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Taxable and Nontaxable Income

For use in preparing 2006 Returns

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What’s New for 2006

Hurricane relief provisions. The Katrina Emergency Tax Relief Act of 2005 and the Gulf Opportunity Zone Act of 2005 provide tax relief for persons affected by Hurricanes Katrina, Rita, and Wilma. Some of the provisions are covered in this publication. For information on other provisions, see Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

Elective deferrals. The limit on the amount of your wages you can elect to defer into certain retirement plans (such as section 401(k) plans) increased. If you are age 50 or older, you may be able to make additional catch-up elective

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What’s New for 2007

Income exclusion for retired public safety officer. For distributions in tax years beginning after 2006, a retired public safety officer can elect to exclude from income an eligible retirement plan distribution. The distribution must be from a governmental plan and must be transferred directly to pay the premiums for accident or health insurance or qualified long-term care insurance for the officer, his or her spouse, and dependents.

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 exempt by law. Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable may have to become certain disaster assistance, disability, and National Distribution Center payments 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 business day after your request is received.

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 business day after your request is received. A check or deposit is considered constructive receipt if you have a right, under applicable law, to the proceeds in income. See the discussion on constructive receipt.

Disaster mitigation payments under Welfare and Other Public Assistance Benefits. Nonqualified deferred compensation plans. Generally, all amounts deferred under a nonqualified deferred compensation plan for all tax years are included in gross income for the current year, unless certain requirements are met. See Nonqualified deferred compensation plans, under Employee Compensation.

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 otherwise would 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.

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.

Astronauts. You also can exclude death payments for astronauts dying in the line of duty after 2002.

Foreign income. If you are a U.S. citizen or resident alien, 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.

Disaster mitigation payments. You can exclude from income grants you use to mitigate the severity of potential damage from future natural disasters that are paid to you through state and local governments. If you reported income from qualified disaster mitigation payments in previous years, you may be able to file a claim for refund. For more information, see Effective Deferrals in the discussion on retirement plan contributions under Employee Compensation.

Employer-owned life insurance contract. If you receive life insurance proceeds from an employer-owned life insurance contract on an employee, you may have to include some or all of the proceeds in income. See the discussion under Life Insurance Proceeds.

Designated Roth contributions. Employers with certain retirement plans can create a qualified Roth contribution program so that you may elect to have part or all of your elective deferrals to the plan designated as after-tax Roth contributions. See the discussion under Elective Deferrals.
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 an employee, you are probably self-employed and must include payments for your services on Schedule C (Form 1040), Profit or Loss From Business (Form 1040), 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.

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

Bankruptcy. If, after October 16, 2005, you filed for bankruptcy under Chapter 11 of the Bankruptcy Code, you must allocate your wages and withheld income tax. Your W-2 will show your total wages and withheld income tax for the year. On your tax return, you report the wages and withheld income tax for the period before you filed for bankruptcy. Your bankruptcy estate reports the wages and withheld income tax for the period after you filed for bankruptcy. If you receive other information returns (such as Form 1099-DIV or 1099-INT) that report gross income to you, rather than to the bankruptcy estate, you must allocate that income. The only exception is for purposes of figuring your self-employment tax, if you are self-employed. For that purpose, you must take into account all your self-employment income for the year from services performed both before and after the beginning of the case.

You must file a statement with your income tax return stating that you filed a Chapter 11 bankruptcy case. The statement must show the allocation and describe the method used to make the allocation. For a sample of this statement and other information, see Notice 2006-83 on page 596 of Internal Revenue Bulletin 2006-40 at www.irs.gov/pub/irs-ibts/ibts06-40.pdf.

Miscellaneous Compensation

This section discusses many types of employee compensation, but 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. However, 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, you generally 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 disinguised pay. 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 or if more than 10% of eligible employees previously received safety achievement awards during the year.

Example. Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, 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.

Donated accrued leave. If your employer has provided a leave-based donation program to aid victims of Hurricane Katrina, you can elect to give up vacation, sick, or personal leave in exchange for cash payments your employer makes to a qualified charitable organization for the relief of those victims. Your employer must make the payments to the organizations before January 1, 2007. These payments are not included in your income and you do not get a deduction for the payments made to the organization. For more information on qualified charitable organizations, see Organizations That Qualify To Receive Deductible Contributions, in Publication 526, Charitable Contributions.

Government cost-of-living allowances. Cost-of-living allowances that are not considered income are generally not 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.

Nonqualified deferred compensation plans. Your employer will report to you the total amount of deferrals for the year under a nonqualified deferred compensation plan. This amount is shown on Form W-2, box 12. The amount code Y. This amount is not included in your income.

However, if at any time during the tax year, the plan fails to meet certain requirements, or is not operated under those requirements, all amounts deferred under the plan for the tax year and all preceding tax years are included in your income for the current year. This amount is included in your wages shown on Form W-2, box 12. It is also shown on Form W-2, box 12, using code Z.

For information on the requirements and the amount to include in income, see Internal Revenue Code section 402A. The notice is on page 274 of Internal Revenue Bulletin 2005-2 at www.irs.gov/pub/irs-ibts/ibts05-02.pdf.

Note received for services. If your employer gives you a note or other telling your services, you must include the fair market price (usually the discount value) of the note in your income for the year you receive it. If 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 compensa-
tion income when you receive them.

Severance pay. You must include in income money equal to the fair market value of you may receive a separate Form W-2 showing gross income. The shareholder-employ
ee can

right. When you use the right, you are entitled to to your other compensation on one Form W-2, or are includible in the sharehold er-employee's

ployer in income until you exercise (use) the The value of your fringe benefits may be added dered are treated as guaranteed paym ents and

Form 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 be- tween the severance pay included in income and the amount actually received) as a miscella-
neous deduction (subject to the 2% of adjusted gross income (AGI) 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 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-
pees.

An insurance company, if your employer paid for the plan.

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

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. The payment is also treated as a taxable fringe benefit. Your employer to your Archer MSA generally are

just the value of your fringe benefits in box 1 with a notation in box 14.

Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not includible in your income. Distr-

receive from the plan may be taxable, as ex-
plained, later, under Sickness and Injury

Benefits.

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

Archer MSA contributions. Contributions by your employer to your Archer MSA generally are not included in your income. Their total will be reported in box 12 of Form W-2, with code R. You must report this amount on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts. File the form with your return.

Health flexible spending arrangement (health FSA). If your employer provides a health FSA that qualifies as an accident or health plan, the amount of your salary reduction, and reimbursements of your medical care ex-

penses and those of your spouse and depen-
dents, generally are not included in your income.

Health reimbursement arrangement (HRA). If your employer provides an HRA that qualifies as an accident or health plan, coverage and reimbursements of your medical care expenses and those of your spouse and dependents gen-

erally are not included in your income.

See also Reimbursement for medical care under Other Sickness and Injury Benefits, later.

Health savings accounts (HSA). If you are an eligible individual, you and any other person, including your employer or a family member, can make contributions to your HSA. Contribu-
tions, other than employer contributions, are de-
deductible on your return whether or not you itemize deductions. Contributions made by your employer to your Archer MSA generally are

distributed from your HSA that are used to pay qualified medical expenses are not included in your income. Distributions not used for qualified medical expenses are included in your income. See Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans, for more information.

Contributions by a partnership to a bona fide partner's HSA are not contributions by an em-

ploys. The contributions are treated as a distri-

bution of money and are not included in the partner's gross income. Contributions by a part-

ership to a partner’s HSA for services rendered are treated as guaranteed payments that are includible in the partner's gross income. In both situations, the partner can deduct the contribu-

tion made to the partner's HSA.

Contributions by an S corporation to a 2% shareholder-employee's HSA for services ren-
dered are treated as guaranteed payments and are includible in the shareholder-employee's gross income. The shareholder-employee can
deduct the contribution made to the share
holder-employee’s HSA.

Adoption Assistance
You may be able to exclude from your income amounts paid or expenses incurred by your em-
ployer for qualified adoption expenses in con-
nection with your adoption of an eligible child. See Instructions for Form 8839 (Qualified Adoption Expenses) for more information.

