $33.

Entire cost excluded. You are not taxed on the cost of group-term life insurance if any of the following circumstances 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:
   a. You retired before January 2, 1984, and were covered by the plan when you retired, or
   b. 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 circumstances 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.
- 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 lesser 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 cost per month is $4,000, he would have to include $1,000 in his income ($5,000 – $4,000).

Moving Expense Reimbursements

Generally, if your employer pays for your moving expenses (either directly or indirectly) and the expenses would have been deductible if you paid them yourself, the value is not included in your income. See Publication 521 for more information.

No-Additional-Cost Services

The value of services you receive from your employer for free, at cost, or for a reduced price is not included in your income if your employer:

- Offers the same service for sale to customers in the ordinary course of the line of business in which you work, and
- Does not have a substantial additional cost (including any sales income given up) to provide you with the service (regardless of what you paid for the service).

Generally, no-additional-cost services are excess capacity services, such as airline, bus, or train tickets, hotel rooms, and telephone services.

Example. You are employed as a flight attendant for a company that owns both an airline and a hotel chain. Your employer allows you to take personal flights (if there is an unoccupied seat) and stay in any one of their hotels (if there is an unoccupied room) at no cost to you. The value of the personal flight is not included in your income. However, the value of the hotel room is included in your income because you do not work in the hotel business.

Retirement Planning Services

If your employer has a qualified retirement plan, qualified retirement planning services provided to you (and your spouse) by your employer are not included in your income. Qualified services include retirement planning advice, information about your employer’s retirement plan, and in-
employee, former employee who retired or became disabled, or his or her spouse and dependent children.

- For education furnished to a graduate student at an educational institution if the graduate student is engaged in teaching or research activities for that institution.

- Representing payment for teaching, research, or other services if you receive the amount of the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.

For more information, see Publication 970.

Working Condition Benefits

If your employer provides you with a product or service and the cost of it would have been allowable as a business or depreciation deduction if you paid for it yourself, the cost is not included in your income.

Example. You work as an engineer and your employer provides you with a subscription to an engineering trade magazine. The cost of the subscription is not included in your income because the cost would have been allowable to you as a business deduction if you had paid for the subscription yourself.

Valuation of Fringe Benefits

If a fringe benefit is included in your income, the amount included is generally its value determined under the general valuation rules or under the special valuation rules. For an exception, see Group-Term Life Insurance, earlier.

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

1. The amount, if any, you paid for the benefit, plus

2. Any amount specifically excluded from your income by law.

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

Fair market value. The fair market value of a fringe benefit is determined by all the facts and circumstances. It is the amount you would have to pay a third party to buy or lease the benefit. This is determined without regard to:

- 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. An example of a comparable lease term is the amount of time the vehicle is available for your use, such as a 1-year period. The value cannot be determined by multiplying a 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 generally can use a special valuation rule for a fringe benefit only if your employer uses the rule. If your employer uses a special valuation rule, you cannot use a different special rule to value that benefit. You always can use the general valuation rules discussed earlier, based on facts and circumstances, even if your employer uses a special rule.

If you and your employer use a special valuation rule, you must include in your income the amount your employer determines under the special rule minus the sum of:

1. Any amount you repaid your employer, plus

2. Any amount specifically excluded from income by law.

The special valuation rules are the following:

- The automobile lease rule.
- The vehicle cents-per-mile rule.
- The commuting rule.
- The unsafe conditions commuting rule.
- The employer-operated eating-facility rule.

For more information on these rules, see Publication 15-B, Employer’s Tax Guide to Fringe Benefits.

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.

Retirement Plan Contributions

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, earlier, under Fringe Benefits.

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 in the plan is not transferable or 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.
Elective Deferrals

If you are covered by certain kinds of retirement plans, you can choose to have part of your compensation deferred to a qualified plan that is not included in wages subject to income tax at the time contributed. However, it is included in wages subject to social security and Medicare taxes.

Elective deferrals include elective contributions to the following retirement plans:

1. Cash or deferred arrangements (section 401(k) plans).
2. The Thrift Savings Plan for federal employees.
3. Salary reduction simplified employee pension plans (SARSEPs).
4. Savings incentive match plans for employees (SIMPLE plans).
5. Tax-sheltered annuity plans (403(b) plans).
6. Section 501(c)(18)(D) plans. (But see Reporting by employer, later.)
7. Section 457 plans.

Overall limit on deferrals. For 2004, you generally should not have deferred more than a total of $13,000 of contributions to the plans listed in (1) through (6) above. You should not have deferred more than the lesser of your includible compensation (defined later) or $13,000 of contributions to the plan listed in (7) above (section 457 plan). Your employer or plan administrator should apply the proper annual limit when figuring your plan contributions. However, you are responsible for monitoring the total you defer to ensure that the deferrals are not more than the overall limit.

Catch-up contributions. You may be allowed catch-up contributions (additional elective deferrals) if you are age 50 or older by the end of your tax year. For more information about catch-up contributions to 403(b) plans, see chapter 6 of Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans).

For more information about additional elective deferrals to:

- SEPs (SARSEPs), see Salary Reduction Simplified Employee Pension Plans in Publication 560, Retirement Plans for Small Businesses.
- SIMPLE plans, see How Much Can Be Contributed on Your Behalf in chapter 3 of Publication 590, Individual Retirement Arrangements (IRAs).
- Section 457 plans, see Limit for deferrals under section 457 plans, later.

Limit for deferrals under SIMPLE plans. If you are a participant in a SIMPLE plan, you generally should not have deferred more than $9,000 in 2004. Amounts you defer under a SIMPLE plan count toward the overall limit ($13,000 for 2004) and may affect the amount you can defer under other elective deferral plans.

Limit for deferrals under section 457 plans. If you are a participant in a section 457 plan (a deferred compensation plan for employees of state or local governments or tax-exempt organizations), you should have deferred no more than the lesser of your includible compensation or $13,000. However, if you are within 3 years of normal retirement age, you may be allowed an increased limit if the plan allows it. See Increased limit, later.

Includible compensation. This is the pay you received for the year from the employer who maintained the section 457 plan. It generally includes the following payments:

- Wages and salaries.
- Fees for professional services.
- The value of any employer-provided qualified transportation fringe benefit (defined under Transportation, earlier) that is not included in your income.
- Other amounts received (cash or noncash) for personal services you performed, including, but not limited to, the following items:
  a. Commissions and tips.
  b. Fringe benefits.
  c. Bonuses.
- Employer contributions (elective deferrals) to:
  a. The section 457 plan.
  b. Qualified cash or deferred arrangements (section 401(k) plans) that are not included in your income.
  c. A salary reduction simplified employee pension (SARSEP).
  d. A tax-sheltered annuity (section 403(b) plan).
  e. A savings incentive match plan for employees (SIMPLE plan).
  f. A section 125 cafeteria plan.

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

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

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

1. Twice the dollar limit for the year, or
2. The limit for prior years minus the amount you deferred in prior years plus the lesser of:
   a. Your includible compensation for the current year, or
   b. The dollar limit for the current year.

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

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

If you qualify, your limit can be the lesser of your includible compensation or $13,000 ($14,000 for 2005), plus $3,000 ($4,000 for 2005). However, if you are within 3 years of retirement age and your plan provides the increased limit earlier, that limit may be higher.

Limit for tax-sheltered annuities. If you are a participant in a tax-sheltered annuity plan (403(b) plan), the limit on elective deferrals for 2004 generally is $13,000 ($14,000 for 2005). However, if you have at least 15 years of service with a public school system, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches (or associated organization), the limit on elective deferrals is increased by the least of the following amounts:

1. $3,000.
2. $15,000, reduced by increases to the overall limit that you were allowed in earlier years because of this years-of-service rule.
3. $5,000 times your number of years of service for the organization, minus the total elective deferrals under the plan for earlier years.

For more information, see Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans).

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

Section 501(c)(18)(D) contributions. Wages shown in box 1 of your Form W-2 should not have been reduced for contributions you made to a section 501(c)(18)(D) retirement plan. The amount you contributed should be identified with code “H” in box 12. You may deduct the amount deferred subject to the limits that apply. Include your deduction in the total on Form 1040, line 35. Enter the amount of “501(c)(18)(D)” on the dotted line next to line 35.

