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Older Americans' Tax Guide

For use in preparing

1997 Returns

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Contents

Important Changes for 1997

Standard deduction. For most people, the standard deduction has increased. See *Standard Deduction,* later.

Earned income credit. You may be eligible for the credit if you earn less than:

1) $25,760 and have one qualifying child living with you,
2) $29,290 and have more than one qualifying child living with you, or
3) $9,770, do not have a qualifying child, and are at least 25 years old and under 65.

For more information see *Earned Income Credit,* later.

Individual retirement arrangements (IRAs). There are various changes affecting contributions to IRAs for 1997 and 1998. The changes effective in 1997 are covered under *Individual Retirement Arrangement (IRA) Deductions,* in this publication. For changes effective in 1998, see Publication 553, *Highlights of 1997 Tax Changes.*

Minimum required distribution rule modified. Beginning in 1997, the definition of the required beginning date used to figure the minimum required distribution from qualified retirement plans takes into account whether a plan participant has retired. The required beginning date of a participant who is still employed after age $70\frac{1}{2}$ is April 1 of the calendar year that follows the calendar year in which he or she retires. This does not apply to IRAs. For more information, see *Tax for Failure to Make Minimum Distribution,* near the end of the publication.

Repeal of 15% additional tax on excess distributions and excess retirement accumulation. If you receive retirement distributions from a qualified retirement plan after December 31, 1996, you are no longer subject to the additional 15% excise tax on excess distributions. New law also repeals the additional 15% tax on excess retirement accumulations for taxpayers who died after December 31, 1996.

Long-term care insurance. Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. See Publication 525, *Taxable and Nontaxable Income.*

Insurance premiums are deductible as an itemized deduction up to certain limits. These are discussed in Publication 502, *Medical and Dental Expenses.*

Life insurance proceeds paid before death. Beginning January 1, 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs. The exclusion for payments made on a periodic basis is limited. See *Accelerated Death Benefits,* later.

Exclusion for sale of home after May 6, 1997. If you sell your main home after May 6, 1997, you may be able to exclude any gain from income up to a limit of $250,000 ($500,000 on a joint return in most cases). See *Sales After May 6, 1997,* under *Sale of Home,* later, for details.

Voluntary withholding. Beginning in 1997, you may be able to have federal income tax withheld from your social security or equivalent railroad retirement benefits. See *Tax Withholding and Estimated Tax* under *Social Security and Equivalent Railroad Retirement Benefits.*

Important Reminders

Tax return preparers. Choose your preparer carefully. If you pay someone to prepare your return, the preparer is required, under the law, to sign the return and fill in the other blanks in the *Paid Preparer's* area of your return. Remember, however, that you are still responsible for the accuracy of every item entered on your return. If there is any underpayment, you are responsible for paying it, plus any interest and penalty that may be due.

Employment tax withholding. Your wages are subject to withholding for income tax, social security, and Medicare even if you are receiving social security benefits.

Introduction

In general, the federal income tax laws apply equally to all taxpayers regardless of age. However, certain provisions give special treatment to older Americans.

While some items are discussed in this publication because of their interest to older Americans, they apply to taxpayers generally and are explained in detail in other publications of the Internal Revenue Service (IRS). References to these free publications are included for the convenience of readers who need more information on specific subjects.

Specific tax benefits for older Americans. Specific tax benefits are available to older Americans and are listed here.

1) **Taxpayers 65 or older** benefit from a higher gross income threshold for filing a federal income tax return. File Form 1040 or 1040A to get this benefit. (You are considered 65 on the day before your 65th birthday.)

2) **Taxpayers who qualify** and who meet the age requirements may benefit from the:

   a) Credit for the elderly or the disabled,

   b) Exclusion of gain on the sale of their home, or

   c) Increased standard deduction.

Ordering publications and forms. To order free publications and forms, see *How To Get More Information,* near the end of this publication.

Large print tax forms. For easier reading and to practice preparing your return, you may order large print tax forms. Call 1–800–829–3676 and order:

- **Publication 1614** that contains Form 1040, Schedules A, B, D, E, EIC, and R, and instructions

- **Publication 1615** that contains Form 1040A, Schedules 1, 3, and EIC, and instructions.

CAUTION *When you file your actual return, do not send the large print tax forms to IRS. Use the standard forms.*

Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). These programs help older, disabled, low-income, and non-English-speaking people fill in their returns. Call the telephone number listed in the forms instructions for your city or state for the location of the volunteer assistance site near you.

Or for the location of an American Association of Retired Persons (AARP) Tax-Aide site in your community, simply call 1–888–227–7669. Enter your 5–digit zip code, or use their Internet site locator at *www.aarp.org/taxaide/home.html.*

1997 Filing Requirements

If income tax was withheld from your pay, or if you can take the earned income credit, you should file a return even if you are not required to do so.

General Requirements

You must file a return if your gross income for the year was at least the amount shown on the appropriate line in *Table 1.* Instructions for Form 1040, 1040A, or 1040EZ and Publication 501, *Exemptions, Standard Deduction, and Filing Information,* contain more detailed information.

Gross income. Gross income is all income you receive in the form of money, goods, property, and services that is not exempt from tax.

If you are employed, gross income also includes your total salary or wages. If you own rental property, it also includes the total rent you receive before you deduct any rental expenses. If you are self-employed, it also includes the total gross profit (gross receipts minus cost of goods sold) from your trade or business.

Gross income does not include nontaxable income, such as welfare benefits or nontaxable social security benefits.

For more information on what income is taxable, see *Taxable and Nontaxable Income,* later.

Dependents. If you could be claimed as a dependent by another taxpayer, special rules apply. See Publication 501.

Decedents

A personal representative of an estate can be an executor, administrator, or anyone who is in charge of the decedent's property.

If you are acting as the personal representative of a person who died during the year, you may have to file a final return for the decedent. You also have other duties, such as notifying the IRS that you are acting as the personal representative. **Form 56**, *Notice Concerning Fiduciary Relationship,* is available for this purpose. For more information, see Publication 559, *Survivors, Executors, and Administrators.*

When you file a return for the decedent, either as the personal representative or as the surviving spouse, you should write “DECEASED,” the decedent's name, and the date of death, across the top of the tax return.

If no personal representative has been appointed by the due date for filing the return, the surviving spouse (on a joint return) should sign the return and write in the signature area “Filing as surviving spouse.” See Publication 559 for other important information.

TIP *If you are the surviving spouse, the year your spouse died is the last year you may file a joint return with that spouse. After that, if you do not remarry, you must file as a qualifying widow(er) with dependent child, head of household, or single. If you remarry before the end of the year of the decedent's death, you can file a joint return with your new spouse. The filing status of your deceased spouse is married filing a separate return.*

CAUTION *The level of income that requires you to file changes when your filing status changes. Even if you and your deceased spouse did not have to file a return for several years, you may have to file a return for 1997. See Publication 501 for more information on filing requirements.*

Taxable and Nontaxable Income

Generally, all income is taxable unless it is specifically exempted by law. Your taxable income may include compensation for services, interest, dividends, rents, royalties, income from partnerships, estate and trust income, gain from sales or exchanges of property, and business income of all kinds.

Under special provisions of the law, certain items are partially, or fully, exempt from tax. Provisions that are of special interest to older taxpayers are discussed in this section.

Compensation for Services

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

You need not receive the compensation in cash for it to be taxable. Payments you receive in the form of goods or services generally must be included in gross income at their fair market value.

You must include in your income all unemployment compensation you receive. See Publication 525, *Taxable and Nontaxable Income,* for more detailed information on specific types of income.

Volunteer work. Do not include in your gross income amounts you receive for supportive services or reimbursements for out-of-pocket expenses under any of the following volunteer programs:

- Retired Senior Volunteer Program (RSVP)
- Foster Grandparent Program
- Senior Companion Program
- Service Corps of Retired Executives (SCORE)
- Active Corps of Executives (ACE)

Table 1. **1997 Filing Requirements Chart for Most Taxpayers**

To use this chart, first find your filing status. Then, read across to find your age at the end of 1997. You must file a return if your **gross income**** was at least the amount shown in the last column.