Adoption benefits are reported by your em-
ployer in box 12 of Form W-2 with code T. They also are included as social security and Medi-
care wages in boxes 3 and 5. However, they are not included as wages in box 1. To determine the taxable and nontaxable amounts, you must complete Part III of Form 8839, Qualified Adoption Expenses. File the form with your return.

Athletic Facilities
If your employer provides you with the free or
low-cost use of an employer-operated gym or
other athletic club on your employer’s premises, the value is not included in your compensation. The gym must be used primarily by employees, their spouses, and their dependent children.

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

De Minimis (Minimal) Benefits
If your employer provides 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
thank you, ham, or other item of nominal value at
Christmas or other holidays, do not include the
value of the gift in your income. However, if your employer gives you cash, a gift certificate, or a similar item that you easily can 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, and
• 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-
rately).

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 as-
sitance. For more information, see Publication
870.

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 invest-
ment (such as stocks or bonds).

The exclusion is limited to the price charged nonemployee customers multiplied by the fol-
lowing percentage.

• For a discount on property, your em-
ployer’s gross profit percentage (gross
profit divided by gross sales) on all prop-
erty sold during the employer’s previous
tax year. (Ask your employer for this per-
centage.)
• 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 de-
ducted on Schedule A (Form 1040) as a miscel-
naneous deduction (subject to the 2% of AGI limit).

Qualified retirement planning services paid for
you by your employer may be excluded from
your income. For more information, see Retire-
ment 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 in-
come is reported as part of wages in box 1 of your Form W-2. It is also shown separately in
box 12 with code C.

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

• Provides a general death benefit,
• Is provided to a group of employees,
• Is provided under a policy carried by the
employer, and
• Provides an amount of insurance to each
employee based on a formula that pre-
vents individual selection.

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

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

Former employer. If your former employer provided more than $50,000 of group-term life insurance coverage during the year, the amount included in your income is reported as wages in box 1 of Form W-2. Also, it is shown separately in box 12 with code C. Box 12 also will show the amount of uncollected social security and Medi-
care 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 63, Form 1040, and enter “UT,” and the amount of the taxes on the dotted line next to line 63.

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 re-
ported 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

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Premiums Paid per Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 through 29</td>
<td>$4.15</td>
</tr>
<tr>
<td>30 through 34</td>
<td>$6.90</td>
</tr>
<tr>
<td>35 through 39</td>
<td>$9.00</td>
</tr>
<tr>
<td>40 through 44</td>
<td>$10.00</td>
</tr>
<tr>
<td>45 through 49</td>
<td>$15.00</td>
</tr>
<tr>
<td>50 through 54</td>
<td>$23.00</td>
</tr>
<tr>
<td>55 through 59</td>
<td>$43.00</td>
</tr>
<tr>
<td>60 through 64</td>
<td>$66.00</td>
</tr>
<tr>
<td>65 through 69</td>
<td>$127.00</td>
</tr>
<tr>
<td>70 and older</td>
<td>$206.00</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 A group plan. You figure the amount to include in your income as follows.

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. .30
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 you paid the premiums .... 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. Neither employer provided over $50,000 insurance coverage, so the wages shown on your Forms W-2 do not include any part of that $33. You must add it to the wages shown on your Forms W-2 and include the total on your return.

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

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

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

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 25</td>
<td>$8.05</td>
</tr>
<tr>
<td>25 through 29</td>
<td>$4.15</td>
</tr>
<tr>
<td>30 through 34</td>
<td>$6.90</td>
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<td>35 through 39</td>
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<td>55 through 59</td>
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<tr>
<td>60 through 64</td>
<td>$66.00</td>
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<tr>
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<td>70 and older</td>
<td>$206.00</td>
</tr>
</tbody>
</table>

The total amount to include in income for the cost of excess group-term life insurance is $33. Neither employer provided over $50,000 insurance coverage, so the wages shown on your Forms W-2 do not include any part of that $33. You must add it to the wages shown on your Forms W-2 and include the total on your return.

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

Meals and Lodging

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

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

You also do not include in your income the value of meals or meal money that qualifies as a de minimis fringe benefit. See De Minimis (Minimal) Benefits, earlier.

Lodging for employees affected by Hurricane Katrina. If your employer provides in-kind lodging to you (or your spouse or dependents), you may be able to exclude from income part or all of the value of this lodging. The exclusion is equal to the value of lodging furnished from January through June 2006, up to a maximum value of $600 per month.

You can exclude this value only if you had your main home in the Gulf Opportunity Zone on August 28, 2005, and you perform substantially
all your work in the Gulf Opportunity Zone for the employer furnishing the lodging. You cannot be a dependent of, or related to, your employer. For information on the Gulf Opportunity Zone, see Publication 4492.

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

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

• Its principal purpose or function is to provide medical or hospital care or medical education;

• It receives payments for graduate medical education under the Social Security Act.

• One of its principal purposes or functions is to provide and teach basic and clinical medical science and research using its own faculty.

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

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

• 5% of the appraised value of the lodging, or

• The average of rentals paid by individuals (other than employees or students) for comparable lodging held for rent by the educational institution.

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

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 information about how the plan may fit into your overall individual retirement income plan. You cannot exclude the value of any tax preparation, accounting, legal, or brokerage services provided by your employer. Also, see Financial Counseling Fees, earlier.

Transportation

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

• Transportation in a commuter highway vehicle (such as a van) between your home and work place.

• A transit pass, or

• Qualified parking.

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

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than a total of $105 a month.

The exclusion for the qualified parking fringe benefit cannot be more than $205 a month. If the benefits have a value that is more than these limits, the excess must be included in your income.

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

• For transporting employees between their homes and work place, and

• On trips during which employees occupy at least half of the vehicle’s adult seating capacity (not including the driver).

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

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

Tuition Reduction

You can exclude a qualified tuition reduction from your income. This is the amount of a reduction in tuition:

• For education (below graduate level) furnished by an educational institution to an employee, 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 under 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 rule or under the special valuation rules. For the special rules, 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. The amount, if any, 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 employer 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 rule 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.

Retirement Plan Contributions

Your employer’s contributions to a qualified retirement plan for which you have 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 until it is transferable or no longer subject to a substantial risk of forfeiture.

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:

• SEP's (SARSEPs), see Salary Reduction Simplified Employee Pension in Publication 560, Retirement Plans for Small Business.
• SIMPLE plans, see How Much Can Be Contributed on Your Behalf in chapter 3 of Publication 590, Individual Retirement Arrangements (IRAs).
• Section 401(k) plans, see Limit for deferrals under section 401(k) 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 $10,000 in 2006. Amounts you defer under a SIMPLE plan count toward the overall limit ($15,000 for 2006) and may affect the amount you can defer under other elective deferral plans.

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 2006 generally is $15,000. 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.
Limit for deferral under section 501(c)(18) plans. If you are a participant in a section 501(c)(18) plan (a trust created before June 26, 1959, funded only by employee contributions), you should have deferred no more than the lesser of $7,000 or 25% of your compensation.

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 orga-
nizations), you should have deferred no more than the lesser of your includible compensation or $15,000. However, if you are within 3 years of normal retirement age, you may be allowed an increased limit if the plan allows it. See In-
creased 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 all the following payments.

1. Wages and salaries.
2. Fees for professional services.
3. The value of any employer-provided quali-
fied transportation fringe benefit (defined under Transportation, earlier) that is not included in your income.
4. Other amounts received (cash or noncash) for personal services you performed, in-
cluding, but not limited to, the following items.
   a. Commissions and tips.
   b. Fringe benefits.
   c. Bonuses.
5. Employer contributions (elective deferrals) to:
   a. The section 457 plan.
   b. Qualified cash or deferred arrange-
ments (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 em-
ployees (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 se-
curity withholding (including elective def-
errals).