Excess deferrals. If your deferrals exceed the limit, you must notify your plan by the date required by the plan. If the plan permits, the excess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of any of the plans that permit these distributions. You must notify each plan by the date required by that plan of the amount to be paid from that particular plan.
plan must then pay you the amount of the ex-
cess, along with any income earned on that
amount, by April 15 of the following year.
You must include the excess deferral in your
income for the year of the deferral. File Form
1040 to add the excess deferral amount to your
wages. Use Form 1040EZ to report excess deferral
amounts.
Excess not distributed. If you do not take
out the excess, you may include the excess deferral,
the cost of the contract even though you in-
cluded it in your income. Therefore, you are
taxed twice on the excess deferral left in the
plan—and you are not allowed to recharacterize
it, and again when you receive it as a distribu-
tion.
Excess distributed to you. If you take out
the excess after the year of the deferral and you
receive the corrective distribution by April 15 of
the following year, do not include it in income
again in the year you receive it. If you receive it
later, you must include it in income in both the
year of the deferral and the year you receive it.
Any income on the excess deferral taken out is
taxable in the tax year in which you take it out. If
you take out part of the excess deferral and the
income on it, allocate the distribution propor-
tionately between the excess deferral and the in-
come.
You should receive a Form 1099-R, Distribu-
tions From Pensions, Annuities, Retirement or
Profit-Sharing Plans, IRAs, Insurance Con-
tracts, etc., for the year in which the excess
deferral is distributed to you. Use the following
rules to report a corrective distribution shown on
Form 1099-R for 2004.
• If the distribution was for a 2004 excess
deferral, your Form 1099-R should have the
code “B” in box 7. Add the excess deferral amount to your wages
on your 2003 tax return, regardless of
when the excess deferral was made.
Report a loss on a corrective distribution of an
excess deferral in the year the excess amount
(reduced by the loss) is distributed to you. In-
clude the loss as a negative amount on Form
1040, line 21 and identify it as “Loss on Excess
Deferral Distribution.”

Even though a corrective distribution of
excess deferrals is reported on Form
1099-R, it is not otherwise treated as a
distribution from the plan. It cannot be rolled
over into another plan, and it is not subject to the
additional tax on early distributions.
Excess Contributions
If you are a highly compensated employee, the
total of your elective deferrals and other contri-
butions made for you for any year under a sec-
tion 401(k) plan or SARSEP can be, as a
percentage of pay, no more than 125% of the
average deferral percentage (ADP) of all eligible
non-highly compensated employees.
If the total contributed to the plan is more
than the amount allowed under the ADP test, the
excess contributions must be either distributed
to you or recharacterized as after-tax employee
contributions by treating them as distributed
to you and then contributed by you to the plan.
You must include the excess contributions in your
income as wages on Form 1040, line 7. You
cannot use Form 1040A or Form 1040EZ to
report excess contribution amounts.
If you receive excess contributions from a
401(k) plan and any income earned on the con-
tributions within 2½ months after the close of
the plan year, you must include them in your income in the year of the contribu-
tion. If the excess contributions are recharac-
terized, you must include them in income in the
year a corrective distribution would have oc-
curred. For a SARSEP, the employer must notify
you by March 15 following the year in which excess contributions are made that you
must withhold the excess and earnings. You
must include the excess contributions in your income in the year of the contribution
(or the year of the notification if less than $100) and include the earnings in your income in the year withdrawn.
You should receive a Form 1099-R for the
year in which the excess contributions are dis-
tributed to you (or are recharacterized). Add excess contributions or earnings shown on
Form 1099-R for 2004 to your wages on your
2004 tax return if code “B” is in box 7. If code “P”
or “D” is in box 9, you may have to file an
amended return on Form 1040 to add the excess contributions or earnings to your
wages in the year of the contribution.

Even though a corrective distribution of
excess contributions is reported on Form
1099-R, it is not otherwise treated as a dis-
bution from the plan. It cannot be
rolled over into another plan, and it is not
subject to the additional tax on early distrib-
utions.
Excess Annual Additions
The amount contributed in 2004 to a defined
collection plan is generally limited to the
lesser of 100% of your compensation or $40,000. Under certain circumstances, contribu-
tions that exceed these limits (excess annual
additions) may be corrected by a distribution of
your elective deferrals or a return of your
after-tax contributions and earnings from these
contributions.
A corrective payment of excess annual addi-
tions consisting of elective deferrals or earnings
from your after-tax contributions is fully taxable
in the year paid. A corrective payment consisting of your after-tax contributions is not taxable.
If you received a corrective payment of ex-
cess annual additions, you should receive a separate Form 1099-R for the year of the pay-
ment with the code “E” in box 7. Report the total
payment shown in box 1 of Form 1099-R on line
16a of Form 1040 or line 12a of Form 1040A.
Report the taxable amount shown in box 2a of
Form 1099-R on line 16b of Form 1040 or line
12b of Form 1040A.

Even though a corrective distribution of
excess annual additions is reported on
Form 1099-R, it is not otherwise
treated as a distribution from the plan. It cannot
be rolled over into another plan, and it is not
subject to the additional tax on early distrib-
utions.
Stock Options
If you receive a nonstatutory option to buy or sell
stock or other property as payment for your
services, you usually will have income when you
receive the option, when you exercise the option
(use it to buy or sell the stock or other property),
or when you sell or otherwise dispose of the
option. However, if your option is a statutory stock
option (defined later), you will not have any income until you sell or exchange your 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 only if all of the following conditions
exist.
• You can transfer the option.
• You can exercise the option immediately
in full.
• The option or the property subject to the
option is not subject to any condition or
restriction (other than a condition to se-
cure payment of the purchase price) that
has a significant effect on the fair market
value of the option.
• The fair market value of the option privi-
lege can be readily determined.
The option privilege for an option to buy is the
opportunity to benefit during the option’s exer-
cise period from any increase in the value of
property subject to the option without risking any
capital. For example, if during the exercise pe-
riod 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
price.

value. The option privilege for an option to sell is the opportunity to benefit during the exercise period as a decrease in the value of the property subject to the option.

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

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

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. For more information on restricted property, see Restricted Property, later.

Related person. If you transferred this kind of option in an arm’s-length transaction to a related person after July 1, 2003, the option is not treated as exercised or closed at that time, and you do not include in your income the money or other property you received for the transfer at that time. See Temporary Regulations section 1.83-7T for the definition of a related person.

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

Tax form. If you receive compensation from employer-provided nonstatutory stock options, it is reported in box 1 of Form W-2. It is also reported in box 12 using code “V.” If you are a nonemployee spouse and you exercise nonstatutory stock options you received incident to a divorce, the income is reported to you on Form 1099-MISC, Miscellaneous Income, in box 3.

### Statutory Stock Options

There are two kinds of statutory stock options.

- **Incentive stock options (ISOs),** and
- **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 the option is granted, until 3 months before you exercise the option (for an incentive stock option, 1 year before if you are disabled). Also, the option must not be transferable 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 you receive 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 a deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it 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 or otherwise dispose of the stock in either of the following situations:

- **Do not meet the holding period requirement.** This situation generally applies if you sell the stock within 1 year after its transfer to you or within 2 years after the option was granted. However, you are considered to meet the holding period requirement for certain sales after October 22, 2004, to comply with conflict-of-interest requirements.
- **Meet the conditions described under Option granted at a discount, under Employee stock purchase plan, later.**

See Restricted Property, later, for more information.

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

Example. The facts are the same as in the previous example. On January 17, 2004, when the stock was selling on the open market for $14 a share, your rights to the stock became transferable. You included $400 ($1,400 value when your rights first became transferable minus $1,000 purchase price) as an adjustment on Form 6251, line 13.

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

- **The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted,** or
- **The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of the disposition or death.**
For this purpose, if the option price was not fixed or determinable at the time the option was granted, the option price is figured as if the option had been exercised at the time it was granted.

Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss, and you do not have any ordinary income.

Example. Your employer, Y Corporation, grants 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 wages the difference between the option price ($20) and the value at the time the option was granted ($22). The rest of your gain ($8 per share) is capital gain, figured as follows:

- Selling price ($30 × 100 shares) ........ $3,000
- Purchase price (option price) ($20 × 100 shares) ........ $2,000
- Gain ........................................ $1,000
- Amount reported as wages ($3,000 – $2,000) ........ $1,000

Amount reported as capital gain $ 800

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. You did not hold the stock long enough, so you must report $300 as wages and $700 as capital gain, figured as follows:

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

Restricted Property

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 in the year you receive any additional compensation in the year you receive the income or have the right to use the property. When the property becomes substantially vested, you must include its 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. Your stock is not substantially vested when it is transferred, so 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 additional compensation during the period the stock can be forfeited.

Substantially vested. Property is substantially vested when:

- It is transferable, or
- 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 performing (or not performing) substantial services, or on a condition related to the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.

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 or for any reason within 3 years from the date of transfer. You must perform substantial services over a period of time and you must resell the stock to the corporation at $100 a share (regardless of its value) if you do not perform the services, so your rights to the stock are subject to a substantial risk of forfeiture.

Choosing to include in income for year of transfer. You can choose to include the value of restricted property at the time of transfer (minus any amount you paid for the property) in your income for the year it 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. Your basis for figuring gain or loss when you sell the property is the amount you paid for it plus the amount you included in income as compensation.

If you make this choice, you cannot revoke it without the consent of the Internal Revenue Service. Consent will be given only if you were under a mistake of fact as to the underlying transaction.

If you forfeit the property after you have included its value in income, your loss is the amount you paid for the property minus any amount you realized on the forfeiture.

You cannot make this choice for a non-statutory stock option.