Filing status	Age*	Gross income**
Single	under 65	$6,800
	65 or older	$7,800
Head of household	under 65	$8,700
	65 or older	$9,700
Married, filing jointly***	under 65 (both spouses)	$12,200
	65 or older (one spouse)	$13,000
	65 or older (both spouses)	$13,800
Married, filing separately	any age	$2,650
Qualifying widow(er) with dependent child	under 65	$9,550
	65 or older	$10,350

**If you turned age 65 on January 1, 1998, you are considered to be age 65 at the end of 1997.*

*****Gross income** means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of your home (even if you may exclude or postpone part or all of the gain). **Do not** include social security benefits unless you are married filing a separate return and you lived with your spouse at any time in 1997.*

****If you didn’t live with your spouse at the end of 1997 (or on the date your spouse died) and your gross income was at least $2,650, you must file a return regardless of your age.*

Retirement Plans, Pensions, and Annuities

This section summarizes the tax treatment of amounts you receive from individual retirement arrangements, employee pensions or annuities, and disability pensions or annuities. More detailed information can be found in Publication 590, *Individual Retirement Arrangements (IRAs),* or Publication 575, *Pension and Annuity Income.*

Individual retirement arrangement (IRA) distributions. In general, include IRA distributions in your gross income in the year you receive them. Exceptions to this general rule are distributions that are properly rolled over into another IRA, timely withdrawals of excess or unintended contributions under the tax-free withdrawal rule, and the return of nondeductible contributions. These exceptions are discussed in Publication 590.

TIP *If you made nondeductible contributions, file Form 8606. If you do not, the contributions will be treated as deductible contributions when you withdraw them.*

Premature distributions. Generally, premature distributions (early withdrawals) are amounts you withdraw from your IRA before you are age $59\frac{1}{2}$. You must include premature distributions in your income. They are also subject to an additional tax (generally 10% of the amount of the premature distribution). However, there are a number of exceptions.

CAUTION *Beginning in 1997, early withdrawal of funds from a SIMPLE retirement plan made within 2 years of beginning participation in the plan are subject to a 25% penalty, rather than 10%.*

Exceptions. There are exceptions for:

- Death,
- Disability,
- Annuity distributions,
- Distributions for certain unreimbursed medical expenses, and
- Distributions for certain medical insurance premiums.

The additional tax also does not apply to:

- Distributions that represent a return of your nondeductible contributions, and
- Distributions that are properly rolled over.

For more information on premature distributions, get Publication 590.

After age $59\frac{1}{2}$ and before age $70\frac{1}{2}$. Generally, you can withdraw assets from your IRA after you reach age $59\frac{1}{2}$ without penalty. Even though you can, you do not have to withdraw any assets from your IRA until you reach age $70\frac{1}{2}$.

Required distributions. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age $70\frac{1}{2}$. See *Required Distributions* in Publication 590.

Tax on excess accumulations (insufficient distributions). If distributions from your IRA(s) during the year are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the excess amount remaining in your IRA.

Pensions and annuities. Generally, if you did not pay any part of the cost of your employee pension or annuity, and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable.

If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. Your annuity starting date (defined later) determines the method you use to figure the tax-free and the taxable parts of your annuity payments. If you contributed to your pension or annuity and your annuity starting date is:

1) **After November 18, 1996,** and your payments are from a qualified plan, you ***must*** use the Simplified Method. You generally must use the General Rule only for nonqualified plans.
2) **After July 1, 1986, but before November 19, 1996,** you ***can*** use either the General Rule or, if you qualify, the Simplified Method, to figure the taxability of your payments from qualified and nonqualified plans. See *Simplified Method, later.*
3) **Before July 2, 1986,** and you recovered your cost under the Three-Year Rule, you cannot use the General Rule or the Simplified Method because your payments are fully taxable.

Loans. If you borrow money from an employer's qualified pension or annuity plan, a tax-sheltered annuity program, or a government plan, you may have to treat the loan as a nonperiodic distribution. This means that you may have to include all or part of the amount borrowed in your income. (The amount includible in income may be subject to a **10% tax** on early distributions, discussed later.) For more information, see *Loans Treated as Distributions* in Publication 575.

Cost. Before you can figure how much, if any, of your pension or annuity is taxable, you must determine your cost in the plan (your investment). In general, your cost is your net investment in the contract as of the annuity starting date. This includes amounts your employer contributed that were taxable at the time paid.

From this total cost you must subtract:

1) Any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income and that you received by the later of the annuity starting date or the date on which you received your first payment.
2) Any other tax-free amounts you received under the contract or plan by the later of the dates in (1).

The ***annuity starting date*** is the later of the first day of the first period for which you receive a payment from the plan or the date on which the plan's obligation became fixed.

Generally, the amount of your contributions recovered tax free during the year is shown in box 5 of Form 1099–R.

Foreign employment. If you worked in a foreign country before 1963, the amount your employer paid into your retirement plan may be considered part of your cost. For details, see *Foreign employment* in Publication 575.

Amount of exclusion. If you contributed to your pension or annuity and your annuity starting date was before 1987, you could continue to take your monthly exclusion for as long as you receive your annuity.

If your annuity starting date is after 1986, the total amount of annuity you can exclude over the years as a return of the cost cannot exceed your total cost.

In either case, any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit on miscellaneous deductions.

General Rule. You must use the General Rule if you receive pension or annuity payments from:

1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if you are 75 or over and your annuity payments from the qualified plan are guaranteed for at least 5 years (regardless of your annuity starting date).

You can use the General Rule for a qualified plan if your annuity starting date is *before* November 19, 1996 (but after July 1, 1986), and you do not qualify to use, or choose not to use, the Simplified Method.

You cannot use the General Rule for a qualified plan if your annuity starting date is after November 18, 1996.

TIP **If you are 75 or over,** *and your annuity starting date is after November 18, 1996, you must use the General Rule if the payments are guaranteed for at least 5 years. You must use the Simplified Method if the payments are guaranteed for fewer than 5 years.*

For more information on the General Rule, see Publication 939, *General Rule.* That publication tells you how to figure your expected return and exclusion percentage, and contains certain actuarial tables you will need.

Simplified Method. The following discussion outlines the rules that apply for using the Simplified Method.

What is the Simplified Method. The Simplified Method is one of the two methods used to figure the tax-free part of each annuity payment using the annuitant's age at his or her annuity starting date. The other method is the General Rule (discussed earlier).

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, **and** you receive pension or annuity payments from a qualified plan or annuity **unless** you were at least 75 years old and entitled to annuity payments from a qualified plan that are guaranteed for 5 years or more.

How to use it. Use the following worksheet to figure your taxable annuity for 1997. In completing this worksheet, use your age at the birthday preceding your annuity starting date. Be sure to keep a copy of the completed worksheet; it will help you figure your taxable pension in later years.

Example. Bill Kirkland, age 65, began receiving retirement benefits in January 1997 under a joint and survivor annuity. The benefits are to be paid for the joint lives of Bill and his wife, Kathy. He had contributed $24,700 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,000 a month, and Kathy is to receive a monthly survivor benefit of $500 upon Bill's death.

Bill must use the Simplified Method because his annuity starting date is after November 18, 1996, and the payments are from a qualified plan. He completes the worksheet as follows:

Simplified Method Worksheet

1.	Total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a		$12,000
2.	Your cost in the plan (contract) at annuity starting date, as adjusted (if it applies)		24,700
3.	Age at annuity starting date:	Enter:	
	55 and under	360	
	56–60	310	
	61–65	260	
	66–70	210	
	71 and over	160	260
4.	Divide line 2 by line 3		95
	Caution: If your annuity starting date is **before November 19, 1996** (and you received payments in prior years), skip lines 3 and 4. You do not need to recompute the tax-free monthly amount. Enter your monthly exclusion computed in prior years on line 4.		
5.	Multiply line 4 by the number of months for which this year's payments were made		1,140
6.	Any amounts previously recovered tax free in years after 1986		–0–
7.	Subtract line 6 from line 2		24,700
8.	Enter the lesser of line 5 or line 7		1,140
9.	**Taxable pension for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b		$10,860
	NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.		
10.	Add lines 6 and 8		1,140
11.	Balance of cost to be recovered. Subtract line 10 from line 2		$23,560

Bill's tax-free monthly amount is $95 ($24,700 ÷ 260 as shown on line 4 of the worksheet). If he lives to collect more than 260 payments, he will have to include the full amount of the additional payments in his gross income.

If Bill dies before collecting 260 monthly payments and Kathy begins receiving payments, she will also exclude $95 from each payment until her payments, when added to Bill's, total 260 payments. If she dies before 260 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on her final income tax return. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

TIP *Had Bill's retirement annuity payments been from a nonqualified plan, he would have used the General Rule. He can only use the Simplified Method Worksheet for plans that are qualified.*

For more details on how to fill in the worksheet, see the examples in Publication 575.

Death benefit exclusion. If you are the beneficiary of a deceased employee (or former employee) who died:

- After August 20, 1996, you are **not eligible** for the $5,000 death benefit exclusion.
- Before August 21, 1996, you may qualify for a death benefit exclusion of up to $5,000. If you are eligible for the exclusion, add it to the cost of the annuity when you figure your cost at the annuity starting date.