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 calendar year.
   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 $15,000, plus $5,000. However, if you are within 3 years of retirement age and your plan provides the in-
creased limit earlier, that limit may be higher.

Designated Roth contributions. Employers with section 401(k) and section 403(b) plans can create qualified Roth contribution programs so that you may elect to have part or all of your elective deferrals to the plan designated as af-
ter-tax Roth contributions. Designated Roth contributions are treated as elective deferrals, except that they are included in income. Your retirement plan must maintain separate ac-
counts and recordkeeping for the designated Roth contributions.

Qualified distributions from a Roth plan are not included in income. Generally, a distribution made before the end of the 5-tax-year period beginning with the first tax year for which you made a designated Roth contribution to the plan is not a qualified distribution.

Reporting by employer. Your employer gen-
erally 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 box 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 included 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 36. Enter the amount and “501(c)(18)(D)” on the dotted line next to line 36.

Designated Roth contributions. These contributions are elective deferrals but are in-
cluded in your wages in box 1 of Form W-2.

Designated Roth contributions to a section 401(k) plan are reported using code AA in box 12, or, for section 403(b) plans, code BB in box 12.

Excess deferrals. If your deferrals exceed the limit, you must notify your plan by the date re-
quired by the plan. If the plan permits, the ex-
cess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of all 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. The plan then must pay you the amount of the ex-
cess, along with any income earned on that amount, by April 17, 2006. You also must add it to your wages on your 2006 income tax return. Do not use Form 1040A or Form 1040EZ to report ex-
cess deferral amounts.

Excess not distributed. If you do not take out the excess amount, you cannot include it in the cost of the contract even though you in-
cluded it in your income. Therefore, you are taxed twice on the excess deferral return in the plan—once when you contribute it, and again when you receive it as a distribution.

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 proportion-
ately 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 2006.

• If the distribution was for a 2006 excess deferral, your Form 1099-R should have the code “B” in box 7. Add the excess deferral amount to your wages on your 2006 tax return.
• If the distribution was for a 2006 excess deferral to a designated Roth account, your Form 1099-R should have code “B” in box 7. Do not add this amount to your wages on your 2006 return.
• If the distribution was for a 2005 excess deferral, your Form 1099-R should have the code “P” in box 7. If you did not add the excess deferral amount to your wages on your 2005 tax return, you must file an amended return on Form 1040X, Amended U.S. Individual Income Tax Re-
turn. If you did not receive the distribution by April 17, 2006, you must add it to your wages on your 2006 tax return.
• If the distribution was for a 2004 excess deferral, your Form 1099-R should have the code “D” in box 7. If you did not add the excess deferral amount to your wages on your 2004 tax return, you must file an amended return on Form 1040X. You also must add it to your wages on your 2006 income tax return.
• If the distribution was for the income earned on an excess deferral, your Form 1099-R should have the code “B” in box 7. Add the income amount to your wages on your 2006 income tax return, regardless of when the excess deferral was made.
Excess Annual Additions

The amount contributed in 2006 to a defined contribution plan is generally limited to the lesser of 100% of your compensation or $14,000. Under certain circumstances, contributions 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 additions 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 have excess contributions, you should receive a separate Form 1099-R for the year of the payment 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.

Option with readily determined value. If you receive a nonstatutory stock option that has a readily determined fair market value at the time it is granted to you, the option is treated like other property received as compensation. See Restricted Property, 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 exercise or transfer the option.

Exercise. 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.

Transfer in arm's-length transaction. If you transfer this kind of option in an arm's-length transaction to an unrelated person, you must include in your income the money or other property you received for the transfer, as if you had exercised the option.

Transfer in non-arm's-length transaction. If you transfer this kind of option in a non-arm's-length transaction (for example, a gift), the option is not treated as exercised or closed at that time. You must include in your income, as compensation, any money or property received. When the transferee exercises the option, you must include in your income, as compensation, the excess of the fair market value of the stock acquired by the transferee over the sum of the exercise price paid and any amount you included in income at the time you transferred the option. At the time of the exercise, the transferee recognizes no income and has a basis in the stock acquired equal to the fair market value of the stock.

The option privilege for an option to buy is the opportunity to benefit during the option’s exercise period from any increase in the value of property subject to the option without risking any capital. For example, if during the exercise period the fair market value of stock subject to an option is greater than the option’s exercise price, a profit may be realized by exercising the option and immediately selling the stock at its higher value. The option privilege for an option to sell is the opportunity to benefit during the exercise period of a decrease in the value of the property subject to the option.
Any transfer of this kind of option to a related person after July 1, 2003, is treated as a non-arm’s-length transaction. See Regulations section 1.83-7 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 your 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 be nontransferable except at death. If you do not meet the employment requirements, or you receive a transferable option, your option is a nonstatutory stock option. See Nonstatutory Stock Options, earlier in this discussion.

If 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 the stock. If you later sell the stock for a price in excess of the stock (the option price) and the amount you received when you sell the stock, you have a capital gain and the amount you later sell the stock is a capital loss.

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

Incentive stock options (ISOs). If you sell stock acquired by exercising an ISO and meet the holding period requirement, your gain or loss from the sale is capital gain or loss.

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

Example. Your employer, X Corporation, granted you an ISO on March 11, 2004, to buy 100 shares of X Corporation stock at $10 a share, its fair market value at the time. You exercised the option on January 14, 2005, when the stock was selling on the open market for $12 a share. On January 24, 2006, you sold the stock for $15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 2006, you must report the difference between the option price ($10) and the value of the stock when you exercised the option ($12) as wages. The rest of your gain is capital gain, figured as follows:

| Selling price ($15 × 100 shares) | $1,500 |
| Purchase price ($10 × 100 shares) | $1,000 |
| Gain | $500 |
| Amount reported as wages ($12 × 100 shares $1,000) | $200 |
| Amount reported as capital gain | $300 |

Alternative minimum tax (AMT). For the AMT, you must treat stock acquired through the exercise of an ISO as if no special treatment applied. This means that, when your rights in the stock are transferable or no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price. Enter this adjustment on line 13 of Form 6251, Alternative Minimum Tax—Individuals.

Increase your AMT basis in any stock you acquire by exercising the ISO by the amount of the adjustment. However, no adjustment is required if you exercise the option in the same year you exercise the option. 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 18, 2006, when the stock was selling on the open market for $14 a share, your rights to the stock first became transferable. You include $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 your 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, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Y Corporation for $20 a share at a time when the stock had a value of $22 a share. Eighteen months later, when the value of the stock was $23 a share, you exercised the option, and 14 months after that you sold your stock for $30 a share. In the year of sale, you must report as 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 ($22 × 100 shares $2,000) | $200 |
| 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:
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 as 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 in the year 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 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 nonstatutory stock option.

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

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

• 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 also are reported on a Form 1099-DIV, Dividends and Distributions, you should list them on Schedule B (Form 1040) or Schedule 1 (Form 1040A), Interest and Ordinary Dividends for Form 1040A Filers, with a statement that you have included them as wages. Do not include them in the total dividends received.

Stock you chose to include in your income. Dividends you receive on restricted stock you chose to include in your income in the year you transferred and that is not substantially vested. 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 is not considered an arm’s-length transaction. See Regulations section 1.83-7 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 2003, you paid your employer $50 for a share of stock that had a fair market value of $100 and was subject to forfeiture until 2006. In 2005, 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 2006, when the stock had a fair market value of $120, it became substantially vested. For 2006, you must report additional compensation of $60, figured as follows:

- Fair market value of stock at time of vesting: $120
- Minus: Amount paid for stock: $50
- Minus: Compensation previously included in income from sale to spouse: $0
- Additional income: $60
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 income in respect of a decedent and is taxed according to the rules for restricted property received for services. For information about income in respect of a decedent, see Publication 559.

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.

Clergy

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you. If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. See Publication 526. Also, see Members of Religious Orders, later.

Pension.

A pension or retirement pay for a member of the clergy usually is treated as any other pension or annuity. However, 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 pay 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 a charitable contribution deduction for the amount paid to the organization. See Publication 526. Also, see Members of Religious Orders, later.