How to make the choice. You make the choice by filing a written statement with the Internal Revenue Service, within a 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:

- Your name, address, and taxpayer identification number.
- A description of each property for which you are making the choice.
- The date or dates on which the property was transferred and the tax year for which you are making the choice.
- The nature of any restrictions on the property.
- 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.
- Any amount that you paid for the property.
- A statement that you have provided copies to the appropriate persons.

Dividends received on restricted stock. Dividends you receive on restricted stock are treated as compensation and not as dividend income. Your employer should include these payments on your Form W-2. If they are also reported on a Form 1099-DIV, Dividends and Distributions, you should list them on Schedule B (Form 1040) or Schedule D (Form 1040A), Interest and Ordinary Dividends for Form 1040A Filers, with a notation that these dividends are dividends paid to you 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 you did not choose to include in your income in the year transferred and that is not substantially vested.

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

The sale or other disposition of a nonstatutory stock option to a related person after July 1, 2003, is not considered an arm’s-length transaction. See Temporary Regulations section 1.83-7T for the definition of a related person.

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 2001, you paid your employer $50 for a share of stock that had a fair market value of $100 and was subject to forfeiture until 2004. In 2003, you sold the stock to your spouse for $10 in a transaction not at arm’s length. You had compensation of $10 from this transaction. In 2004, when the stock had a fair market value of $120, it became substantially vested. For 2004, you must report additional compensation of $60, figured as follows:

<table>
<thead>
<tr>
<th>Fair market value of stock at time of substantial vesting</th>
<th>$120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus: Amount paid for stock</td>
<td>$50</td>
</tr>
<tr>
<td>Minus: Compensation previously included in income from sale to spouse</td>
<td>$10</td>
</tr>
<tr>
<td>Additional income</td>
<td>$60</td>
</tr>
</tbody>
</table>

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

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 organization is not substantially vested, 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. See Publication 526, Charitable Contributions. Also, see Members of Religious Orders, later.

Pension. A pension or retirement plan for a member of the clergy usually is treated as other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A.

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 designated housing allowance provided to you as part of your pay. However, the exclusion cannot be more than the reasonable payment for your service. If you pay for the utilities, you can exclude any allowance designated for utility cost, up to your actual cost. The home or allowance must be provided as compensation for your services as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040). See Self-Employment Tax, if you are subject to the self-employment tax. For more information, see Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers.

Members of Religious Orders

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

Services performed for the order. If you 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 a member 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 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 income.

Services performed outside the order. If you are directed to work outside the order, your services are not an exercise of duties required by the order unless you meet both of the following requirements:

• They are the kind of services that are ordi- narily the duties of members of the order.
• They are part of the duties that you must exercise 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 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 em- ployee 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 income.

Example 2. Gene Dennis is a member of a religious order who, as a condition of member- ship, 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 coun- seling members of religious orders as well as nonmembers. Although 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 accom- plished.

Gene’s private practice as a psychologist does not make him an agent of the religious order. The psychological services provided by Gene are not the type of services that are pro- vided 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.

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 govern- ment, 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

Special Rules for Certain Employees

This part of the publication deals with special rules for people in certain types of employment: members of the clergy, members of religious orders, people working for foreign employers, military personnel, and volunteers.
self-employment tax on your earnings from ser-

cies 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 gov-

ernment.

Employees of international organizations or foreign governments. Your compensation for office pay, which is taxed as a compensation to an organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal in-

come tax if all of the following are true.

• You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

• Your work is like the work done by em-

ployees of the United States in foreign countries.

• The foreign government gives an equal exemp-

tion to employees of the United States in its country.

Waiver of alien status. If you are an alien who works for a foreign government or interna-
tional organization and you file a waiver under section 247(b) of the Immigration and National-

ity Act to keep your immigrant status, any salary you receive after the date you file the waiver is not exempt under this rule. However, it may be exempt under a treaty or agreement. See Publi-

cation 519, U.S. Tax Guide for Aliens, for more information about treaties.

Nonwage income. This exemption applies onl

ely to employees' wages, salaries, and fees. Pensions and other income do not qualify for this exemp-
tion.

Employment abroad. For information on the tax treat-

ment of income earned abroad, see Publication 54.

Military Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as compensation to an organization.

Allowances generally are not taxed. For more information on the tax treatment of military al-

lowances and benefits, see 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 income as a pension on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A. Do not include in your income the amount of any reduc-
tion in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protec-
tion Plan or the Survivor Benefit Plan.

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

Disability. If you are retired on disability, see Military and Government Disability Pen-

sions under Sickness and Injury Benefits, later.

Veterans' benefits. Do not include in your in-

come any veterans' benefits paid under any law, regulation, or administrative practice adminis-

tered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

• Education, training, and subsistence al-

lowances.

• Disability compensation and pension pay-

ments for disabilities paid either to veter-

ans or their families.

• Grants for homes designed for wheelchair

living.

• Grants for motor vehicles for veterans who

are blind or for the use of their limbs.

• Veterans' insurance proceeds and divi-

dends paid either to veterans or their ben-

eficiaries, including the proceeds of a vet-

eran's endowment policy paid before death.

• Interest on insurance dividends left on de-

posit with the VA.

• Benefits under a dependent-care assis-

tance program.

• The death gratuity paid to a survivor of a


Rehabilitative program payments. VA pay-

ments to hospital patients and resident vet-

erans for their services under the VA's therapeu-
tic or rehabilitative programs are not treated as not taxable veterans' benefits. Report these payments as income on Form 1040, line 21.

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

Taxable allowances. The following al-

lowances must be included in your income and reported as wages.

• Allowances paid to your spouse and minor

children while you are a volunteer leader

training in the United States.

• Living allowances designated by the Di-

rector of the Peace Corps as basic com-

pensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, enter-

tainment and recreation, transportation, and other miscellaneous expenses.

• Leave allowances.

• Readjustment allowances or termination

payments. These are considered received by you when credited to your account.

Example. 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 in-
clude 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 the amounts you receive for supportive services or reimburse-

ments for out-of-pocket expenses from the fol-

lowing programs.

• Retired Senior Volunteer Program (RSVP).

• Foster Grandparent Program.

• Senior Companion Program.

Service Corps of Retired Executives (SCORE). If you receive amounts for support-

ive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in gross income.

Volunteer tax counseling. 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 assis-
tance (VITA) program.

Business and Investment Income This section provides information on the treat-

ment of income from certain rents and royalties, and from interests in partnerships and S corpo-

rations. For additional information about busi-

ness and investment income, you may want to see the following publications.

• Publication 334, Tax Guide for Small Busi-

ness (For Individuals Who Use Schedule C or C-EZ).

• Publication 527, Residential Rental Prop-

erties (Including Rental of Vacation Homes).

• Publication 541, Partnerships.

• Publication 544, Sales and Other Disposi-

tions of Assets.

• Publication 550, Investment Income and

Expenses (Including Capital Gains and Losses).

Income from sales at auctions, includ-

ing online auctions, may be business

income. For more information, see Publica-

tion 334.

Rents From Personal Property If you rent out personal property, such as equip-

ment or vehicles, how you report your income and expenses is generally determined by:

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• Whether or not the rental activity is a business, and
• 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, Business Expenses, 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 Schedule C-EZ (Form 1040). 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 Form 1040, line 21. List the amount and amount of the income on the dotted line next to line 21.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on Form 1040, line 35. Also, enter the amount and “PPR” on the dotted line next to line 35.

If you do not rent personal property for profit, your deductions are limited and you cannot report a loss to offset other income. See Activity not for profit under Other Income in the discussion of Miscellaneous Income, later.

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), Supplemental Income and Loss. However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, artist, etc., report your 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 generally are 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 10 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, see Publication 544.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale of oil, gas, or mineral properties may be considered a capital gain or loss, and you report the gain or loss on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544.

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

Part of future production sold. 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.

Partnership Income
A partnership generally 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. For more information, see Publication 541, Partnerships.

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 income, 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 generally pays no tax, it must file an information return on Form 1065. U.S. Return of Partnership Income. This shows the results 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, Deductions, Credits, etc., showing your share of income, deductions, credits, and tax preference items of the partner for the tax year. Retain Schedule K-1 for your records. Do not attach it to your Form 1040.

Partner’s return. You generally must report partnership items on your individual return in the same way 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).

Generally, Schedule K-1 (Form 1065) will tell you where to report each item of income on your individual return.

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, Deductions, Credits, etc., showing your share of income, losses, deductions, and credits, of the S corporation for the tax year. Retain Schedule K-1 for your records. Do not attach it to your Form 1040.

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.

Generally, Schedule K-1 (Form 1120S) will tell you where to report each item of income on your individual return.

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.

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 pay-
ments may not be taxable to you. For informa-
tion on nontaxable payments, see Military and
Government Disability Pensions and Other
Sickness and Injury Benefits, later in this discus-
sion.

Do not report as income any amounts you had to pay for medical ex-
penses you incurred after the plan was
established.

Cost paid by you. If you pay the entire cost of an
accident or health plan, do not include any amounts not dis-
babled.