TIP *The payer of the annuity cannot add the death benefit exclusion to the cost for figuring the nontaxable and taxable part of payments reported on Form 1099–R. Therefore, the Form 1099–R taxable amount will be larger than the amount you will figure for yourself. Report on your return the smaller amount that you figure. Every year keep a copy of the worksheet for your records until you fully recover the cost in the pension or annuity plan.*

This exclusion is discussed in Publication 575. Publication 575 also discusses the special rules that apply if you are the survivor under a joint and survivor annuity.

Changing the method under prior law. If your annuity starting date is after July 1, 1986 (but before November 19, 1996), you can change the way you figure your pension cost recovery exclusion. You can change from the General Rule to the Simplified Method, or the other way around. Make the change by filing amended returns for all your tax years beginning with the year in which your annuity starting date occurred. You must use the same method for all years. Generally, you can make the change only within 3 years from the due date of your return for the year in which you received your first annuity payment. You can make the change later if the date of the change is within 2 years after you paid the tax for that year.

Survivors. If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the Three-Year Rule, include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the General Rule, you should apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree had chosen to report the annuity under the Simplified Method, the monthly tax-free amount remains fixed. Continue to use the same monthly tax-free amount for your survivor payments.

Under some circumstances, if you are a beneficiary of a deceased employee or former employee, you may qualify for a death benefit exclusion of up to $5,000. Add it to the cost or unrecovered cost of the annuity at the annuity starting date. See *Death benefit exclusion,* earlier.

Reporting your annuity. If you file Form 1040, report your total annuity on line 16a, and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b. Do not make an entry on line 16a. For example, if you received monthly payments totaling $1,200 during 1997 from a pension plan that was completely financed by your employer, and you had paid no tax on the payments that your employer made to the plan, the entire $1,200 is taxable. You include $1,200 on line 16b, Form 1040.

If you file Form 1040A, report your total annuity on line 11a, and the taxable part on line 11b. If your pension or annuity is fully taxable, enter it on line 11b. Do not make an entry on line 11a.

Withholding. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable part of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Withholding Tax and Estimated Tax* and *Rollovers* in Publication 575 for more information.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing a Form W–4P, *Withholding Certificate for Pension or Annuity Payments.*

Form 1099–R. For 1997, you will receive a Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for your pension or annuity, whether or not any tax was withheld. Form 1099–R shows your pension or annuity for the year and any income tax withheld.

Tax on early distributions. Most distributions you receive from your qualified retirement plan or deferred annuity contract before you reach age 59½ are subject to an additional tax of 10%. The tax applies to the part of the distribution that you must include in gross income.

For this purpose, a qualified retirement plan includes:

1) A qualified employee retirement plan,
2) A qualified annuity plan,
3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
4) An IRA, including a SIMPLE IRA.

25% rate on certain early distributions from SIMPLE retirement accounts. Distributions from a SIMPLE retirement account are subject to IRA rules and are includible in income when withdrawn. An early withdrawal is generally subject to a 10% penalty. However, if the distribution is made in 1997 (within the first two years of participation in the SIMPLE plan), the additional tax is 25%. Your Form 1099–R should show distribution code “S” in box 7 if the 25% rate applies.

Exceptions to tax. The early distribution tax does not apply to distributions that are:

1) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,
2) Made because you are totally and permanently disabled,
3) Made as part of a series of substantially equal periodic (at least annual) payments over your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your beneficiary (if from an employee plan, payments must begin after separation from service),
4) Made to you after you separated from service with your employer if the separation occurred during or after the calendar year in which you reach age 55,
5) Paid to you to the extent you have deductible medical expenses (whether or not you itemize deductions for the tax year),
6) Paid to alternate payees under qualified domestic relations orders (QDROs),
7) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election that provides a specific schedule of benefit payments,
8) Made to correct excess deferrals, excess contributions, or excess aggregate contributions,
9) Allocable to investment in a deferred annuity contract before August 14, 1982,
10) From an annuity contract under a qualified personal injury settlement,
11) Made under an immediate annuity contract, or
12) Made under a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity that is held by your employer until you separate from the service of the employer.

Only exceptions (1) through (3) apply to distributions from individual retirement plans (IRAs). Exceptions (4) through (8) apply only to distributions from qualified employee plans. Exceptions (9) through (12) apply only to deferred annuity contracts not purchased by qualified employer plans.

Form 5329. Use Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs,* to report the additional tax you owe on the taxable part of the early distribution. You may also have to file Form 5329 if you meet one of the exceptions listed earlier. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099–R shows a “1” in box 7. Instead, enter 10% of the taxable part of the distribution on line 50 of Form 1040 and write “No” on the dotted line next to line 50.

Tax for failure to make minimum distribution. Your qualified retirement plan must distribute to you your entire interest in the plan, or begin to make minimum distributions to you, by your required beginning date.

Beginning in 1997, you must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the **later of** the:

1) Calendar year in which you reach age 70½, or

2) Calendar year in which you retire.

Before 1997, you were required to begin receiving distributions from your retirement plan by April 1 of the year following the calendar year in which you reached age 70½, regardless of whether or not you had retired. This rule still applies if you are a 5% owner or the distribution is from an IRA.

The new rule applies to qualified employee retirement plans, qualified annuity plans, deferred compensation plans under section 457, and tax-sheltered annuity programs (for benefits accruing after 1986).

Amount of tax. If you do not receive these required minimum distributions, you, as the payee, are subject to an additional excise tax. The tax equals 50% of the difference between the amount that must be distributed and the amount that was distributed during the tax year. You can get this excise tax excused if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

Additional information. For more detailed information on this topic see Publication 575.

Lump-Sum Distributions

If you receive a lump-sum distribution from a qualified retirement plan, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify for capital gain treatment. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 5– or 10–year tax option to figure tax on the ordinary income part.

You can use these tax options to figure your tax on a lump-sum distribution only if the plan participant was born before 1936.

TIP *You may be able to figure the tax on a lump-sum distribution under the 5–year tax option even if the plan participant was born after 1935. You can do this only if the distribution is made on or after the date the participant reached age 59½ and the distribution otherwise qualifies. For more detailed information, get Publication 575 or Form 4972, Tax on Lump-Sum Distributions.*

Form 1099–R. If you receive a total distribution from a plan, you should receive a Form 1099–R. If you do not get a Form 1099–R, or if you have questions about it, contact your plan administrator.

Railroad Retirement Benefits

Benefits paid under the Railroad Retirement Act fall into two categories. These categories are treated differently for income tax purposes.

Tier 1. The first category is the amount of tier 1 railroad retirement benefits that equals the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system. This part of the tier 1 benefit is called the “social security equivalent benefit” (SSEB) and is treated (for tax purposes) like social security benefits. (See *Social Security and Equivalent Railroad Retirement Benefits,* later.)

Nonsocial security equivalent benefits. The second category consists of the rest of the tier 1 benefits, called the “nonsocial security equivalent benefit” (NSSEB), and any tier 2 benefits, vested dual benefits, and supplemental annuity benefits. This category of benefits is treated as an amount received from a qualified employer plan. This allows for the tax-free recovery of employee contributions from the tier 2 benefits and the NSSEB part of the tier 1 benefits. Vested dual benefits and supplemental annuity benefits are fully taxable.

For more information about railroad retirement benefits, see Publication 575.

Military Retirement Pay

Military retirement pay based on age or length of service is taxable and must be included in gross income as a pension on lines 16a and 16b of Form 1040 or on lines 11a and 11b of Form 1040A. But certain military and government disability pensions that are based on a percentage of disability from active service in the Armed Forces of any country are generally not taxable.

Veterans' benefits and insurance are discussed in Publication 525.

Sickness or Injury Benefits

Most payments you receive as compensation for illness or injury are not taxable. These include the following:

Workers' compensation. Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivor(s). If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. ***Note.*** If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

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

Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your gross income.

Long-term care insurance contracts. Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. Long-term care insurance contracts are discussed in more detail in Publication 525.

Disability benefits you receive for loss of income or earning capacity as a result of injuries under a "no-fault" car insurance policy.

Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. These benefits are not taxable even though your employer pays for the accident and health plan that provides these benefits.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older by the end of 1997, or you were retired on permanent and total disability and received taxable disability income in 1997, you may be able to claim the credit for the elderly or the disabled. See *Credit for the Elderly or the Disabled,* later.

Taxable disability pensions or annuities. Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. However, certain payments may not be taxable to you. See *Sickness or Injury Benefits,* earlier.