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 an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your 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 as an employee of 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 they meet both of the following requirements:

- They are the kind of services that are ordinarily done by 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 employee of the school, and, at his request, the school made the salary payments directly to the order. Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his income.

Example 2. Gene Dennis is a member of a religious order who, as a condition of membership, has taken vows of poverty and obedience. All claims to his earnings are renounced. Gene received permission from the order to establish a private practice as a psychologist and counsel 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 accomplished.

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 provided by the order. The income Gene earns as a psychologist is earned in his individual capacity. Gene must include in his income the earnings from his private practice.

Foreign Employer

Special rules apply if you work for a foreign employer.

U.S. citizen.

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

Social security and Medicare taxes.

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

Employees of international organizations or foreign governments.

Your compensation for official services to an international organization is exempt from federal income tax if you are 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 income 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 employees of the United States in foreign countries.
- The foreign government gives an equal exemption 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 international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, any salary you receive after the date you file the waiver is not exempt under this rule. However, it may be exempt under a treaty or agreement. See Publication 519, U.S. Tax Guide for Aliens, for more information about treaties.

Nonwage income.

This exemption applies only to employees of an international organization.

Pensions and other income do not qualify for this exemption.

Employment abroad.

For information on the tax treatment 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 a pension. Allowances generally are not taxed. For more information on the tax treatment of military allowances 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 reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman’s Family Protection Plan or the Survivor Benefit Plan. For more detailed discussion of survivor annuities, see Publication 757.

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

Veterans' benefits. Do not include in your income any veterans’ benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans’ insurance proceeds and dividends left on deposit with the VA.
- Annuities, see Publication 575.
- Life insurance proceeds, see Publication 334.
- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the Armed Forces who died after September 10, 2001.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA’s therapeutically or rehabilitative programs are not treated as nontaxable veterans’ benefits. Report these payments as income on Form 1040, line 21.

Volunteers

The tax treatment of amounts you receive as a volunteer is covered in the following discussions.

Mileage reimbursements to charitable volunteers providing relief relating to Hurricane Katrina. You can exclude from income amounts you receive as mileage reimbursements from qualified charitable organizations.

Rents From Personal Property

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

- 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 type 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 your tax return.
Form 1040, line 36. Also, enter the amount and "PPR" on the dotted line next to line 36.

If you do not rent personal property for profit, your deductions are limited and you cannot re-
port a loss to offset other income. See Acti-
vely not for profit under Other Income in the discus-
sion 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, inventor, 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 treated as ordinary income for the year you receive your work over a specified period of time. Roy-
ties 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 ex-
tracted 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 eco-
nomic 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 9 of Publication 535.

Coal and iron ore. Under certain circum-
stances, you can treat amounts you receive from the disposal of coal and iron ore as pay-
ments 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 is subject to capital gain or loss treatment 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 allow-
ance.

Part of future production sold. If you own mineral property but sell part of the future pro-
duction for a predetermined price, you re-
ceive 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 produc-
tion 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.

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

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

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 result of the partner-
ship’s operations for its tax year and the items of income, losses, deduc-
tions, or credits that affect the shareholders’ individual income tax return.

Schedule K-1 (Form 1065). You should receive from the S corporation in which you are a shareholder a copy of Schedule K-1 (Form 1065), Shareholder’s Share of Income. Deduc-
tions, Credits, etc., showing your share of in-
come, 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 sep-
arately on your Form 1040. The characterization 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 dis-
tributions 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 distri-
butions 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 sick-
ness 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 paid to reimburse you 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 you receive from the plan for personal injury or sickness as income on your tax return. If your plan reimbursed you for medical ex-
penses you deducted in an earlier year, you may have to include some, or all, of the reimburse-
ment in your income. See Recoveries under Miscellaneous Income, later.

Cafeteria plans. Generally, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insur-
ance premiums was not included in your in-
come, you are not considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are
considered to have paid the premiums and any benefits you receive are not taxable.

**Disability Pensions**

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

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

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A. For more information on pensions and annuities, see Publication 575.

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

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

**Military and Government Disability Pensions**

Certain military and government disability pensions are not taxable.

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

- 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 government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
3. You receive the disability payments for a combat-related injury. This is a personal injury or sickness that:
   a. Results directly from armed conflict,
   b. Takes place while you are engaged in extra-hazardous service,
   c. Takes place under conditions simulating war, including training exercises that are otherwise (for the cost of qualified long-term care services during the period from the larger of the earlier) for the cost of qualified long-term care services.
   d. Is caused by an instrumentality of war.
4. You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it. Your exclusion under this condition is equal to the amount you would be entitled to receive from the VA.

**Pension based on years of service.** If you receive a disability pension based on years of service, you generally must include it in your income. However, if the pension qualifies for the exclusion for a service-connected disability (discussed 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 pension in your income.

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

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, include 100% of the severance benefit from your income. However, you must include in your income any lump-sum reemployment or other nondisability severance payment you received on release from active duty, even if you are later given a retroactive disability rating by the VA.

**Terrorist attack or military action.** Do not include in your income disability payments you receive for injuries resulting directly from a terrorist or military action.

**Necessary non-service-connected payments.** If you receive necessary non-service-connected payments for qualified long-term care services, include the payments in your income. The payments are treated as accident and health insurance proceeds and are not taxable. Under this limit, the excluded 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 type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
If part of the payments you receive under FECA reduces your social security (or equivalent railroad retirement) benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For a discussion of the taxability of these benefits, see 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% of AGI limit on Schedule A (Form 1040). If you buy back sick leave in the same year you receive the amount reduces your taxable sick leave pay. Do not deduct it separately.

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

• Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See Court awards and damages under 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 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 Recoveries, later. 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.

Amounts you receive under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits are included in your income. Reimbursements received under your employer’s plan of the amount paid for nonprescription 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 you received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Generally, you report this income on Schedule C or Schedule C-EZ (Form 1040). 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 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 to the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan. If your financial institution cancels or forgives a debt you owe of $600 or more, you will receive a Form 1099-C, Cancelled Debt.

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

TIP

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

Canceled Debts

Generally, if a debt you owe is canceled or forgiven, obtained 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 intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold. If the debt is a nonbusiness debt, report the canceled amount on 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 canceled debt is deductible if you paid it. See Deductible Debt under Exceptions, later.

If the interest would not be deductible (such as 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 to the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

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 Excluded debt, 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 repossession), the 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, to the canceled debt is a constructive distribution that is generally dividend income to you. For more information, see Publication 542, Corporations.

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

Repayment of canceled debt. If you included a canceled amount in your income and later pay the debt, you may be entitled to a refund for the year the amount was included in income. You can file a claim on Form 1040X if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

Exceptions

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

Debt canceled as a result of Hurricane Katrina. If you qualify, you can exclude from income the amount of a canceled nonbusiness debt. The debt must be canceled by an applicable entity after August 24, 2005, and before January 1, 2007. You qualify for this relief if your main home was located:

- In the core disaster area, or
- In the Hurricane Katrina disaster area (but outside the core disaster area) and you suffered losses that was caused by Hurricane Katrina.

For a definition of Hurricane Katrina disaster area and the core disaster area, see Publication 1492.

This exclusion does not apply to a canceled debt to the extent that real property, which was security for the debt, is located outside of the Hurricane Katrina disaster area.

Applicable entity. The term applicable entity means an executive, judicial, or legislative agency and an applicable financial entity as defined in Internal Revenue Code section 6050P(c).

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

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

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

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

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

A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.
2. Under the loan regime, the non-owner of you are the policyholder of an employer-owned the life insurance contract is received that the contract for helping a direct seller make sales. You must are more than the premiums and any other

Debt in your gross income in the following situa-
tions.

Do not include a canceled $4,500 for an entire year), is interest income to 1040 or on lines 12a and 12b of Form 1040A.

Excluded debt.

The cancellation is intended as a gift. protection and other taxable economic can continue to take the exclusion.