• Certain military and government disability pen-
sications are not taxable. If you receive a lump-sum redu-
tion or other periodic basis under a

Service-connected disability. You may be able to
exclude from income amounts you re-
ceive as a pension, annuity, or similar allowance
for personal injury or sickness resulting from
active service in one of the following govern-
ment services.
  • The armed forces of any country.
  • The National Oceanic and Atmospheric
    Administration.
  • The Public Health Service.
  • 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 govern-
   ment 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 simulat-
      ing 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 Vet-
   erans Affairs (VA) if you filed an applica-
tion 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. However, if the pension qualifies for the
exclusion for a service-connected disability (dis-
cussed earlier), 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 pen-
sion in your income.

Retroactive VA determination. If you receive
from the armed services based on years of serv-
ic and are later given a retroactive service-con-
necting disability rating by the VA, your
retirement pay for the retroactive period is ex-
cluded 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 re-
turn on Form 1040X for each previous year
during the retroactive period.

If you receive a lump-sum disability sever-
ance payment and are later awarded VA disabili-

Military and Government Disability Pensions

Certain military and government disability pen-
sions are not taxable.
daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continuity.

- An individual who requires substantial supervision to be protected from threats to health or safety due to severe cognitive impairment.

Limit on exclusion. The exclusion for payments made on a per diem or other periodic basis under a long-term care insurance contract is subject to a limit. The limit applies to the total of these payments and any accelerated death benefits made on a per diem or other periodic basis under a life insurance contract because the insured is chronically ill. (For more information on accelerated death benefits, see Life Insurance Proceeds on page 16 of Schedule C or Schedule C-EZ (Form 1040).)

Under this limit, the excludable amount for any period is figured by subtracting any reimbursement received (through insurance or otherwise) for the cost of qualified long-term care services during the period from the larger of the following amounts:

- The cost of qualified long-term care services during the period.
- The dollar amount for the period ($230 per day for any period in 2004).

See Section C of Form 8853 and its instructions for more information.

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 of a workers' compensation act. The exemption also applies to your survivors. The exemption, 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.

If part of your workers' compensation payments is paid under a statute that provides benefits only to employees with service-connected disabilities, part of it may be workers' compensation.

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.

Other Sickness and Injury Benefits

In addition to disability pensions and annuities, you may receive other payments for sickness or injury.

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

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 following the date of the claim in accordance with the Code. Report this 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.

If part of the payments you receive under FECA reduces your social security (or equivalent railroad retirement) benefits and may be taxable. For a discussion of the taxability of these benefits, see Other Income under Miscellaneous Income, later.

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:

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See Court awards must include damages under Other 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 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 generally is not taxable. However, it may reduce your medical expense deduction. If you receive reimbursement for an expense you deducted in an earlier year, see Recovery of Amounts.

If you receive an "advance reimbursement" or "loan" for future medical expenses from your employer without regard to whether you suffered a personal injury or sickness or incurred medical expenses, that amount is included in your income, whether or not you incur uninsured medical expenses during the year.

Reimbursements received under your employer's plan for expenses incurred before the plan was established are included in income.

Reimbursements received under your employer's plan of the amount paid for preprescription medicines and drugs (such as allergy medicine, pain reliever, and cold medicine) are not included in income. However, reimbursements of the amount paid for dietary supplements (such as vitamins) that are merely beneficial to your general health are included in income.

Miscellaneous Income

This section discusses various types of income. You may have taxable income from certain transactions even if no money changes hands. For example, you may have taxable income if you lend money at a below-market interest rate or have a debt you owe canceled.

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 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). However, if the barter involves an exchange of something 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) 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, Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, or a similar statement from the barter exchange should be sent to you by January 31, 2005. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2004. The IRS will also receive a copy of Form 1099-B.

Backup withholding. The income you receive from bartering generally is 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, 28% of the income if:

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

If you join a barter exchange, you must certify that all the necessary information 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 up to the amount of any cash paid to you or deposited in your account and any scrip or credit issued to you (and converted to cash).

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 income. You have no income from the canceled debt if it is a nonbusiness debt. However, if the canceled amount on Form 1040, line 21. If it is a business debt, report the amount on Schedule C or Schedule C-EZ, (Form 1040) (or on Schedule F (Form 1040), Profit or Loss From Farming, if the debt is farm debt and 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 also will be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your 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 Form 1099-C, box 2. 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. You must include the canceled amount in your income.

Mortgage relief upon sale or other disposition. If you are personally liable for a mortgage (recourse debt), and you are relieved of the mortgage when you dispose of the property, you may realize gain or loss up to the fair market value of the property. To the extent the mortgage discharge exceeds the fair market value of the property, it is income from discharge of indebtedness unless it qualifies for exclusion under this section. Later. Report any income from discharge of indebtedness on nonbusiness debt that does not qualify for exclusion as other income on Form 1040, line 21.

If you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure or reposession), that relief is included in the amount you realize. You may have a taxable gain if the amount you realize exceeds your adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

See Foreclosures and Repossessions in Publication 544 for more information.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you. For more information, see Publication 542.
• Religious.
• Scientific.
• Testing for public safety.

**Exception.** You do have income if your stu- dent loan was made by an educational institu- tion and is canceled because of services you performed for the institution or other organiza- tion 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 ac- counting. For more information, see chapter 5 of Publication 334.

**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 situa- tions.

• The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publi- cation 908, Bankruptcy Tax Guide.

• The debt is canceled when you are insol- vent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent. See Publication 908.

• The debt is qualified farm debt and is can- celed by a qualified person. See chapter 3 of Publication 225, Farmer’s Tax Guide.

• The debt is qualified real property busi- ness debt. See chapter 5 of Publication 334.

• The cancellation is intended as a gift.

**Education Loan Repayment Assistance**

Beginning in 2004, education loan repayments made to you by the National Health Service Corps Loan Repayment Program (NHSC Loan Repayment Program) or a state education loan repayment program eligible for funds under the Public Health Service Act are not taxable if you agree to provide primary health services in health professional shortage areas. For more information, see Publication 970.

**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 endorsement 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 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 re- ceive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount received by the insurance company (gener- ally the total lump sum payable at the death of the insured person) by the number of install- ments 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 re- ceive 120 monthly installments of $1,000 each. The excluded part of each installment is $625 ($75,000 ÷ 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 pro- ceeds 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 in- cluded 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.

**The exclusion.** If your spouse died before October 23, 1986, and 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 inter- est exclusion from the time you begin to receive payments.

**Surrender of policy for cash.** If you surren- der 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 unpaid 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 12a and 12b of Form 1040A.**

**For information on when the proceeds are excluded from income, see Accelerated Death Benefits, later.**

**Split-dollar life insurance.** Generally, a split-dollar life insurance arrangement is an ar- rangement between an owner and a non-owner of a life insurance contract under which either party to the arrangement pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover all or part of those premiums from the proceeds of the con- tract. There are two mutually exclusive regimes to tax split-dollar life insurance arrangements.

1. **Under the economic benefit regime, the owner of the life insurance contract is treated as providing current life insurance protection and other taxable economic benefits to the non-owner of the contract.**

2. **Under the loan regime, the non-owner of the life insurance contract is treated as loaning premium payments to the owner of the contract.**

Only one of these regimes applies to any one policy. For more information, see sections 1.61-22 and 1.7872-15 of the regulations.

**Endowment Contract Proceeds**

An endowment contract is a policy under which you are paid a specified amount of money on a certain date unless you die before that date, in which case, the money is paid to your desig- nated beneficiary. 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, subtract any amount that you previously received under the contract and excluded from your income from the total premiums (or other consideration) paid for the contract. Include the part of the lump sum payment that is more than 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.

**Accelerated Death Benefits**

Certain amounts paid as accelerated death ben- efits under a life insurance contract or viatical settlement before the insured’s death are ex- cluded from income if the insured is terminally or chronically ill.

**Vitiation settlement.** This is the sale or assign- ment of any part of the death benefit under a life insurance contract to a viatical settlement pro- vider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are termi- nally or chronically ill and who meets the require- ments of section 101(g)(2)(B) of the Internal Revenue Code.

**Exclusion for terminal illness.** Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person 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.
Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, the exclusion is based on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts. For information on the limit and the definitions of chronically ill individual, qualified long-term care services, and long-term care insurance contracts, see Long-Term Care Insurance Contracts under Sickness and Injury Benefits, earlier.

Exception. The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:
- Is a director, officer, or employee of the person.
- Has a financial interest in the person’s business.

Form 8853. To claim an exclusion for accelerated death benefits made on a per diem or other periodic basis, you must file Form 8853 with your return. You do not have to file Form 8853 to exclude accelerated death benefits paid on the basis of actual expenses incurred.

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 also may 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 up to the amount by which 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 2004, you generally must include it in your income in the year you receive it. The payer should send Form 1099-G, Certain Government Payments, to you by January 31, 2005. The IRS also will receive a copy of the Form 1099-G. Use the worksheet in the 2004 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income.