Cost paid by you. If you pay a specific part of the cost of your disability pension, any amounts you receive that are due to your payments to the disability pension are not taxed. You do not report them on your return. They are treated as benefits received under an accident or health insurance policy that you bought. You generally must include in income the rest of the amounts you receive that are due to your employer's payments. Your employer should be able to give you specific details about your pension plan and the amount, if any, you paid for your disability pension.

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

Workers' compensation. If part of your disability pension is workers' compensation, that part is exempt from tax. If you die, the part of your survivor's benefit that is a continuation of the workers' compensation is exempt from tax.

How to report. You must report all your taxable disability income as wages on line 7 of Form 1040 or Form 1040A, until you reach minimum retirement age. Generally, this is the age at which you can first receive a pension or annuity if you are not disabled.

Beginning on the day after you reach minimum retirement age, the payments you receive are taxable as a pension. Report them on lines 16a and 16b of Form 1040 or on lines 11a and 11b of Form 1040A.

Life Insurance Proceeds

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

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

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

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

Specified amount payable. If each installment you receive under the insurance contract is a specific amount, you figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments necessary to use up the principal and guaranteed interest in the contract.

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

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are paid to you because of the death of your spouse, and you receive them in installments, you can generally exclude up to $1,000 a year of the interest included in the installments.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the amount of premiums that you paid. You should receive a Form 1099–R. Report these amounts on lines 16a and 16b of Form 1040, or lines 11a and 11b of Form 1040A.

Endowment Proceeds

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

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity. 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.

Payments to beneficiaries of deceased employees. Generally, payments made by or for an employer because of an employee's death must be included in the income of the beneficiaries. However, if the dwecedent died before August 21, 1996, the first $5,000 paid to the beneficiaries may be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than $5,000 regardless of the number of employers or the number of beneficiaries.

Accelerated Death Benefits

Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. See the exception later. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs. The exclusion for payments made on a periodic basis is limited.

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

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

1) Is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity,

2) Has a level of disability similar to the disability in (1) above, or

3) Requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

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

ÿÿ• Because the insured is a director, officer, or employee of the other person, or

ÿÿ• Because the insured has a financial interest in the business of the other person.

Additional information. For more information on life insurance proceeds, see Publication 525. For more information on annuities, see Publication 575.

Other Nontaxable Items

The following items are generally excluded from taxable income. You should not report them on your return.

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

Veterans' benefits. Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs (VA), are not included in gross income. See Publication 525.

Public assistance. Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness.

Payments from a state fund for victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund.

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

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

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

Social Security and Equivalent Railroad Retirement Benefits

This discussion explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits.

When the term "benefits" is used in this section, it applies to both social security benefits and equivalent tier 1 railroad retirement benefits. Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income payment (SSI) which are not taxable.

If you received these benefits during 1997, you should have received a Form SSA–1099 or Form RRB–1099 (Form SSA–1042S or Form RRB–1042S if you are a nonresident alien) showing the amount.

Are Any of Your Benefits Taxable?

To find out whether any of your benefits are taxable, compare the ***base amount*** for your filing status with the total of:

1) One-half of your benefits, plus

2) All your other income, including tax-exempt interest.

Do not reduce your income by any exclusions for:

1) Interest from Series EE U.S. savings bonds,

2) Foreign earned income or foreign housing, or

3) Income earned in American Samoa or Puerto Rico by bona fide residents.

Use the worksheet later in this discussion to figure this total income. If the total income is more than your base amount, part of your benefits is taxable.

TIP *If the only income you received during 1997 was your social security or equivalent tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable.*

If you are married and file a joint return for 1997, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether if any of your benefits are taxable.

Base Amount

Your base amount is:

- $25,000 if you are single, head of household, or qualifying widow(er),
- $25,000 if you are married filing separately and ***lived apart*** from your spouse for ***all*** of 1997,
- $32,000 if you are married filing jointly, or
- $–0– if you are married filing separately and ***lived with*** your spouse at any time during 1997.

Repayments

Any repayment of benefits you made during 1997 must be subtracted from the gross benefits you received in 1997. It does not matter whether the repayment was for a benefit you received in 1997 or in an earlier year. If you repaid more than the gross benefits you received in 1997, see Publication 915.

Your gross benefits are shown in box 3 of Form SSA–1099 or RRB–1099 and your repayments are shown in box 4. The amount in box 5 shows your net benefits for 1997 (box 3 minus box 4). Use the amount in box 5 to figure whether any of your benefits are taxable.

How To Report Your Benefits

If part of your benefits is taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ.

Reporting on Form 1040. Report your net benefits (the amount in box 5 of your Form SSA–1099 or Form RRB–1099) on line 20a and the taxable part on line 20b. If you are married filing separately and you lived apart from your spouse for all of 1997, also enter "D" to the left of line 20a.

Reporting on Form 1040A. Report your net benefits on line 13a and the taxable part on line 13b. If you are married filing separately and you lived apart from your spouse for all of 1997, enter "D" to the left of line 13a.

Benefits not taxable. If none of your benefits are taxable, do not report any of them on your tax return. But, if you are married filing separately and you lived apart from your spouse for all of 1997, make the following entries. On Form 1040, enter "D" to the left of line 20a and "–0–" on line 20b. On Form 1040A, enter "D" to the left of line 13a and "–0–" on line 13b.

Tax Withholding and Estimated Tax

You can choose to have federal income tax withheld from your benefits. If you choose to do this, you must complete a Form W-4V, *Voluntary Withholding Request.* You can choose withholding at 7%, 15%, 28%, or 31% of your total benefit payment.

CAUTION *Although a new law, effective January 1,1997, allows voluntary federal income tax withholding, another provision of existing law prohibits such withholding. When the law is changed to allow withholding, the SSA will notify recipients. Until then, do not submit Form W-4V to the SSA.*

CAUTION *If part of your benefits is taxable, you may have to request additional withholding from other income or pay estimated tax during the year. For details, get Publication 505, Tax Withholding and Estimated Tax, or the instructions for Form 1040–ES.*

Worksheet

You can use the following worksheet to figure the amount of income to compare with your base amount.

A. Write in the amount from ***box 5*** of all your Forms SSA–1099 and RRB–1099. Include the full amount of any lump-sum benefit payments received in 1997, for 1997 and earlier years, if you choose to report the full amount for the 1997 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.) .... A. ______

Note: *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*

B. Enter one-half of the amount on line A .... B. ______

C. Add your taxable pensions, wages, interest, dividends, other taxable income and write in the total .... C. ______

D. Write in any tax-exempt interest income (such as interest on municipal bonds) plus exclusions from income (such as the Series EE U.S. Savings Bond interest exclusion) .... D. ______

E. Add lines B, C, and D and write in the total .... E. ______

Note. *Compare the amount on line E to your* ***base amount*** *for your filing status. If the amount on line E equals or is less than the base amount for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your* ***base amount,*** *some of your benefits are taxable.*

How Much Is Taxable?

If part of your benefits is taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. The taxable part of your benefits cannot usually be more than 50%. However, up to 85% of your benefits can be taxable, if one of the following situations applies to you.

1) The total of one-half of your benefits and all your other income is more than $34,000 ($44,000 if you are married filing jointly), or

2) You are married filing separately and ***lived with your spouse*** at any time during 1997.

Which worksheet to use. A worksheet to figure your taxable benefits is in the instructions for your Form 1040 or 1040A. You can use either that worksheet or Worksheet 1 in Publication 915, unless one of the following situations applies to you.

1) You contributed to an individual retirement arrangement (IRA) and your IRA deduction is limited because you or your spouse is covered by a retirement plan at work. In this situation you ***must*** use the special worksheets in Appendix B of Publication 590 to figure both your IRA deduction and your taxable benefits.

2) Situation (1) does not apply and you take an exclusion for interest from Series EE U.S. savings bonds (Form 8815), for adoption benefits (Form 8839), for foreign earned income or housing (Form 2555 or Form 2555–EZ), or for income earned in American Samoa (Form 4563) or Puerto Rico by bona fide residents. In this situation, you ***must*** use Worksheet 1 in Publication 915 to figure your taxable benefits.

3) You received a lump-sum payment for an earlier year. In this situation, also complete Worksheet 2 or 3 **and** Worksheet 4 in Publication 915.

Lump-Sum Election

You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 1997 in your 1997 income, even if the payment includes benefits for an earlier year.

TIP *This type of lump-sum benefit payment should not be confused with the lump-sum* death *benefits that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.*

Generally, you use your 1997 income to figure the taxable part of the total benefits received in 1997. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits. See Publication 915 for more information.