The debt is qualified real property busi-

Debt is canceled when you are insol-

The debt is canceled in a bankruptcy case under an insurance contract, you are entitled to erated Death Benefits,

Fostering national or international amateur sports competition (but only if none of the for giving the party.

For more information about the 50% limit for meal and entertainment expenses, see 50% Limit in Publication 463.

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 held by the insurance company (generally 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.

Employer-owned life insurance contract. If you are the policyholder of an employer-owned life insurance contract, you must include in in-

come any life insurance proceeds received that are more than the premiums and any other amounts you paid on the policy. You are subject to this rule if you have a trade or business, you own a life insurance contract on the life of your

employee, and you (or a related person) are a beneficiary under the contract.

However, you may exclude the full amount of the life insurance proceeds if the following apply.

1. You provided written notice about the in-
surance to the employee and the em-
ployee agreed to be insured.

2. Either:

a. The employee was your employee within the 12-month period before death, or, at the time the contract was issued, was a director or highly com-

   pensated employee, or

b. The amount is paid to the family or des-

   ignated beneficiary of the employee.

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

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 the installments.

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 unexpired 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 Accel-
erated 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 or 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.

Host or Hostess

If you host a party at which sales are made, any
gift you receive for giving the party is a payment for helping a direct seller make sales. You must report it as income at its fair market value.

Your out-of-pocket party expenses are sub-
ject to the 50% limit for meal and entertainment expenses. These expenses are deductible as miscellaneous itemized deductions subject to the 2% of AGI limit on Schedule A (Form 1040), but only up to the amount of income you receive for giving the party.

For more information about the 50% limit for meal and entertainment expenses, see 50% Limit in Publication 463.

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.

Education loan repayment assistance. 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 eligi-
ble 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.

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.

• 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.

Publication 525 (2006)
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 designated 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 are treated as a series of payments on a per diem or other periodic basis, the proceeds are more than the cost of the policy, and the payments 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 benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. 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 terminally or chronically ill and who meets the requirements 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 or chronically 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, 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 paid and any periodic payments received from a long-term care insurance contract. 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, or
• 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) to deduct for 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 tax refund. If you received a state or local income tax refund (or credit or offset) in 2006, you generally must include it in income if you deducted the tax in an earlier year. The payer should send Form 1099-G, Certain Government Payments, to you by January 31, 2007. The IRS also will receive a copy of the Form 1099-G. Use the worksheet in the 2006 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income. See Itemized Deduction Recoveries, later, for when you must use Worksheet 2 on page 22 of this publication.

After 2003, you could choose to deduct for a tax year either:
• State and local income taxes, or
• State and local general sales taxes.

For 2006, the maximum refund that you may have to include in income is limited to the excess of the tax you chose to deduct for that year over the tax you did not choose to deduct for that year.

Example 1. For 2005 you can choose an $11,000 state income tax deduction or a $10,000 state general sales tax deduction. You choose to deduct the state income tax. In 2006, you receive a $2,500 state income tax refund. The maximum refund that you may have to include in income is $2,500, since it is less than the excess of the tax deducted ($11,000) over the tax you did not choose to deduct ($11,200 - $1,500 = $9,700). Since you earned the $11,000 state income tax, you do not include the state income tax refund in income.

Mortgage interest refund. If you received a refund or credit in 2006 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 2006. 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 over thetfedera1 rate 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.

Example. You paid 2005 estimated state income tax of $4,000 in four equal payments. You made your fourth payment in January 2006. You had no state income tax withheld during 2006. In 2006, you received a $400 tax refund based on your 2005 state income tax return. You claimed itemized deductions each year on your federal income tax returns. You must allocate the $400 refund between 2005 and 2006, 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 2005, so 75% of the $400 refund, or $300, is for amounts you paid in 2005 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 2006, 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 2006 estimated tax payment. When you figure your deduction for state and local income taxes paid during 2006, you will reduce the $1,000 paid in January by $100. Your deduction for state and local income taxes paid during 2006 will include the January net amount of $900 ($1,000 - $100), plus any estimated state income taxes paid in 2005 and 2006, and any state income tax withheld during 2006.
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 2005 federal income tax return. In 2006 you received a refund of your 2005 state income tax. Do not report any of the refund as income because you did not itemize deductions for 2005.

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 recoveries are state or local income taxes paid in 2005. Instead, use the worksheet in the 2006 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 are true:

1. The recovery is for a tax year other than 2005.
2. The recovery is for a deducted item other than state or local income taxes, such as a general sales tax or real property tax refund.
3. On your 2005 Form 1040, line 42 was more than line 41.
4. You received a refund of state and local income taxes in 2006 that was more than the excess of your 2005 state and local income tax deduction over the amount you could have deducted for your 2005 state and local general sales tax.
5. You made your last payment of 2005 state or local estimated tax in 2006.
7. You could not deduct all your tax credits for 2005 because their total was more than the amount of tax shown on your 2005 Form 1040, line 46.
8. You could be claimed as a dependent by someone else in 2005.
9. You had to use the Itemized Deductions Worksheet in the 2005 Schedule A instructions because your 2005 adjusted gross income was over $145,950 ($72,975 if married filing separately) and both of the following apply:
   a. You could not deduct all of the amount on the 2005 Itemized Deductions Worksheet.
   b. The amount on line 8 of that 2005 worksheet would be more than the amount on line 4 of that worksheet if the amount on line 4 were reduced by 80% of the refund you received in 2006.

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,")
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 itemized 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.

State tax refund. In addition to the previous six items, you must include in your income the full amount of a refund of state or local income tax or general sales tax if the excess of the tax you deducted over the tax you did not deduct is more than the refund of the tax deducted.

If the refund is more than the excess, 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 2005, you filed a joint return. Your taxable income was $60,000 and you were not entitled to any tax credits. Your standard deduction was $10,000, and you had itemized deductions of $11,000. In 2006, you received

the following recoveries for amounts deducted on your 2005 return:

- Medical expenses .................. $200
- State and local income tax refund .... $400
- Refund of mortgage interest .......... $35
- Total recoveries .................. $955

None of the recoveries were more than the deductions taken for 2005. The difference between the state and local income tax you deducted and your local general sales tax was more than $400.

Your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($11,000 − $10,000 − $1,000), so you must include your total recoveries in your income for 2006. 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. You also can use Worksheet 2 to determine the part of a state tax refund (discussed earlier) to include in income.

Allocating the included part. If you are not required to include all of your recoveries in your income, and you have both a state income tax refund and other itemized deduction recoveries, you must allocate the taxable recoveries between the state income tax refund you report on Form 1040, line 10, and the amount you report as other income on Form 1040, line 21. If you do not use Worksheet 2, make the allocation as follows:

1. Divide your state income tax refund by the total of all your itemized deduction recoveries.
2. Multiply the amount of taxable recoveries by the percentage in (1). This is the amount you report as a state income tax refund.
3. Subtract the result in (2) above from the amount of your taxable recoveries. This is the amount you report as other income.

Example. In 2006 you recovered $2,500 of your 2005 itemized deductions, but the recoveries you must include in your 2006 income are only $1,500. Of the $2,500 you recovered, $500 was due to your state income tax refund. Your state income tax was more than your state general sales tax by $600. The amount you report as a state tax refund on Form 1040, line 10, is $300 ($500 − $2,500) × $1,500. The balance of the taxable recoveries, $1,200, is reported as other income on Form 1040, line 21.
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 2006 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 2005 and a casualty loss reimbursement from 2004, 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 credit1 ....................................... 1.
2. Enter the total of all other Schedule A refunds or reimbursements (excluding the amount you entered on line 1)2 .................................. 2.
3. Add lines 1 and 2 ........................................................ 3.
4. Itemized deductions for the prior year (for example, line 28 of Schedule A for 2005) ................................. 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 year3 (for example, line 43, Form 1040 for 2005) ................................................ 1 0.

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 B from the amount on line 11. Enter the result here and on line 21, Form 1040 ................................. C.