Mortgage interest refund. If you received a refund or credit in 2004 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 2004. 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 Form 1040, line 8a.

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 you paid it. 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.


You must allocate the $400 refund between 2003 and 2004, the years in which you paid the tax on which the refund is based. You paid 75% (3,000 ÷ 4,000) of the estimated tax in 2003, so 75% of the $400 refund, or $300, is for amounts you paid in 2003 and is a recovery item. If all of the $300 is a taxable recovery item, you will include $300 on Form 1040, line 10, for 2004, 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 2004 estimated tax. When you figure your deduction for state and local income taxes paid during 2004, you will reduce the $1,000 paid in January by $100. Your deduction for state and local income taxes paid during 2004 will include the January net amount of $900 ($1,000 – $100), plus any estimated state income taxes paid in 2004 for all state income tax withheld during 2004.

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 claimed the standard deduction on your 2003 federal income tax return. In 2004 you received a refund of your 2003 state income tax. Do not report any of the refund as income because you did not itemize deductions for 2003.

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. However, you generally do not need to use this discussion if the recovery is for state or local income taxes paid in 2003. Instead, use the worksheet in the 2004 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income.

You cannot use the Form 1040 worksheet and must use this discussion if any of the following statements is true.
- The recovery is for a tax year other than 2003.
- The recovery is for a deducted item other than state or local income taxes, such as real property taxes.
- Your 2003 taxable income was less than zero.
- You made your last payment of 2003 state or local estimated tax in 2004.
- You could not deduct all your tax credits for 2003 because their total was more than the amount of tax shown on your 2003 Form 1040, line 43.
- You could be claimed as a dependent by someone else in 2003.

If you also recovered an amount deducted as a non-itemized deduction, figure the amount of that recovery to include in your income and add it to your adjusted gross 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 generally must 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 or local income tax refund on Form 1040, line 10, and the total of all other recoveries as other income on Form 1040, line 21. You cannot use Form 1040A or Form 1040EZ.

Example. For 2003, you filed a joint return. Your taxable income was $60,000 and you were not entitled to any tax credits. Your standard deduction was $9,500, and you had itemized deductions of $11,000. In 2004, you received the following recoveries for amounts deducted on your 2003 return:

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

None of the recoveries were more than the deductions taken for 2003.

Your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($11,000 − $9,500 = $1,500), so you must include your total recoveries in your income for 2004. Report the state and local income tax refund of $400 on Form 1040, line 10, and the balance of your recoveries, $525, on Form 1040, line 21.

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 statements (4), (5), and (6) are true (your itemized deductions were not limited, you had no unused tax credits, and you were not subject to the alternative minimum tax), you can use Worksheet 2 to determine the part of your recovery to include in your income.
Worksheet 2. Recoveries of Itemized Deductions

To determine whether you should complete this worksheet to figure the part of a recovery amount to include in income on your 2004 Form 1040, see Total recovery not included in income under Itemized Deduction Recoveries. If you recovered amounts from more than one year, such as a state income tax refund from 2003 and a casualty loss reimbursement from 2002, complete a separate worksheet for each year. Use information from Schedule A (Form 1040) for the year the expense was deducted.

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. 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\(^1\) ....................................... 1.  
2. Enter the total of all other Schedule A refunds or reimbursements (excluding the amount you entered on line 1)\(^1\) .................................. 2.  
3. Add lines 1 and 2 ........................................................ 3.  
4. Itemized deductions for the prior year (for example, line 28 of Schedule A for 2003) 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.  
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\(^2\) (for example, line 41, Form 1040 for 2003) ................................................ 10.  
11. Amount to include in income for 2004:  
   - If line 10 is zero or more, enter the amount from line 9.  
   - If line 10 is a negative amount, add lines 9 and 10 and enter the result (but not less than zero).\(^3\) ........................................... 11.  

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 on line 10, Form 1040. If there is an amount on line 2, enter the amount from line 11 on line 21, Form 1040.

If line 11 is less than line 3, and there are amounts on both lines 1 and 2, complete the following 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. Enter the result here and on line 10, Form 1040  
   ................................. B.  
C. Subtract the amount on line 8 from the amount on line 11. Enter the result here and on line 21, Form 1040  
   ................................. C.  

\(^1\) Do not enter more than the amount deducted for the prior year.  
\(^2\) If 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 (NOLs) for Individuals, Estates, and Trusts.  
\(^3\) For example, $700 + ($400) = $300.
### Table 2. 2003 Standard Deduction Tables

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AND the</th>
<th>THEN Your Standard Deduction is ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single 1</td>
<td>1</td>
<td>5,900</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>7,050</td>
</tr>
<tr>
<td>Married 1</td>
<td>1</td>
<td>10,450</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>11,450</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>12,350</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>13,300</td>
</tr>
<tr>
<td>Married sp</td>
<td>1</td>
<td>5,700</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>6,650</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>7,600</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>8,550</td>
</tr>
<tr>
<td>Head of house</td>
<td>1</td>
<td>8,150</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>9,350</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>10,450</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>11,650</td>
</tr>
</tbody>
</table>

### Example

In 2004 you recovered $2,500 of your 2003 itemized deductions, but the recoveries you must include in your 2004 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 state tax refund on Form 1040, line 10, is $300. The balance of the taxable recoveries, $1,200, is reported as other income on line 21. If none, enter -0-.

1. Enter the smaller of line 5 or line 6. If under 65 and not blind, stop here.

2. If 65 or older or blind, multiply $1,150 ($950 if married filing separately) by the number in the box above.

3. Add lines 7a and 7b. This is your standard deduction for 2003.

4. Enter the larger of line 3 or line 4.

5. Enter the amount shown below for your filing status.

6. If under 65 and not blind, stop here.

7. Standard deduction.

8. Enter the smaller of line 5 or line 6. If under 65 and not blind, stop here.

9. This is your standard deduction.

10. Enter the smaller of line 7a or line 7b. This is your standard deduction.

11. Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.
Recovery limited to deduction. You do not nonbusiness casualty and theft losses, $850. include $650 in your 2004 income, rather than by the negative amount. were reduced by the smaller of the following:

- Your actual medical expense deducted in the earlier year if your adjusted gross income (AGI) was more than a base amount. For example, this amount was:
  - For 2003, $139,500 ($69,750 if married filing separately), and
  - For 2001, $132,950 ($66,475 if married filing separately).

If the limit applied, your itemized deductions were reduced by the smaller of the following amounts:
- 3% of the amount by which your AGI exceeded the base amount.
- 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.

### Table I. Standard Deduction Chart for Most People*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Your Standard Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$4,700</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>7,850</td>
</tr>
<tr>
<td>Married filing separate return</td>
<td>3,925</td>
</tr>
<tr>
<td>Head of household</td>
<td>6,900</td>
</tr>
</tbody>
</table>

*DO NOT use this chart if you were 65 or older or blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

### Table II. Standard Deduction Chart for People Age 65 or Older or Blind*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AND the Number in the Box Above</th>
<th>THEN Your Standard Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td></td>
<td>$5,850</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>8,750</td>
<td></td>
</tr>
<tr>
<td>Married filing separate return</td>
<td>10,550</td>
<td></td>
</tr>
<tr>
<td>Head of household</td>
<td>11,450</td>
<td></td>
</tr>
</tbody>
</table>

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table III, instead.

### Table III. Standard Deduction Worksheet for Dependents*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AND the Number in the Box Above</th>
<th>THEN Your Standard Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td></td>
<td>$5,850</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>8,750</td>
<td></td>
</tr>
<tr>
<td>Married filing separate return</td>
<td>10,550</td>
<td></td>
</tr>
<tr>
<td>Head of household</td>
<td>11,450</td>
<td></td>
</tr>
</tbody>
</table>

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.
Table I. Standard Deduction Chart for Most People*

<table>
<thead>
<tr>
<th>IF Your Filing Status is ...</th>
<th>AND the Number in the Box Above is ...</th>
<th>THEN Your Standard Deduction is ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>1</td>
<td>$5,650</td>
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<tr>
<td></td>
<td>2</td>
<td>6,750</td>
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<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>1</td>
<td>8,500</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>9,400</td>
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<tr>
<td></td>
<td>3</td>
<td>10,300</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>11,200</td>
</tr>
<tr>
<td>Married filing separate return</td>
<td>1</td>
<td>4,700</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>5,600</td>
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<td></td>
<td>3</td>
<td>6,500</td>
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<tr>
<td></td>
<td>4</td>
<td>7,400</td>
</tr>
<tr>
<td>Head of household</td>
<td>1</td>
<td>7,750</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>8,850</td>
</tr>
</tbody>
</table>

*DO NOT use this chart if you were 65 or older or blind. OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

Table II. Standard Deduction Chart for People Age 65 or Older or Blind*

<table>
<thead>
<tr>
<th>IF Your Filing Status is ...</th>
<th>THEN Your Standard Deduction is ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Head of household, enter $6,650</td>
<td></td>
</tr>
<tr>
<td>Marital filing separate return, enter $4,550</td>
<td></td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child, enter $7,600</td>
<td></td>
</tr>
</tbody>
</table>

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table III, instead.