Repayments More Than Gross Benefits

In some situations, your Form SSA–1099 or RRB–1099 will show that the total benefits you repaid (box 4) is more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 (a figure in parentheses) will be a negative figure and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year. If you have any questions about this negative figure, contact your local Social Security Administration office or your local U.S. Railroad Retirement Board field office.

Joint return. If you and your spouse file a joint return, and your Form SSA–1099 or RRB–1099 has a negative figure in box 5 but your spouse's does not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

Repayment of benefits received in an earlier year. If the total amount shown in box 5 of all of your Forms SSA–1099 and RRB–1099 is a negative figure and all or part of this negative figure is for benefits you included in gross income in an earlier year, you can take an itemized deduction on Schedule A (Form 1040) for the amount of the negative figure that represents those benefits.

If this deduction is ***$3,000 or less,*** it is subject to the 2%-of-adjusted-gross-income limit and is claimed on line 22 of Schedule A (Form 1040).

If this deduction is ***more than $3,000,*** you have some special instructions to follow. Get Publication 915 for those instructions.

Sale of Home

If you have a gain from the sale of your main home, follow the rules that apply to your date of sale. Different rules apply to sales before May 7, 1997, and sales after May 6, 1997.

How to report the sale. You must report the sale of your main home using **Form 2119,** *Sale of Your Home.* This is true whether you sell the home at a gain or a loss. If you sell it at a loss, you cannot deduct the loss.

Sales Before May 7, 1997

If you have a gain from a sale before May 7, 1997, you must include it in your income, except for any part you postpone or exclude. Generally, you ***postpone*** tax on the gain on the sale of your main home if you buy and live in a new home within the replacement period (beginning 2 years before and ending 2 years after the sale) and meet certain other conditions. Also, if you are age 55 or older on the date of sale and meet certain other conditions, no tax applies to any gain you choose to ***exclude.*** See *Exclusion of Gain,* later.

These rules apply to you if:

1) You sold your home before May 7, 1997, or

2) You sold your home after May 6, 1997, but choose to use the rules for sales before May 7, 1997. Generally, you can make this choice if you sold your home before August 6, 1997 (or after August 5, 1997, under a contract binding on that date) or bought a new home on or before August 5, 1997. See chapter 4 of Publication 523, *Selling Your Home,* for details about making this choice.

The following discussion covers the exclusion of gain for sales before May 7, 1997. But for more information on postponing or excluding gain, see Publication 523.

Exclusion of Gain

You can exclude from gross income all or part of your gain from the sale of your main home if you meet certain age, ownership, and use tests at the time of the sale. This is a one-time exclusion of gain for sales after July 26, 1978, and before May 7, 1997. However, for sales after May 6, 1997, you may qualify for the exclusion described later. (In certain cases, you may choose instead to claim the one-time exclusion, as described earlier.)

If you meet the requirements described in this section and you make the choice to exclude gain, the gain you exclude is not taxed.

If you change your mind after you file the return for the year of sale, you may be able to make or revoke the choice later. You would have to file an amended return for the year of sale within certain time limits. See *How to make and revoke a choice to exclude gain,* later.

Amount excluded. If you meet the age, ownership, and use tests, you can choose to exclude $125,000 of your gain on the sale of your home. If you are married on the date of the sale and file a separate return, you can choose to exclude only $62,500. If there is gain remaining after the exclusion, you may have to postpone tax on the rest of the gain if you meet the conditions explained in Publication 523.

Age, ownership and use tests for sales before May 7, 1997. You can claim the exclusion if you meet all the following tests.

1) You were age ***55 or older*** on the date of the sale.

2) During the ***5-year period*** ending on the date of the sale, you:

   a) ***Owned*** your main home for at least ***3 years***, and

   b) ***Lived in*** your main home for at least ***3 years***.

3) Neither you nor your spouse have ever excluded gain on the sale of a home after July 26, 1978.

However, see *Effect of marital status,* later, for more details.

Age 55 at time of sale. You must be 55 by the date you sell the home to qualify for the exclusion. You do not meet the age 55 test if you sell the property during the year in which you will be 55 but before you actually become 55. The earliest date on which you can sell your home and still qualify for the exclusion is your 55th birthday.

Ownership and use tests. The required 3 years of ownership and use (during the 5-year period ending on the date of the sale) do not have to be continuous. You meet the tests if you can show that you owned and lived in the property as your main home for either 36 full months or 1,095 days (365×3) during the 5-year period. Short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use. See *Ownership and use tests met at different times,* later.

Joint owners who are married. Both you and your spouse will meet the age, ownership, and use tests if you meet all of the following requirements.

1) You hold the home either as joint tenants, tenants by the entirety, or community property on the date of the sale.

2) You file a joint return for the tax year in which you sell the home.

3) Either you or your spouse has met the age, ownership, and use tests.

Joint owners who are not married. If the joint owners of a home are not husband and wife, each owner who chooses to exclude gain from income must meet the age, ownership, and use tests. If one owner meets the tests, that does not automatically qualify the other owners to exclude their gain from income.

Each owner excludes gain on an individual basis. If one owner chooses to exclude gain, the other owners do not have to exclude their gain. They can choose to exclude gain when they sell a different home in the future.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 3-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 1990, Grace Jones was 50 years old and lived in a rented apartment. The apartment building was later changed to a condominium and she bought her apartment on December 1, 1993. In 1995, Grace became ill and on April 14 of that year she moved to her daughter's home. On February 14, 1997, while still living in her daughter's home, she sold her apartment.

Grace can exclude gain on the sale of her apartment because she met the age, ownership, and use tests. Grace was over 55 at the time of the sale. Her 5-year period is from February 15, 1992, to February 14, 1997, the date she sold the apartment. She owned her apartment from December 1, 1993, to February 14, 1997 (over 3 years). Grace lived in the apartment from February 15, 1992, to April 14, 1995 (over 3 years).

Exception for individuals with a disability. There is an exception to the 3-out-of-5-year use test if you become physically or mentally unable to care for yourself at any time during the 5-year period.

You qualify for this exception to the use test if, during the 5-year period before the sale of your home:

1) You became physically or mentally unable to care for yourself, and

2) You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you reside in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 3-out-of-5-year ownership test to claim the exclusion.

Home of spouse who died. You will meet the ownership and use tests if your spouse is deceased on the date you sell your main home, and:

1) You have not remarried,

2) Your deceased spouse had met the ownership and use tests for that main home, and

3) Your deceased spouse had not previously chosen or joined in choosing to exclude gain on the sale of another main home after July 26, 1978.

You must still meet the age test (be at least 55 on the date of sale) to qualify for the exclusion.

Example. Ellen and Doug Smith were married January 6, 1995. After their marriage, their main home was property Doug had owned and lived in as his main home since January 2, 1985. Doug died on January 2, 1997. He had never chosen or joined in choosing to exclude gain on the sale of any home.

Ellen inherited the property and continued to live in it as her main home until April 10, 1997, when she sold it. At the date of sale she was 56 years old, had not remarried, and had never chosen or joined in choosing to exclude gain on the sale of any home. Ellen can choose to exclude up to $125,000 of the gain from the sale of her home. This is because she meets the age test and Doug met the 3-out-of-5-year ownership and use tests for the property.

Sale by executor. Gain from the sale of a home by the executor of an estate may qualify for this exclusion. To qualify, the sale must be made under a contract entered into before death by a taxpayer who met the age, ownership, and use tests.

Effect of marital status. For purposes of the exclusion, your marital status is determined as of the date of sale of your home. If you are legally separated under a decree of divorce or of separate maintenance, you are not considered married.

Your marital status on the date of the sale determines:

- The amount you can exclude,
- Whether your spouse must join you in the choice to exclude gain, and
- Whether each spouse can choose to exclude gain later.

Married persons must choose exclusion jointly. If you are married when you sell your main home, you cannot choose to exclude the gain unless your spouse joins you in making the choice. Your spouse must join you in the choice, even if:

1) You or your spouse owned the home separately,

2) You and your spouse file separate returns, or

3) The spouse not owning an interest in the home had not lived in it for the required period before the sale.

Death of spouse after sale. If your spouse died after the sale, but before making the choice to exclude the gain, his or her personal representative (for example, the administrator or executor) must join with you in making the choice. You, as the surviving spouse, are considered the personal representative of your deceased spouse if no one else has been appointed.

Home not jointly owned. If the home is not jointly owned, the spouse who owns it must meet the age, ownership, and use tests. The other spouse must join in making the choice.

Separate return. If you are married on the date of the sale, file a separate return, and meet the age, ownership and use tests, you can exclude no more than $62,500 of gain on the sale of your main home. Your spouse must show agreement to your choice by writing in the bottom margin of Form 2119 or on an attached statement, “I agree to the Part II election.” Your spouse must also sign his or her name.