Do not enter more than the amount deducted for the prior year. Do not enter more than the excess of your state and local income tax deduction over your state and local general sales taxes you could have deducted.

If taxable income is a negative amount (for example, line 42 was more than line 41 on your 2005 Form 1040), 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.

\[^{1}\text{Do not enter more than the amount deducted for the prior year. Do not enter more than the excess of your state and local income tax deduction over your state and local general sales taxes you could have deducted.}\]

\[^{2}\text{Do not enter more than the amount deducted for the prior year. If you deducted state and local general sales taxes and received a refund of those taxes, include the amount on line 2, but do not enter more than the excess of your sales tax deduction over your state and local income tax you could have deducted.}\]

\[^{3}\text{For example, $700 + ($400) = $300.}\]
Standard deduction limit. You generally are allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the lesser of:

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

Standard deduction for earlier years. To determine if amounts recovered in 2006 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. The standard deduction tables for 2005, 2004, and 2003 are shown in Tables 2, 3, and 4. If you need the standard deduction amounts for years before 2005, see the copy of your return for that year.

Example. You filed a joint return for 2005 with taxable income of $45,000. Your itemized deductions were $10,350. The standard deduction that you could have claimed was $10,000. In 2006, you recovered $2,100 of your 2005 itemized deductions. None of the recoveries were more than the actual deductions for 2005. Include $350 of the recoveries in your 2006 income. This is the smaller of your recoveries ($2,100) or the amount by which your itemized deductions were more than the standard deduction ($10,350 – $10,000 = $350).

Negative taxable income. If your taxable income was a negative amount, reduce the recovery you must otherwise include in your income by the negative amount. For example, line 42 was more than line 41 on your 2005 Form 1040.

Example. The facts are the same as in the previous example except line 42 was $200 more than line 41 on your 2005 Form 1040 giving you a negative taxable income of $200. You must include $150 in your 2006 income, rather than $350.

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

Table 2. 2005 Standard Deduction Tables

<table>
<thead>
<tr>
<th>Table I. Standard Deduction Chart for Most People*</th>
</tr>
</thead>
<tbody>
<tr>
<td>IF your filing status is . . .</td>
</tr>
<tr>
<td>---------------------------------</td>
</tr>
<tr>
<td>Single or Married filing separately</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
</tr>
<tr>
<td>Head of household</td>
</tr>
</tbody>
</table>

* DO NOT use this chart if you were born before January 2, 1941, or you are 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 Who Were Born Before January 2, 1941, or Were Blind*

<table>
<thead>
<tr>
<th>Table II. Standard Deduction Chart for People Who Were Born Before January 2, 1941, or Were Blind*</th>
</tr>
</thead>
<tbody>
<tr>
<td>IF your filing status is . . .</td>
</tr>
<tr>
<td>---------------------------------</td>
</tr>
<tr>
<td>Single</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
</tr>
<tr>
<td>Married filing separate return</td>
</tr>
<tr>
<td>Head of household</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>Table III. Standard Deduction Worksheet for Dependents*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter the amount shown below for your filing status.</td>
</tr>
<tr>
<td>THEN your standard deduction is . . .</td>
</tr>
<tr>
<td>Single</td>
</tr>
<tr>
<td>Married filing jointly or Qualifying widow(er) with dependent child</td>
</tr>
<tr>
<td>Married filing separate return</td>
</tr>
<tr>
<td>Head of household</td>
</tr>
</tbody>
</table>

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

Table 3. 2004 Standard Deduction Tables

Table I. Standard Deduction Chart for Most People*

<table>
<thead>
<tr>
<th>IF your filing status is . . .</th>
<th>THEN your standard deduction is . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or Married filing separately</td>
<td>$4,850</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>9,700</td>
</tr>
<tr>
<td>Head of household</td>
<td>7,150</td>
</tr>
</tbody>
</table>

* DO NOT use this chart if you were born before January 2, 1940, or you are 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 Who Were Born Before January 2, 1940, or Were Blind*

Check the correct number of boxes below. Then go to the chart.

You Born before January 2, 1940
Your spouse, if claiming spouse's exemption Born before January 2, 1940

Total number of boxes you checked

<table>
<thead>
<tr>
<th>IF your filing status is . . .</th>
<th>AND the number on the line above is . . .</th>
<th>THEN your standard deduction is . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>1</td>
<td>$8,050</td>
</tr>
<tr>
<td>2</td>
<td>7,250</td>
<td></td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>1</td>
<td>10,650</td>
</tr>
<tr>
<td>2</td>
<td>11,600</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>12,550</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>13,500</td>
<td></td>
</tr>
<tr>
<td>Married filing separate return</td>
<td>1</td>
<td>5,800</td>
</tr>
<tr>
<td>2</td>
<td>6,750</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>7,700</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>8,650</td>
<td></td>
</tr>
<tr>
<td>Head of household</td>
<td>1</td>
<td>8,350</td>
</tr>
<tr>
<td>2</td>
<td>9,550</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), use Table III instead.

Table III. Standard Deduction Worksheet for Dependents*

If you were born before January 2, 1940, or you were blind, check the correct number of boxes below. Then go to the worksheet.

You Born before January 2, 1940
Your spouse, if claiming spouse's exemption Born before January 2, 1940

Total number of boxes you checked

1. Enter your earned income (defined below). If none, enter -0-. 1.
2. Additional amount 2. $250
3. Add lines 1 and 2 3.
4. Minimum standard deduction 4. $600
5. Enter the larger of line 3 or line 4 5.
6. Enter the amount shown below for your filing status.
   * Single or Married filing separately — $4,850
   * Married filing jointly or Qualifying widow(er) with dependent child — $9,700
   * Head of household — $7,150
7. Standard deduction.
   a. Enter the smaller of line 5 or line 6. If born after January 1, 1940, and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.
   b. If born before January 2, 1940, or blind, multiply $1,200 ($950 if married or qualifying widow(er) with dependent child) by the number in the box above.
   c. Add lines 7a and 7b. This is your standard deduction for 2004.

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.

• The amount deducted on Schedule A (Form 1040), or
• The amount recovered.

Example. During 2005, you paid $1,700 for medical expenses. From this amount you subtracted $1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was $200. In 2006, you received a $500 reimbursement from your medical insurance for your 2005 expenses. The only amount of the $500 reimbursement that must be included in your income for 2006 is $200—the amount actually deducted.

Itemized deductions limited. You were subject to the limit on itemized deductions in the earlier year if your adjusted gross income (AGI) was more than a base amount. For example, this amount was:
• For 2005, $145,950 ($72,975 if married filing separately),
• For 2004, $142,700 ($71,350 if married filing separately), and
• For 2003, $139,500 ($69,750 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 4. 2003 Standard Deduction Tables

Table I. Standard Deduction Chart for Most People*

<table>
<thead>
<tr>
<th>IF your filing status is ...</th>
<th>THEN your standard deduction is ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or Married filing separately</td>
<td>$4,750</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying</td>
<td>9,500</td>
</tr>
<tr>
<td>widow(er) with dependent child</td>
<td></td>
</tr>
<tr>
<td>Head of household</td>
<td>7,000</td>
</tr>
</tbody>
</table>

* DO NOT use this chart if you were born before January 2, 1939, or you are 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 Who Were Born Before January 2, 1939, or Were Blind*

Check the correct number of boxes below. Then go to the chart.

You Born before January 2, 1939 □ Blind □
Your spouse, if claiming spouse’s exemption Born before January 2, 1939 □ Blind □

Total number of boxes you checked

<table>
<thead>
<tr>
<th>IF your filing status is ...</th>
<th>AND the number on the line above is ...</th>
<th>THEN your standard deduction is ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>1</td>
<td>$5,900</td>
</tr>
<tr>
<td>Married filing joint return or Qualifying widow(er) with dependent child</td>
<td>2</td>
<td>10,450</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>11,400</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>12,350</td>
</tr>
<tr>
<td>Married filing separate return</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 household</td>
<td>1</td>
<td>8,150</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>9,300</td>
</tr>
</tbody>
</table>

* If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 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 26.