Table III. Standard Deduction Worksheet for Dependents*

1. Enter your earned income (defined below), if none, enter -0-.
2. Additional amount
3. Add lines 1 and 2.
4. Minimum standard deduction
5. Enter the larger of line 3 or line 4.
6. Enter the amount shown below for your filing status.
   - Single, enter $4,550
   - Married filing separate return, enter $3,800
   - Married filing jointly or Qualifying widow(er) with dependent child, enter $7,600
   - Head of household, enter $6,650
7a. Enter the smaller of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction.
7b. If 65 or older or blind, multiply $1,100 ($900 if married or qualifying widow(er) with dependent child) by the number in the box above.
7c. Add lines 7a and 7b. This is your standard deduction for 2001.

*DO NOT use this chart if you were 65 or older or blind. OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table II or III instead.

To determine the part of the recovery you must include in income, follow the two steps below.

1. Figure the greater of:
   a. The standard deduction for the earlier year, or
   b. The amount of itemized deductions you would have been allowed for the earlier year (after taking into account the limit on itemized deductions) if you had figured them using only the net amount of the recovery item. The net amount is the amount you actually paid reduced by the recovery amount.

   Note. If you were required to itemize your deductions in the earlier year, use step 1(b) and not step 1(a).

2. Subtract the amount in step 1 from the amount of itemized deductions actually allowed in the earlier year after applying the limit on itemized deductions.

   The result of step 2 is the amount of the recovery to include in your income for the year you receive the recovery. If your taxable income for the earlier year was a negative amount, reduce your recovery by the negative amount.

   If you had unused tax credits in the earlier year, see Unused tax credits on page 24.

   For more information on this computation, see Revenue Ruling 80-75. This ruling is in Cumulative Bulletin 1993-2.

   Example. Eileen Martin is single. She had an AGI of $1,137,300 and itemized her deductions on her federal income tax return for 2003. She was not subject to alternative minimum tax amount of itemized deductions actually allowed in the earlier year after applying the limit on itemized deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Note. If you were required to itemize your deductions in the earlier year, use step 1(b) and not step 1(a).
AGI for 2003

State income taxes paid in 2003

3% reduction on 2003 Itemized Deduction Worksheet, line 8)

($1,137,300 − $137,300) × 3%] $30,000

80% reduction not applied (amount on 2003 Itemized Deduction Worksheet, line 4)

($40,000 × 80%) $32,000

2003 deduction (amended)

($40,000 − $30,000) $10,000

Refund received in 2004 of 2003 state income tax

$5,000

Net amount of 2003 state income tax ($40,000 − $5,000) $35,000

If Eileen had used the $35,000 net amount of state income tax to figure her itemized deductions for 2003, the deduction allowed would have been $7,000. This is her otherwise allowable deduction of $35,000 reduced by $28,000 ($35,000 × 80%). By deducting the full $10,000 paid in 2003, she derived a tax benefit of $3,000 ($10,000 − $7,000). Therefore, only $3,000 of the $5,000 refund is included in her income for 2004.

Unused tax credits. If you recover an item deducted in an earlier year in which you had unused tax credits, you must reduce 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 up to the amount of the deduction that reduced the tax in the earlier year. If there is a decrease in the amount deducted carried over to the current year that resulted from deducting the recovered credit in the earlier year, the recovery is for an itemized deduction claimed in a year in which the deductions were limited, see itemized deductions limited.

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 2003, Jean Black filed as head of household and itemized her deductions. Her taxable income was $5,260 and her tax was $528. She claimed a child care credit of $1,200. The credit reduced her tax to zero and she had an unused tax credit of $672 ($1,200 − $528). In 2004, Jean recovered $1,000 of her itemized deductions. She reduces her 2003 itemized deductions by $1,000 and refigures that year’s tax on taxable income of $6,260. However, the child care credit does not increase the recomputed tax of $628. Jean’s liability for 2003 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 2004.

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 changes your total tax, you do not include the recovery in your income. However, if your total tax increases by any amount, you recovered a tax credit from the deduction and you must include the recovery in your income up to the amount of the deduction that 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 2004 tax by reason of a downward price program paid as a substitute for unemployment compensation, recoveries of compensation for

Example. If you recover an amount that you deducted in an earlier year in figuring your 2004 tax by reason of a downward price program paid as a substitute for unemployment compensation, recoveries of compensation for

• 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. See Workers’ Compensation under Sickness and Injury Benefits, earlier.)

Survivor Benefits

Generally, payments made by or for an employee because of an employee’s death must be included in income. The following discussions explain the tax treatment of certain payments made to survivors. For additional information, see Publication 559.

Lump-sum payments. Lump-sum payments you receive from a decedent’s employer as the surviving spouse or beneficiary may be accrued salary payments; distributions from employee profit-sharing, pension, annuity, or 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, see Publication 575 (or Publication 721 if you are the survivor of a federal employee or retiree).

Public safety officer killed in the line of duty. If you are a survivor of a public safety officer who was killed in the line of duty, you may be able to exclude from income certain amounts you receive. For this purpose, the term public safety officer includes law enforcement officers, firefighters, chaplains, and rescue squad and ambulance crew members. For more information, see Publication 559.

Unemployment Benefits

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 13 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.

• Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.

• State unemployment insurance benefits.

• Railroad unemployment compensation benefits.

• 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. See Workers’ Compensation under Sickness and Injury Benefits, earlier.)

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
• Trade readjustment allowances under the Trade Act of 1974.
• Unemployment assistance under the Disaster Relief and Emergency Assistance Act.

Governmental program. If you contribute to a governmental unemployment compensa-
tion program and your contributions are not de-
ductible, amounts you receive under the program are not included as unemployment compensation until you recover your contribu-
tions.

Repayment of unemployment compensa-
tion. If you repaid in 2004 unemployment compensation you received in a later year, subtract the amount you repaid from the total amount you
received and enter the difference on line 19 of Form 1040A in line 3 of Form 1040EZ. On the dotted line next to your entry, enter “Repay” and the amount you re-
paid. If you repaid unemployment compensation in 2004 that is includible in your income in
an earlier year, you can deduct the amount repaid on Schedule A (Form 1040), line 22, if you item-
ize deductions. If the amount is more than $3,000, see Repayments, later.

Tax withholding. You can choose to have federal income tax withheld from your unem-
ployment compensation. To make this choice, complete Form W-4V, Voluntary Withholding Request, and give it to the paying office. Tax will be withheld at 10% of your payment.

If you do not choose to have tax with-
held from your unemployment compen-
sation, you may be liable for estimated tax. For more information on esti-
rated tax, see Publication 505, Tax Withholding and Estimated Tax.

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. They may be subject to social security and Medicare taxes. For more informa-
tion, see Supplemental Unemployment Benefits in Publication 15-A, section 5, Employer's Sup-
plemental Unemployment Compensation, on line 7 of Form 1040 or Form 1040A or line 1 of Form 1040EZ.

Repayment of benefits. You may have to repay some of your supplemental unemploy-
ment 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, deduct the total benefits by the amount you repay. If you repay the benefits in a later year, you must include in your income as wages the amount you received in the later 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 Form 1040, line 35, and enter “Sub-Pay TRA” and the amount on the dotted line next to line 35. 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

Disaster relief grants. Do not include post-disaster grants received under the Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not de-
duct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Unemployment assistance pay-
ments under the Act are taxable unemployment compensation. See Unemployment compensa-
tion under Unemployment Benefits, earlier.

Disaster relief payments. You can exclude from income any amount you receive that is a quali-
dfied disaster relief payment. A qualified disas-
aster relief payment is an amount paid to you:

1. To reimburse or pay reasonable and nec-
essary personal, family, living, or funeral expenses that result from a qualified disas-
ster.
2. To reimburse or pay reasonable and nec-
essary expenses incurred for the repair or
rehabilitation of your home or repair or re-
placement of its contents to the extent it is due to a qualified disaster,
3. By a person engaged in the furnishing or
sale of transportation as a common carrier
because of the death or personal physical injuries incurred as a result of a qualified disaster, or
4. By a federal, state, or local government, or
agency, or instrumentality in connection with a qualified disaster in order to pro-
mote the general welfare.

You can only exclude this amount to the extent any expense it pays for is not paid for by insur-
ance or otherwise. The exclusion does not apply if you were a participant or conspirator in a
terrorist action or his or her representative.

A qualified disaster is:
• A disaster which results from a terrorist or
terrorism action,
• A Presidentially declared disaster,
• A disaster which results from an accident
involving a common carrier, or from any
other event, which is determined to be cat-
astrophic by the Secretary of the Treasury
or his or her delegate.

For amounts paid under item 4, a disaster
is qualified if it is determined by an applicable federal, state, or local authority to warrant assis-
tance from the federal, state, or local govern-
ment, agency, or instrumentality.