You or your spouse can exclude gain only once. If you or your spouse chooses to exclude gain from a sale after July 26, 1978, neither of you can choose to exclude gain again under these rules. (You may be able to exclude gain on a sale after May 6, 1997, under the rules for those sales described later.

How to make and revoke a choice to exclude gain. Under these rules, you can exclude gain on the sale of your main home ***only once*** for sales after July 26, 1978. For sales after May 6, 1997, you may be able to exclude gain under the rules explained later.

Time to exclude gain. You can make or revoke a choice to exclude gain from a particular sale at any time before the ***latest*** of the following dates:

1) Three years from the due date of the return for the year of sale,
2) Three years from the date you filed the return, or
3) Two years from the date you paid the tax.

How to make the choice. Make the choice by attaching a filled-in **Form 2119** to your income tax return for the year in which you sell your home. However, if you do not have Form 2119, you can make the choice by attaching a signed statement to your return. The statement must say you choose to exclude from income the gain from the sale. It must also include:

1) Your name, age, social security number, and marital status on the date of the sale. If the home was jointly owned, give this information for each owner.
2) The dates you bought and sold the home.
3) The amount realized and the adjusted basis of the property on the date of sale.
4) How long you were away from the home during the 5 years before the sale. Do not include vacations and other seasonal absences, even if you rented out the home during those absences.
5) Whether you or a joint owner ever chose to exclude gain on the sale of a home, and if you did, when and where you did so. If you revoked the choice, give the date you revoked it.

You can choose to exclude the gain even if you originally included it on your tax return for the year of the sale. You do so by filing an amended return on Form 1040X for that year. You must send a filled-in Form 2119 or a statement that includes the information listed above with your amended return.

How to revoke the choice. You can revoke your choice to exclude gain by filing an amended return for the year of sale using Form 1040X. Attach a new completed Form 2119 and, if needed, a Schedule D (Form 1040). Send the forms to the Internal Revenue Service Center for the place where you live.

If you were married when you sold your home, your spouse who joined you in making the choice must join you in revoking it. If your spouse is deceased, his or her personal representative must join you in revoking the choice.

Extension of assessment period. If you revoke your choice to exclude gain when less than a year is left in the assessment period (time for determining your correct tax) for the return on which the choice was made, you must agree to extend the assessment period. Before the end of the period, you must file a statement that the assessment period will not end until 1 year after the date the statement is filed. The assessment period normally ends on the latest of the dates shown earlier under *Time to exclude gain.*

Sales After May 6, 1997

If you sell your main home after May 6, 1997, you may qualify to exclude all or part of any gain from your income. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Amount of Exclusion,* next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you will have to pay tax on your entire gain, unless you choose to use the rules for sales before May 7, 1997. The general rules for making that choice were described earlier.

Amount of Exclusion

You can exclude the entire gain on the sale of your main home up to:

1) $250,000, or
2) $500,000 if all of the following are true.
   a) You are married and file a joint return for the year.
   b) Either you or your spouse meets the ownership test.
   c) Both you and your spouse meet the use test.
   d) Neither you nor your spouse is excluding gain from the sale of another home after May 6, 1997.

Ownership and Use Tests for Sales After May 6, 1997

You can claim the exclusion if, during the 5–year period ending on the date of the sale, you have:

1) Owned the home for at least 2 years (the ownership test), ***and***
2) Lived in the home as your main home for at least 2 years (the use test).

Exception. If you owned and used the property as your main home for less than 2 years, you may be able to claim a reduced exclusion. See *Reduced Exclusion* in chapter 4 of Publication 523.

Adjustments to Income

You may be able to subtract amounts from your gross income (Form 1040, line 22 or Form 1040A, line 14) to get your adjusted gross income (Form 1040, line 32 or Form 1040A, line 16). Some adjustments to income follow:

1) Contributions to your individual retirement arrangement (IRA), (Form 1040, line 23, or Form 1040A, line 15) explained later in this publication.

2) Certain moving expenses (Form 1040, line 25) if you changed job locations or started a new job in 1997. See Publication 521, *Moving Expenses,* or get Form 3903, *Moving Expenses,* or Form 3903–F, *Foreign Moving Expenses,* and the accompanying instructions.

3) Some health insurance costs (Form 1040, line 27) if you were self-employed and had a net profit for the year, or if you received wages in 1997 from an S Corporation in which you were a more than 2% shareholder. For more details get Publication 535, *Business Expenses.*

4) Payments to your Keogh and self-employed SEP plans (Form 1040, line 28). For more information, including limits on how much you can deduct, see Publication 560, *Retirement Plans for the Self-Employed.*

5) Penalties paid on early withdrawal of savings. See the instructions for line 29 in your Form 1040 instructions.

6) Alimony payments (Form 1040, line 30a). For more information, see Publication 504, *Divorced or Separated Individuals.*

There are other items you can claim as adjustments to income. These adjustments are discussed in the Form 1040 instructions.

Individual Retirement Arrangement (IRA) Deductions

This section explains the tax treatment of amounts you pay into individual retirement arrangements (IRAs). For more detailed information get Publication 590.

IRA contributions. An IRA is a personal savings plan that offers you tax advantages to set aside money for your retirement. Two advantages are that you may be able to deduct your contributions to your IRA in whole or in part, depending on your circumstances, and that, generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

CAUTION *Although interest earned on your IRA is generally not taxed in the year earned, it is not tax-exempt interest. Do not report this interest on your tax return as tax-exempt interest.*

Contribution limits. Generally, you can take a deduction for the contributions that you are allowed to make to your IRA. However, **if, for 1997, you or your spouse is covered by an employer retirement plan at any time during the year,** your allowable IRA deduction may be less than your contributions. Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income.

Note. For tax years beginning after 1997, you are not considered covered by an employer retirement plan because your spouse is covered. See Publication 553, *Highlights of 1997 Tax Changes,* for more information.

Although your deduction for IRA contributions may be reduced or eliminated because of the adjusted gross income limitation, you can still make **contributions** of up to $2,000 for 1997 or 100% of your compensation, whichever is less. The difference between your total permitted contributions and your total deductible contributions, if any, is your **nondeductible contribution.** You must file **Form 8606**, *Nondeductible IRAs (Contributions, Distributions, and Basis),* to report nondeductible contributions even if you do not have to file a tax return for the year.

Contributions — joint return. Beginning in 1997, in the case of a married couple filing a joint return, up to $2,000 can be contributed to each spouse's IRA, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as $4,000 for the year. For more detailed information, get Publication 590.

Standard Deduction

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. The ***standard deduction*** is a dollar amount that reduces the income on which you are taxed. It is a benefit that eliminates the need for many taxpayers to itemize their actual deductions. The standard deduction is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Persons not eligible for the standard deduction. Your standard deduction is ***zero*** and you should itemize any deductions you have if:

1) You are married and filing a separate return, and your spouse itemizes deductions,

2) You are filing a tax return for a short tax year because of a change in your annual accounting period, or

3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident alien and a resident alien during the year.

If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the year, you can choose to be treated as a U.S. resident. See Publication 519. If you make this choice, you can take the standard deduction.

Higher standard deduction for age (65 or older). If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you can take the higher standard deduction for 1997 if your 65th birthday was on or before January 1, 1998.

Higher standard deduction for blindness. If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction. Use *Table 3* in this publication. You qualify for this benefit if you are totally or partly blind.

Totally blind. If you are totally blind, attach a statement to this effect to your return.

Partly blind. If you are partly blind, you must submit with your return each year a certified statement from an eye physician or registered optometrist that:

- You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, you can avoid having to get a new certified statement each year by having the examining eye physician include this fact in the certification you attach to your return. In later years just attach a statement referring to the certification. You should keep a copy of the certification in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

Spouse 65 or older or blind. You can take the higher standard deduction if your spouse is age 65 or older or blind and:

1) You file a joint return, or
2) You file a separate return, your spouse had no gross income, and an exemption for your spouse could not be claimed by another taxpayer.

CAUTION *You cannot claim the higher standard deduction for an individual, other than yourself and your spouse.*

If you are 65 or older or blind, use *Table 3* in this publication, to figure the standard deduction amount you are entitled to.

If you are under age 65 and not blind, use *Table 2* in this publication, to figure the standard deduction amount you are entitled to.

CAUTION *If an exemption for you can be claimed on another person's return, your standard deduction may be limited. See Standard Deduction for Dependents, later in this section.*

Decedents. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

If you decide to take the standard deduction, you may find your standard deduction amount by referring to the chart that fits your circumstances.