   For more information on this computation, see Revenue Ruling 93-75. This ruling is in Cumulative Bulletin 1993-2.

Example. Eileen Martin is single. She had an AGI of $1,145,950 and itemized her deductions on her federal income tax return for 2005. She was not subject to alternative minimum tax and was not entitled to any credit against income tax. Her only allowable deduction was $4,000 of state income taxes. Her state general sales tax was $20,000. Eileen deducted only $10,000 of her state income taxes in 2005 because her otherwise allowable deductions of $40,000 were reduced by $30,000. In 2006, she received a $5,000 refund of her state income taxes for 2005.

   The following shows how Eileen figured the $30,000 reduction and other amounts from the Itemized Deduction Worksheet in the 2005 Schedule A (Form 1040) instructions. These amounts are needed to figure the part of the $5,000 refund that Eileen must include in her income for 2006.
If you had a recovery if there was a downward price change your total tax, you do not include the recovery in your income. However, if your total tax increases by any amount, you received a tax benefit from the deduction and you must include the recovery in your income 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, you must include the recovery in your income in the year received.

Total recovery not included in income. If any part of the deduction you took for the recovered amount did not reduce your tax, you may be able to exclude at least part of the recovery from your income. You must include the recovery in your income up to the amount of the deduction that reduced your tax in the year of the deduction. (See Tax benefit rule, earlier.)

Negative taxable income. If your taxable income was a negative amount, reduce the recovery by that negative amount. For example, line 42 was more than line 41 on your 2005 Form 1040. Include this reduced recovery in your income.

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, the amount of the recovery to your earlier year’s taxable income and refi gure 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.

Example. In 2005, 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 2006, Jean recovered $1,000 of her itemized deductions. She reduces her 2005 itemized deductions by $1,000 and refigures that year’s tax on taxable income of $5,260. However, the child care credit exceeds the recomputed tax of $672. Jean’s tax liability for 2005 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 2006.

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 minimum tax. If the recomputation results in a lower tax, you do not include the recovery in your income. However, if your total tax increases by any amount, you received a tax benefit from the deduction and you must include the recovery in your income up to the amount of the deduction that reduced your tax in the earlier year.

Amounts Recovered for Credits

If you recovered a credit in 2006 for an item for which you claimed a credit in an earlier year, you must increase your 2006 tax by the amount of the recovery, up to the amount by which the credit reduced your tax in the earlier year. If you had a recovery if there was a downward price adjustment or similar adjustment on the item for which you claimed a credit.

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

Survivor Benefits

Generally, payments made by or for an employer 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.)
repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For information on this, see Repayments, later.

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

Payments by a union. Benefits paid to you as an unemployed member of a union from a regular union fund are included in your income in the same year you receive them. If you contribute the taxable amount on Form 1040, line 21, the amounts you receive are not deductible. Include them on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

State employees. Payments similar to a qualified disaster relief payment. A qualified disaster relief payment is an amount paid to you: 1. To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses that result from a qualified disaster. 2. To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of your home or repair or replacement 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 injury incurred as a result of a qualified disaster, or 4. By a federal, state, or local government, agency or instrumentality in connection with a qualified disaster in order to promote the general welfare. You can exclude this amount only to the extent any expense it pays for is not paid for by insurance 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: 1. A disaster which results from a terrorist or military action, 2. A Presidentially declared disaster, or 3. A disaster which results from an incident involving a common carrier, or from any other event, which is determined to be catastrophic 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 assistance from the federal, state, or local government, agency, or instrumentality.

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

Disaster relief grants. 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 deduct casually losses or medical expenses that are specifically reimbursed by these disaster relief grants. Unemployment assistance payments under the Act are taxable unemployment compensation. See Unemployment compensation under Unemployment Benefits, earlier.

Disaster relief payments. You can exclude from income any amount you receive that is a qualified disaster relief payment. A qualified disaster relief payment is an amount paid to you: 1. To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses, but for your training and rehabilitation of your home or repair or replacement of its contents to the extent it is due to a qualified disaster. 2. To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of your home or repair or replacement 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 injury incurred as a result of a qualified disaster, or 4. By a federal, state, or local government, agency or instrumentality in connection with a qualified disaster in order to promote the general welfare. You can exclude this amount only to the extent any expense it pays for is not paid for by insurance 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: 1. A disaster which results from a terrorist or military action, 2. A Presidentially declared disaster, or 3. A disaster which results from an incident involving a common carrier, or from any other event, which is determined to be catastrophic 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 assistance from the federal, state, or local government, agency, or instrumentality.

Publication 525 (2006)
Disaster Mitigation payments. You also can exclude from income any amount you re-
cieve that is a qualified disaster mitigation pay-
ment. Like qualified disaster relief payments, qualified disaster mitigation payments are also most commonly paid to you in the period immedi-
ately following damage to property as a result of a natural disaster. However, disaster mitigat-
ion payments are grants you use to mitigate (reduce the severity of) potential damage from future natural disasters. They are paid to you through state and local governments based on the provisions of the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act.

You cannot increase the basis or adjusted basis of your property for improvements made with nontaxable disaster mitigation payments. If in a previous year you filed a tax return reporting disaster mitigation payments as tax-
able income, you should file Form 1040X to claim a refund for tax years that are not closed by the statute of limitations. The statute of limita-
tions generally does not begin to run until 4 years after the due date of your original return.

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 mortgage assistance program 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.

Relocation Payments and Home Rehabili-
tation 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 flooded property to another residence is not includible in gross income. Home rehabili-
tation grants received by low-income homeowner-
s in a defined area under the same act are also not includible in gross income.

Indian Financing Grants. Nonreimbursable grants under title IV of the Indian Financing Act of 1974 to Indians to expand profit-making In-
dian-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 includible in the gross income of the individuals to whom they are paid. This includes basic (part A (Hospital Insurance Benefits for the Aged)) and supplementary (part B (Supplementary Medical Insurance Benefits for the Aged)).

Old-age, survivors, and disability insurance benefits (OASDI). OASDI payments under section 202 of title II of the Social Security Act are not includible in the gross income of the individuals to whom they are paid. 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 the 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 include a reference to that publication.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity 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 535 for information on whether an activity is considered carried on for profit.

Alaska Permanent Fund dividend. If you re-
ceived a payment from Alaska’s mineral income
fund (Alaska Permanent Fund dividend), report it as income on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. The state of Alaska sends each recipient a document that shows the amount of the payment with the check. The amount also is reported to the IRS.

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 be-
low-market or discount loan, you must in-
clude the forgone interest (at the federal rate) as interest income on your return. These loans are considered a transaction in which you, the lender, are treated 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 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 contracts. 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 recreation 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 into 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 reimburse-
ments. You generally should not report these reimbursements on your return, unless you are figuring gain or loss from the casualty or theft. See Publication 547, Casualties, Disasters, and Thefts, for more information.

Charitable gift annuities. If you are the bene-
 fica ry 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 received 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) on Schedule D, line 8.

Child support payments. You should not report these payments on your return. See Publication 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 income:

1. Interest on any award.
2. Compensation for lost wages or lost profits in most cases.
3. Punitive damages, in most cases. 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 distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7. Attorney fees and costs (including contingent fees) where the underlying 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 include them in your income. 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. 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 1862(b)(3)(A) of the Social Security Act. You can claim this deduction as an adjustment to income on Form 1040, line 36. 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, a claim against the United States government, or the claim under section 1862(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.
- The judgment or settlement to which your attorney fees and court costs apply must occur after October 22, 2004.
- Pre-existing agreements. 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 your 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.
- Down payment assistance. If you purchase a home and receive assistance from a nonprofit corporation to make the down payment, that assistance is not included in your income. If the corporation qualifies as a tax-exempt charitable organization, the assistance is treated as a gift and is included in your basis of the house. If the corporation does not qualify, the assistance is treated as a rebate or reduction of the purchase price and is not included in your basis.
- 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, and trailer property. If a building or structure contains both dwelling 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, Deductions, 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.