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

Replacement housing payments. Replace-
ment housing payments made under the Uni-
form Relocation Assistance and Real Property
Acquisition Policies Act for Federal and Feder-
ally Assisted Programs are not includible in gross income, but are includible in the basis of the newly acquired property.

Welfare and Other Public Assistance Benefits

Do not include in your income governmental benefit payments from a public welfare fund based
on need, 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 ex-
penses that are reimbursed by such a fund. You must include in your income any welfare pay-
ments that are compensation for services or that are obtained fraudulently.

Work-training program. Payments you re-
ceive from a state welfare agency for taking part in a work-training program are not included in your income, as long as the payments (exclu-
sive of extra allowances for transportation or other costs) do not total more than the public welfare benefits you would have received other-
wise. If the payments are 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 disa-
bility, 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 reha-
bilitation because you have a disability. Excluda-
table 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.
Relocation payments and home rehabilita-
tion grants. A relocation payment under sec-
tion 105(a)(11) of the Housing and Community
Development Act made by a local jurisdiction to
a displaced individual moving from a flood-dam-
aged residence to another residence is not in-
ccludible in gross income. Home rehabilitation
grants received by low-income homeowners in a
defined area under the same act are also not in-
ccludible in gross income.

Indian financing grants. Nonreimbursable
grants under title IV of the Indian Financing Act
of 1974 to Indians to expand profit-making
Indian-owned economic enterprises on or near
reservations are not includible in gross income.

Medicare. Medicare benefits received under
title XVIII of the Social Security Act are not in-
ccludible in the gross income of the individuals
for whom the payments are made. This applies
to old-age insurance benefits, and insurance
benefits for wives, husbands, children, widows,
widowers, mothers and fathers, and parents, as
well as the lump-sum death payment.

Nutrition Program for the Elderly. Food
benefits you receive under the Nutrition Pro-
gram for the Elderly are not taxable. If you pre-
pare and serve free meals for the program, include
in your income as wages the cash pay you
receive, even if you are also eligible for food
benefits.

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.

Other Income
The following brief discussions are arranged in
alphabetical order. Income items that are dis-
cussed in greater detail in another publication
clearly refer to that publication.

Activity not for profit. You must include on
your Form 1040 income from an activity from which
you do not expect to make a profit. An example of
this type of activity is a hobby or a farm you
operate mostly for recreation and pleasure.

Enter this income on Form 1040, line 21. Deduc-
tions 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 Publica-
tion 533, Business Expenses, for information on
whether an activity is considered carried on for a
profit.

Alimony. Include in your income on Form
1040, line 11, any alimony payments you re-
ceive. Amounts you receive for child support are
not income to you. For complete information,
see Publication 504, Divorced or Separated In-
dividuals.

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

- A loan to the borrower in exchange for a
  note that requires the payment of interest at
  the applicable federal rate, and
- 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:

- Gift,
- Dividend,
- Contribution to capital,
- Payment of compensation, or
- 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.

Bribes. If you receive a bribe, include it in your
income.

Campaign contributions. These contribu-
tions 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. In-
come Tax Return for Certain Political Organiza-
tions. Excess campaign funds transferred to an
office account must be included in the office-
holder's income on Form 1040, line 21, in
the year transferred.

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 Publi-
cation 537, Installment Sales.

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 arrange-
ments in a profit-making business of transport-
ing workers for hire.

Cash rebates. A cash rebate you receive from
a dealer or manufacturer of an item you buy is
not income, but you must reduce your basis by
the amount of the rebate.

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 basis in the car 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.

Casualty insurance and other
reimbursements. You generally should not
report these reimbursements on your return.
See Publication 547, Casualties, Disasters, and
Thfts, for more information.

Charitable gift annuities. If you are the bene-
ficiary of a charitable gift annuity, you must in-
clude the yearly annuity or fixed percentage
payment in your income.

The payer will report the types of income you
receive on Form 1099-R. Report the gross dis-
tribution from box 1 on Form 1040, line 16a, or
on Form 1040A, line 12a, and the part taxed as
ordinary income (box 2a minus box 3) on Form
1040, line 16b, or on Form 1040A, line 12b.
Report the portion taxed as capital gain (box 3)
see Schedule D, line 8.

Child support payments. You should not re-
port these payments on your return. See Publica-
tion 504 for more information.

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 in-
come:

1. Interest on any award.
2. Compensation for lost wages or lost profits
   in most cases.
3. Punitive damages. It does not matter if
   they relate to a physical injury or physical
   sickness.
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 dis-
tress received to satisfy a claim under Title
7. Attorney fees and costs where the underly-
ing recovery is included in gross income.

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. Emotional distress itself is not a physical injury or physical sickness, but 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 report them on your return.

If the emotional distress is due to a personal injury that is not due to a physical injury or sickness (for example, unlawful 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.

Deduction for costs involved in unlawful discrimination suits. Beginning after October 22, 2004, you may be able to deduct attorney fees and court costs paid to recover a judgment or settlement for a claim of unlawful discrimination under various provisions of federal, state, and local law listed in Internal Revenue Code section 62(e), a claim against the United States government, or a claim under section 1802(b)(3)(A) of the Social Security Act. You can claim this deduction as an adjustment to income on Form 1040, line 35. The following rules apply.

- The attorney fees and court costs may be paid by you or on your behalf in connection with the claim for unlawful discrimination, the claim against the United States government, or the claim under section 1802(b)(3)(A) of the Social Security Act.
- The deduction you are claiming cannot be more than the amount of the judgment or settlement you are including in income for the tax year.
- You must pay the attorney fees and costs after October 22, 2004.
- The judgment or settlement to which your attorney fees and court costs apply must occur after October 22, 2004.

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, do not 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 Form 1040, line 21, the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Employment agency fees. If you get a job through an employment agency, and the fee is paid by your employer, the fee is not includible in your income if you are not liable for it. However, if you pay it and your employer reimburses you for it, it is includible in your income.

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.

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 dwelling units and other units, any subsidy must be properly allocated.

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 (Form 1041), Beneficiary’s Share of Income, Distributions, Credits, etc.

Current income 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:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- 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, 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. (The grantor is the one who transferred property to 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.

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.

Expenses paid by another. If your personal expenses are paid for by another person, such as a corporation, the payment may be taxable to you depending upon your relationship with that person and the nature of the payment. But if the payment makes up for a loss caused by that person, and only restores you to the position you were in before the loss, the payment is not includible in your income.

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

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A notary public, or
- An election precinct official.

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 or Schedule C-EZ (Form 1040).

Personal representatives. All personal representatives must include in their gross income fees paid to them from an estate. If paid to a professional executor or administrator, self-employment tax also applies to such fees. For a nonprofessional executor or administrator (a person serving in such a capacity in an isolated instance, such as a friend or relative of the decedent), self-employment tax only applies if a trade or business is included in the estate’s assets, the executor actively participates in the business, and the fees are related to operation of the business.

The fee is not includible in income if it is waived.

Notary public. Report payments for these services on Schedule C or Schedule C-EZ (Form 1040). These payments are not subject to self-employment tax. (See the separate instructions for Schedule SE (Form 1040) for details.)

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.

Food program payments to daycare providers. If you operate a daycare service and receive payments under the Child and Adult Care Food Program administered by the Department of Agriculture that are not for your services, the payments generally are not included in your income. However, you must include in your income any portion of the payments you do not use to provide food to individuals eligible for help under the program.

Foreign currency transactions. If you have a gain on a personal foreign currency transaction because of changes in exchange rates, you do not have to include that gain in your income unless it is more than $200. If the gain is more than $200, report it as a capital gain.
Foster-care providers. Payments you receive from a state, political subdivision, or a qualified foster care placement agency for providing care to qualified foster individuals in your home generally are not included in your income. However, 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. A qualified foster care placement agency.

Difficulty-of-care payments. These are additional payments that are designated by the payee 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:
- 10 qualified foster individuals under age 19,
- 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). See Publication 587, Business Use of Your Home (Including Use by Daycare Providers), to help you determine the amount you can deduct for the use of your home.

Found property. If you find and keep property that does not belong to you that has been lost or abandoned (treasure-trove), it is taxable to you at its fair market value in the first year it is your undisposed possession.

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 Form 1040, line 21, 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 or Schedule C-EZ (Form 1040).

Gambling winnings. You must include your gambling winnings in your income on Form 1040, line 21. 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. However, the difference between the fair market value and the cost of an oil and gas lease obtained from the government through a lottery is not includible in income.

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. If you sell future lottery payments for a lump sum, you must report the amount you receive from the sale as ordinary income (Form 1040, line 21) in the year you receive it.

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 Form 1040, line 21. Include the amount shown in box 2 on Form 1040, line 63, as federal income tax withheld.

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 income is also taxable 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 What If You Inherit an IRA in Publication 590, Individual Retirement Arrange- ments (IRAs), if you inherited an IRA.

Expected inheritance. If you sell an inter- est in an expected inheritance from a living per- son, include the entire amount you receive in gross income on Form 1040, line 21.