Example 1. Larry, 66, and Donna, 67, are filing a joint return for 1997. Neither is blind. They decide not to itemize their deductions. They use *Table 3*. Their standard deduction is $8,500.

Example 2. Assume the same facts as in *Example 1* except that Larry is blind at the end of 1997. They use *Table 3.* Larry and Donna's standard deduction is $9,300.

Example 3. Susan, 67, who is blind, qualifies as head of household in 1997. She has no itemized deductions. She uses *Table 3.* Her standard deduction is $8,050.

Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of:

- $650, or
- The individual's earned income for the year (but not more than the regular standard deduction amount, generally $4,150).

However, if you are 65 or older or blind, your standard deduction may be higher. Use *Table 4* to determine your standard deduction.

1997 Standard Deduction Tables

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 2. Standard Deduction Chart for People Under Age 65*

If Your Filing Status is:	Your Standard Deduction is:
Single	$4,150
Married filing joint return or Qualifying widow(er) with dependent child	6,900
Married filing separate return	3,450
Head of household	6,050

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

Table 3. Standard Deduction Chart for People Age 65 or Older or Blind*

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

You — 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption — 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

If Your Filing Status is:	And the Number in the Box Above is:	Your Standard Deduction is:
Single	1	$5,150
	2	6,150
Married filing joint return or Qualifying widow(er) with dependent child	1	7,700
	2	8,500
	3	9,300
	4	10,100
Married filing separate return	1	4,250
	2	5,050
	3	5,850
	4	6,650
Head of household	1	7,050
	2	8,050

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 4, instead.

Table 4. Standard Deduction Worksheet for Dependents*

If you were 65 or older or blind, check correct number of boxes below. Then go to the worksheet.

You — 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption — 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

1. Enter your **earned income** (defined below). If none, enter -0-.	**1.** ______
2. Minimum amount	**2.** $650
3. Enter the **larger** of line 1 or line 2.	**3.** ______
4. Enter the amount shown below for your filing status. • Single, enter $4,150 • Married filing separate return, enter $3,450 • Married filing jointly or Qualifying widow(er) with dependent child, enter $6,900 • Head of household, enter $6,050	**4.** ______
5. Standard deduction **a.** Enter the **smaller** of line 3 or line 4. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 5b.	**5a.** ______
b. If 65 or older or blind, multiply $1,000 ($800 if married or qualifying widow(er) with dependent child) by the number in the box above.	**5b.** ______
c. Add lines 5a and 5b. This is your standard deduction for 1997.	**5c.** ______

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.*

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

Itemized Deductions

Some individuals should itemize their deductions because it will save them money. Others should itemize because they do not qualify for the standard deduction. See the discussion under *Standard Deduction,* earlier, to decide if it would be to your advantage to itemize deductions.

Medical and dental expenses, some taxes, certain interest expenses, charitable contributions, certain losses, and other miscellaneous expenses may be itemized as deductions on Schedule A (Form 1040).

CAUTION *You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than $121,200 ($60,600 if you file married filing separately).*

You may benefit from itemizing your deductions on Schedule A of Form 1040 if you:

- Cannot take the standard deduction,
- Had uninsured medical or dental expenses that are more than 7.5% of your adjusted gross income (see *Medical and Dental Expenses* later),
- Paid interest and taxes on your home,
- Had large unreimbursed employee business expenses or other miscellaneous deductions,
- Had large uninsured casualty or theft losses,
- Made large contributions to qualified charities (see Publication 526, *Charitable Contributions*), or
- Have total itemized deductions that are more than the highest standard deduction you can claim.

See the instructions for Schedule A in the Form 1040 instructions for more information.

Medical and Dental Expenses

You can deduct certain medical and dental expenses you paid for yourself, your spouse, and your dependents, if you itemize your deductions on Schedule A (Form 1040).

Table 5 shows items that you can or cannot include in figuring your medical expense deduction. More information can be found in Publication 502, *Medical and Dental Expenses.*

CAUTION *You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 32, Form 1040.*

What to include. You can include only the medical and dental expenses you paid during 1997, regardless of when the services were provided. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a “pay-by-phone” or “on-line” account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

Medical Insurance Premiums

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, X-rays, etc.,
- Prescription drugs,
- Replacement of lost or damaged contact lenses, or
- Membership in an association that gives cooperative or so-called “free-choice” medical service, or group hospitalization and clinical care.

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical portion must be separately stated in the insurance contract or given to you in a separate statement.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid in 1997 for Medicare A can be included as a medical expense.

Medicare B. Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65 or after you became disabled, you can deduct the monthly premiums you paid. If you were over age 65 or disabled when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

Medical savings account. You may be able to make deductible contributions to a medical savings account (MSA) if you are an employee of a small business (fewer than 50 employees), or if you are self-employed and covered only by a high deductible health plan. See Publication 969, *Medical Savings Accounts (MSAs),* for more information.

Prepaid insurance. Premiums you pay before you are 65 for insurance for medical care for yourself, your spouse, or your dependents after you are 65 are medical care expenses in the year paid if they are:

1) Payable in equal yearly installments, or more often, and

2) Paid for at least 10 years, or until you reach 65 (but not for less than 5 years).

Table 5. **Medical and Dental Expenses Checklist**

You can include	You cannot include
• Birth control pills prescribed by your doctor • Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502) • Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled. • Cost of lead-based paint removal (see Publication 502) • Expenses of an organ donor • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Legal abortion • Legal operation to prevent having children • Long-term care contracts, qualified • Meals and lodging provided by a hospital during medical treatment • Medical and hospital insurance premiums • Medical savings accounts • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) • Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric care at a specially equipped medical center (includes meals and lodging) • Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services,* below) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special school or home for mentally or physically disabled persons (see Publication 502) • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services (see Publication 502)	• Bottled water • Diaper service • Expenses for your general health (even if following your doctor's advice) such as— —Health club dues —Household help (even if recommended by a doctor) —Social activities, such as dancing or swimming lessons —Stop smoking program —Trip for general health improvement —Weight loss program • Funeral, burial or cremation expenses • Illegal operation or treatment • Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes • Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc.

Medical and Dental Expenses

You can include in medical expenses your payments for:

- Medicines and drugs that are prescribed, and insulin.
- Medical services by physicians, surgeons, specialists, or any other medical practitioner.
- Hospital services, therapy and nursing services (including part of the cost of all nurses' meals you pay for), ambulance hire, and laboratory, surgical, diagnostic, dental, and X-ray fees.

- Qualified long-term care insurance and services. See Publication 502.
- Life-care fee or a founder's fee paid either monthly or as a lump sum under an agreement with a ***retirement home***. The part of the payment you include is the amount properly allocable to medical care. The agreement must require a specified fee payment as a condition for the home's promise to provide lifetime care that includes medical care.
- Wages and other amounts you pay for nursing services. Services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse. This includes services connected with caring for the patient's condition, such as giving medication or changing dressings, as well as bathing and grooming the patient.

  Only the amount spent for nursing services is a medical expense. If the attendant also provides personal and household services, these amounts must be divided between the time spent in performing household and personal services and time spent for nursing services. However, certain expenses for household services or for the care of a qualifying individual incurred to allow you to work may qualify for the child and dependent care credit. See Publication 503, *Child and Dependent Care Expenses.*
- Social security tax, FUTA, and Medicare tax, and state employment taxes for a worker who provided medical care. For information on employment tax responsibilities of household employers, see Publication 926, *Household Employer's Tax Guide.*
- Treatment at a therapeutic center for drug or alcohol addiction, including meals and lodging provided by the center during treatment.

Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

1) The lodging is primarily for, and essential to, medical care.
2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
3) The lodging is not lavish or extravagant under the circumstances.
4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses cannot be more than $50 per night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to $100 per night is included as a medical expense for lodging. (Meals are not deductible.)

Nursing home. You can include in medical expenses the cost of medical care in a nursing home or a home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

Do not include the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

Medical trip. You cannot deduct the cost of your meals and lodging while you are away from home for medical treatment if you do not receive the treatment at a medical facility or if the lodging is not primarily for or essential to the medical care.