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 corporation director,
- An executor, administrator, or personal representative of an estate,
- A manager of a trade or business you operate before declaring Chapter 11 bankruptcy,
- A notary public, or
TIP
If you are not an employee and the fees are self-employment income on Schedule C or Schedule C-EZ (Form 1040). The fee is not includible in income if it is waived.

A qualified foster care placement agency.

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

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. Re-port the fair market value of the tour on Form 1040, line 21. If you itemize your deductions on Schedule SE (Form 1040) for the tour, more than $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 in-come fees paid to them from an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend’s or relative’s estate), report these fees on Form 1040, line 21. If you are in the trade or business of being an executor, report these fees as self-employment income on Schedule C or Schedule C-EZ (Form 1040). The fee is not includible in income if it is waived.

Manager of trade or business for bank-ruptcy estate. Include in your income all pay-ments received from your bankruptcy estate for managing or operating a trade or business that you operated before you filed for bankruptcy. Report this income on Form 1040, line 21.

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 instruc-tions for Schedule SE (Form 1040) for details.)

Election precinct official. You should re-ceive a Form W-2 showing payments for serv-ices 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 provid-ers. If you operate a daycare service and re-ceive 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 in-come any part 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 or loss on a personal foreign currency transac-tion 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 re-ceive from a state, political subdivision, or a qualified foster care placement agency for pro-viding care to qualified foster individuals in your home generally are not included in your income. However, you must include in your income pay-ments that are designated by the state as additional care that is required for physically, mentally, or emotionally handicapped qualified foster individuals. 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 politi-cal subdivisions, or a lump sum, you must report the amount you re-ceive 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, show-ing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 2 on Form 1040, line 21. Include the amount shown in box 2 on Form 1040, line 64, 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 prop-erty 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 dis-tributed 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 individual retirement arrangement (IRA), you may have to include part of the inher-ited 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, 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 National Historic Preservation Act to pre-serve a historically significant property.

Hobby losses. Losses from a hobby are deductible only to the extent of your hobby 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 ac-counts or funds, are not taxable. You also do not include them in any computations in which you would ordinarily add includible 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
You see Publication 969 may be able to exclude from income the interest on Form 1040, line 21, or on uses to pay your salary while you serve on the Illegal income, such as money or Form 1040A, line 13. If you must give the pay Illegal income.

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Publication 525 (2006)
Service Corps Scholarship Program or the taxable. gifts to you.

receive the amount under the National Health yours when figuring if any of your benefits are clearly show that the union intended  them as for teaching, research, or other services if you benefits, you must add your spouse's income to benefits from your income only wh en the facts

How to report. 

• Fees, books, supplies, and equipment re-quired for courses at the educational insti-

tution. Amounts used for room and board do not qualify for the exclusion. See Publication 970 for more information on qualified scholarships and fellow-

ship grants.

Payment for services. Generally, you must include in income the part of any scholarship or fellowship, that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

Do not include in income the part of any scholarship or fellowship representing payment for teaching, research, or other services if you receive the amount under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.

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 De-partment of Veterans Affairs are not included in your income. These allowances are not consid-ered 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.

Smallpox vaccine injuries. If you are an eligi-
bility to the 2% of AGI limit if they are related to your job and if you itemize deductions on Schedule A (Form 1040). For more information, get Publica-
tion 529, Miscellaneous Deductions.

Stolen property. If you steal property, you must report its fair market value in your income in the year you steal it unless in the same year, you return it to its rightful owner.

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

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union can-
not be excluded from your income.

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

Strike and lockout benefits. Benefits paid by a union as strike or lockout benefits, including both cash and the fair market value of other property, usually are included in your in-
come 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.

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### Reimbursement union convention expenses.

If you are a delegate of your local union chapter and you report your expenses on Schedule A (Form 1040), you may deduct the expenses if you are reimbursed for expenses traveling away from home to attend the convention.

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:

- A reduction in the purchase price of electricity furnished to you (rate reduction).
- 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 for the year in which you repaid it. Or, if the amount you repaid is more than $3,000, you may be able to take a credit against your tax 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 employment income, deduct it as an expense on Schedule C or Schedule C-EZ (Form 1040), or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss 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).

#### 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 2006 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 2006 claiming a credit for the repaid amount.

Follow these steps:

1. Figure your tax for 2006 without deducting the repaid amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2006.
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 2006 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 figured in (3) above on Form 1040, line 70, and enter “I.R.C. 1341” in the column to the right of line 70.

**Example.** For 2005 you filed a return and reported your income on the cash method. In 2006 you repaid $5,000 included in your 2005 income under a claim of right. Your filing status in 2006 and 2005 is single. Your income and tax for both years are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>With Income</th>
<th>Without Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$1,889</td>
<td>$1,139</td>
</tr>
<tr>
<td>2006</td>
<td>$9,051</td>
<td>$7,801</td>
</tr>
</tbody>
</table>

You pay less using method 1, so you should take a deduction for the repayment in 2006.

### 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 make the repayment. If you use any other accounting method, you can deduct the repayment or claim a credit for it 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 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.** The Taxpayer Advocate Service is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the Taxpayer Advocate Service by calling toll-free 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You also can call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, The Taxpayer Advocate Service of the IRS - How to Get Help With Unresolved Tax Problems. You can file Form 911, Application for Taxpayer Assistance, or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate.

### Low income tax clinics (LITCs).

LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers with limited English proficiency or who speak English as a second language. Publication 4134, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at www.irs.gov or at your local IRS office.

### 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 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 at www.irs.gov 24 hours a day, 7 days a week:

- E-file your return. Find out about commercial tax preparation and e-file services available free to eligible taxpayers.
- Check the status of your 2006 refund. Click on Where’s My Refund. Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically).
Have your 2006 tax return available because you will need to know your social security number, 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 withholding calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

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 tax 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 topics. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- Refund information. To check the status of your 2006 refund, call 1-800-829-4477 and press 1 for automated 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 2006 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. When you call IRS representatives to ask questions, solve your tax problem, or help you set up a payment plan, you can be assured of courteous, professional answers. We use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random 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 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 for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you’re more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call your local center and leave a message requesting an appointment to resolve a tax account issue. 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 address below. You should receive a response within 10 business days after your request is received.

National Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903

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

- A CD that is released twice so you have the latest products. The first release ships in January and the final release ships in March.
- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD - Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.

Buy the CD from National Technical Information Service (NTIS) at www.ntis.gov/cdorders for $25 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD for $25 (plus a $5 handling fee). Price is subject to change.

CD for small businesses. Publication 3207, The Small Business Resource Guide CD for 2006, is a must for every small business owner or any taxpayer about to start a business. This year’s CD includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2006.
- Tax Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year 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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**Tax Publications for Individual Taxpayers**

**General Guides**
- Your Rights as a Taxpayer
- Your Federal Income Tax (For Individuals)

**Specialized Publications**
- Armed Forces’ Tax Guide
- Tax Guide for U.S. Citizens and Residents Aliens Abroad
- Farmers’ Tax Guide
- Travel, Entertainment, Gift, and Car Expenses
- Medical and Dental Expenses (Including the Health Coverage Tax Credit)
- Child and Dependent Care
- Divorce or Separated Individuals
- Tax Withholding and Estimated Tax
- Foreign Tax Credit for Individuals
- U.S. Government Civilian Employees Stationed Abroad
- Social Security and Other Information for Members of the Clergy and Religious Workers
- U.S. Tax Guide for Aliens
- Moving Expenses
- Selling Your Home
- Credit for the Elderly or the Disabled
- Taxable and Nontaxable Income
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- Residential Rental Property
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**Spanish Language Publications**

- Derechos del Contribuyente
- Como Preparar la Declaración de Impuesto Federal
- Guía de Impuestos para Personas con Discapacidad
- Ingresos para Impuestos Per Diem Rates
- Informe de Pagos en Efectivo en una Ocupación o Negocio