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 Historic Preservation grants program. Historic Preservation grants to preserve a historically significant property.

Hobby losses. Losses from a hobby are deductable from other income. A hobby is an activity from which you do not expect to make a profit. See Activity Not for Profit, earlier under Other Income.

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.

Holocaust victims restitution. Restitution payments you receive as a Holocaust victim (or the heir of a Holocaust victim) and interest earned on the payments, including interest earned on amounts held in certain escrow accounts or funds, are not taxable. You also do not include them in any computations in which you would ordinarily add excludable income to your adjusted gross income, such as the computation to determine the taxable part of social security benefits. If the payments are made in property, your basis in the property is its fair market value when you receive it.

Excludable restitution payments are pay- ments or distributions made by any country or any other entity because of persecution of an individual on the basis of race, religion, physical or mental disability, or sexual orientation by Nazi Germany, any other Axis regime, or any other Nazi-controlled or Nazi-allied country, whether the payments are made under a law or as a result of a legal action. They include compensa- tion or reparation for property losses resulting from Nazi persecution, including proceeds under insurance policies issued before and during World War II by European insurance compa- nies.

Illegal income. Illegal income, such as money from dealing illegal drugs, must be included in your income on Form 1040, line 21, or on Schedule C or Schedule C-EZ (Form 1040) if you are engaged in a 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.

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:
- The financial institution is bankrupt or in- solvent, or
- 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 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 de- posit during that year, and
2. The amount that could have been with- drawn at the end of that tax year (not re- duced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in your income in the tax year it becomes with- drawable.

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 re- quired 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. However, you must show the amount of any tax-exempt interest on your fed-
eral income tax return. For more information, see State or Local Government Obligations in chapter 1 of Publication 550.

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

Jury duty. Jury duty pay you receive must be
included in your income on Form 1040, line 21. 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 Form 1040, line 35.
Enter “Jury Pay” and the amount on the dotted
line next to line 35.

Kickbacks. You must include kickbacks, side
commissions, push money, or similar payments
you receive in your income on Form 1040, line
21, 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 refer-
ing 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 Schedule C-EZ (Form
1040) if you are self-employed) incentive pay-
ments 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 incen-
tive payments on Form 1040, line 21.

Medical savings accounts (Archer MSAs and Medicare+Choice MSAs). You generally do not include in income amounts you withdraw from your Archer 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 Sched-
ule A (Form 1040). For more information about
Archer MSAs or Medicare+Choice MSAs, see Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Note. Any reference in this publication to a Medicare+Choice MSA includes a Medicare Ad-
vantage MSA.

Moving expense reimbursements. You gen-
erally should not report these benefits on your
return. See Publication 521 for more informa-
tion.

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 Form 1040, line
21. 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 em-
ployer for good work or suggestions generally
must be included in your income as wages. How-
ever, certain noncash employee achieve-
ment 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 merchan-
dise, that are awarded by a distributor or manu-
facturer 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 accom-
plishments in religious, charitable, scientific, ar-
tistic, 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 follow-
ing requirements.

1. You were selected without any action on
your part to enter the contest or proceed-
ing.
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 des-
ignated 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 des-
ignation should contain:
   i. The purpose of the designation by
making a reference to section
74(h)(3) of the Internal Revenue
Code,
   ii. A description of the prize or award,
   iii. The name and address of the organ-
ization to receive the prize or award,
   iv. Your name, address, and taxpayer
identification number, and
   v. Your signature and the date signed.

M. In the case of an unexpected presenta-
tion, 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 de-
scribed in (b).

D. Alter the transfer, you should receive
from the payer a written response stat-
ing when and to whom the designated
amounts were transferred.

These rules do not apply to scholarship or fellow-
ship awards. See Scholarships and fellow-
ships, later.

Qualified tuition program (QTP). A qualified
 tuition program (also known as a 529 program) is
a program set up to allow you to either prepay,
or contribute to an account established for pay-
ing a student’s qualified higher education ex-
penses at an eligible educational institution.
A program can be established and maintained by
a state, an agency or instrumentality of a state,
or an eligible educational institution.

The part of a distribution representing the
amount paid or contributed to a QTP is not included in
income. This is a return of the invest-
ment in the program.

The beneficiary generally does not include
income any earnings distributed from a QTP
established and maintained by a state (or an agency or instrumentality of the state) if the total
distribution is less than or equal to adjusted
qualified higher education expenses. See Publi-
cation 970, Tax Benefits for Education, for more
information.

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.

• Tier 1 railroad retirement benefits that are
more than the social security equivalent
benefit.

• Tier 2 benefits.

• Vested dual benefits.

Rewards. If you receive a reward for providing
information, include it in your income.

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. See Publi-
cation 523.

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

Example. You sold a painting on an online
auction website for $100. You bought the paint-
ing for $20 at a garage sale years ago. Report your $80 gain as a capital gain on Schedule D (Form 1040).

Scholarships and fellowships. A candidate for
a degree can exclude amounts received as a
qualified scholarship or fellowship. A qualified

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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 whether any of your combined benefits are taxable. If you or your spouse did not receive 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 apply.

- You received a lump-sum benefit payment during the year that is for one or more earlier years.
- You exclude employer-provided adoption benefits or interest from qualified U.S. savings bonds.
- 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 909 to figure your taxable income amounts you receive from the Department of Veterans Affairs are not included in purchase price of the electricity. For information about the rules that apply to a tax-free qualified tuition reduction provided to employees and their families by an educational institution, see Publication 970.

**VA payments.** Allowances paid by the Department of Veterans Affairs are not included in your 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 income on Form 1040, line 21, whether or not you use the amounts for educational purposes.

**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, see 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, see Publication 915.

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, usually are 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.

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:

- A reduction in the purchase price of electricity furnished to you (rate reduction), or
- 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.

**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 for the year in which you repaid it. If the amount you repaid is more than $3,000, you may be able to take a credit against your tax for 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. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C or Schedule C-EZ (Form 1040). If you reported it as capital gain, deduct it as capital income on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040).

If you repaid social security or equivalent railroad retirement benefits, see Publication 915.

Repayment of $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 must...
deduct it as a miscellaneous itemized deduction, enter it on Schedule A (Form 1040), line 22.

Repayment over $3,000. If the amount you repaid was more than $3,000, you can deduct the repayment (as explained earlier under Type of deduction). However, you can choose instead 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 2004 claiming a deduction for the repaid amount. If you must deduct it as a miscellaneous itemized deduction, enter it on Schedule A (Form 1040), line 27.

Method 2. Figure your tax for 2004 claiming a credit for the repaid amount. Follow these steps,

1. Figure your tax for 2004 without deducting the repayment amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2004.
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 2004 figured without the deduction (step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim the credit for the amount figured in (4) above on Form 1040, line 69, and enter “1-R.C. 1341” next to line 69.

Example. For 2003 you filed a return and reported your income on the cash method. In 2004 you repaid $5,000 included in your 2003 income under a claim of right. Your filing status in 2004 and 2003 is single. Your income and tax for both years are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Income</th>
<th>With Income</th>
<th>Without Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$49,950</td>
<td>$44,950</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$9,231</td>
<td>$7,981</td>
<td></td>
</tr>
</tbody>
</table>

Your tax under method 1 is $7,981. Your tax under method 2 is $8,481, figured as follows:

Tax previously determined for 2003 $1,904
Less: Tax as refugured $1,154
Decrease in 2003 tax $750

Regular tax liability for 2004 $9,231
Less: Decrease in 2003 tax $750
Refugured tax for 2004 $8,481

You pay less tax using method 1, so you should take a deduction for the repayment in 2004.

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

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

Year of deduction (or credit). If you use the cash method, you can take the deduction (or credit, if applicable) for the tax year in which you actually made the repayment. If you use any other accounting method, you can deduct the repayment or claim a credit for it 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 or credit in the tax year in which the obligation for the repayment accrues.

How To Get Tax Help

You can get help with unresolved tax issues, 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.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can help clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

Free tax services. To find out what services are available, get Publication 910, IRS 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.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at www.irs.gov.

- E-file your return. Find out about commercial tax preparation and e-file services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on Where's My Refund. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

Fax. You can get over 100 of the most commonly requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. The items you request will be faxed to you.

For help with transmission problems, call 703-487-4608. Long-distance charges may apply.

Phone. Many services are available by phone.

- Ordering forms, instructions, and publications. Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040.
- Solving problems. You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
- 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 services. Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- Refund information. If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for auto-
mated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

- Services. You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.

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

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- Eastern part of U.S. and foreign addresses: Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074

CD-ROM for tax products. You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, or saved for recordkeeping.

- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $22 (no handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.
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<td>Expenses for Business Use of Your Home</td>
<td>See How To Get Tax Help for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.</td>
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<td>8863</td>
<td>Education Credits</td>
<td>See How To Get Tax Help for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.</td>
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<tr>
<td>9466</td>
<td>Installment Agreement Request</td>
<td>See How To Get Tax Help for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.</td>
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