Special Items and Equipment

Include payments for:

- False teeth, artificial limbs, contact lenses, eyeglasses, hearing aids and batteries to operate it, and crutches.
- The cost and care of a guide dog or other animal to be used by a visually or hearing impaired person. You can also include the cost and care of a dog or other animal trained to assist persons with other physical disabilities. Amounts you pay for the care of these specially trained animals are also medical expenses.
- The cost and repair of special telephone equipment that lets a hearing-impaired person communicate over a regular telephone.
- The extra cost of a specially equipped television set and the cost of an adapter for a regular set that provides subtitles for a hearing-impaired person.
- The part of the cost of braille books and magazines for use by a visually-impaired person that is more than the price for regular printed editions.
- A plan that keeps your medical information so that it can be retrieved from a computer data bank for your medical care.
- Oxygen and oxygen equipment to relieve breathing problems caused by a medical condition.
- Legal fees you paid that are necessary to authorize treatment for mental illness. You cannot include in medical expenses fees for the management of a guardianship estate, fees for conducting the affairs of the person being treated, or other fees that are not necessary to the medical care.
- Special hand controls and other special equipment installed in a car for the use of a person with a disability. Include the amount by which the cost of a car specially designed to hold a wheelchair is more than the cost of a regular car.

- An autoette or a wheelchair used mainly for the relief of sickness or disability, and not just to provide transportation to and from work. The cost of operating and keeping up an autoette or wheelchair is also a medical expense.

Do not include the cost of operating a specially equipped car, except as discussed next.

Transportation

Amounts paid for transportation primarily for, and essential to, medical care qualify as medical expenses.

You can include:

- Bus, taxi, train, or plane fares, or ambulance service.
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone.
- Actual car expenses, such as gas, oil, parking fees, and tolls. Instead of deducting actual car expenses, you can deduct ***10 cents a mile*** for use of your car for medical reasons. Add the cost of parking fees and tolls to this amount.
  You cannot include depreciation, insurance, or general repair and maintenance expenses on your car, no matter which method you choose to figure the deduction.

CAUTION *Do not include transportation expenses if, for nonmedical reasons, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.*

Home Improvements

Only reasonable costs to accommodate a personal residence to a disabled condition are considered medical care. Additional costs for personal motives, such as for architectural or aesthetic reasons, are not medical expenses. Publication 502 contains additional information and examples, including a capital expense work chart, to assist you in figuring the amount of the capital expense that you can include in your medical expenses. Also, see Publication 502 for information about deductible operating and upkeep expenses related to such capital expense items, and for information about improvement, for medical reasons, to property rented by a person with disabilities.

Credit for the Elderly or the Disabled

This section explains who qualifies for the credit for the elderly or the disabled and how to figure this credit. The maximum credit available is $1,125. You may be able to take this credit if you are 65 or older, or if you retired on permanent and total disability.

CAUTION *You can take the credit only if you file Form 1040 or Form 1040A. You cannot take the credit if you file Form 1040EZ.*

The IRS will figure your credit. If you choose to have the IRS figure your tax on Form 1040 or Form 1040A, and you qualify for the credit for the elderly or the disabled, the IRS will figure the credit for you. See Publication 967, *The IRS Will Figure Your Tax.*

Can You Take the Credit?

You can take the credit for the elderly or the disabled if:

1) You are a ***qualified individual*** and

2) Your income is not more than certain limits.

See *Figures A and B,* later.

Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and:

1) You are age 65 or older by the end of the tax year, or

2) You are under 65 at the end of the tax year, and

   a) You are retired on permanent and total disability,

   b) You did not reach mandatory retirement age before 1997, and

   c) You received taxable disability income in 1997.

TIP **Age 65.** *You are considered 65 on the day before your 65th birthday. Therefore, you are 65 by the end of the year if your 65th birthday is on January 1 of the following year.*

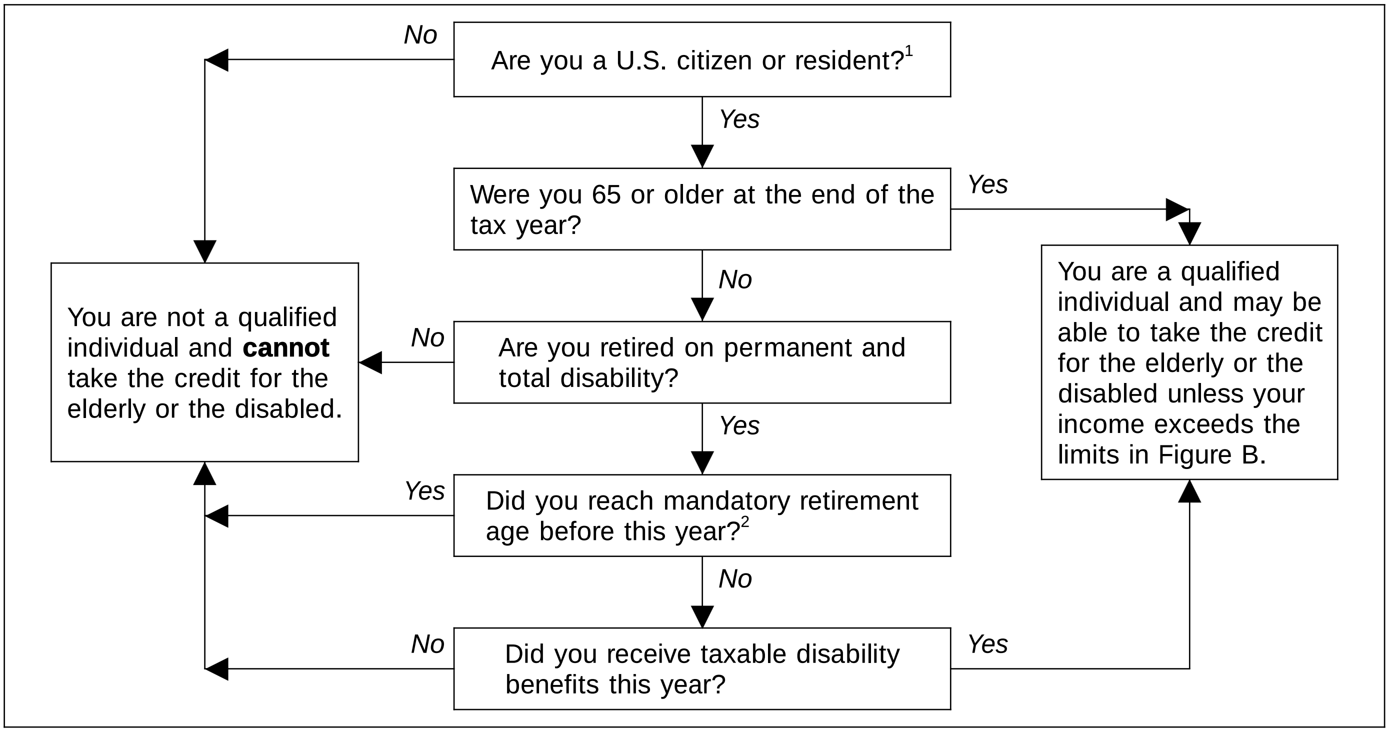
U.S. citizen or resident. You must be a U.S. citizen or resident (or be treated as a resident) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

Exception. If you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you both choose to be treated as U.S. residents and be taxed on your worldwide income, you may be able to take the credit.

Married persons. Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. If you and your spouse did not live in the same household at any time during the tax year, you can file either a joint return or separate returns and still take the credit.

You can file as **head of household** and qualify to take the credit even if your spouse lived with you during the first 6 months of the year if you meet all of the tests. See Publication 524 and Publication 501 or your Form 1040 or 1040A instructions for line 4.

Figure A. **Are You a Qualified Individual?**



[1]If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see *U.S. citizen or resident* under *Qualified Individual.* If you and your spouse both choose to be treated as U.S. residents, answer "yes" to this question.

[2]Mandatory retirement is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure B. **Income Limits**

Even if you qualify (see Figure A), you CANNOT take the credit if:		
Your filing status is	**AND** **your adjusted gross income (AGI)* is equal to or more than**	**OR** **your nontaxable social security or other nontaxable pension(s) is equal to or more than**
Single, Head of household, or Qualifying widow(er) with dependent child	$17,500	$5,000
Married filing a joint return **and** both spouses qualify in *Figure A*	$25,500	$7,500
Married filing a joint return **and** only one spouse qualifies in *Figure A*	$20,000	$5,000
Married filing a separate return **and** you did not live with your spouse at any time during the year	$12,500	$3,750

* AGI is the amount on Form 1040A, line 17, or Form 1040, line 33

Under age 65. If you are under age 65, you can qualify for the credit only if you are retired on permanent and total disability. You are retired on permanent and total disability if:

1) You were permanently and totally disabled when you retired, and

2) You retired on disability before the end of the tax year.

You are considered retired on disability, even if you do not retire formally, when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement,* later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit. Full-time work (or part-time work done at the employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that you are able to engage in substantial gainful activity.

The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

The following examples illustrate the tests of substantial gainful activity.

Example 1. Trisha, a sales clerk, retired on disability. She is 53 years old and now works as a full-time baby-sitter for minimum wage. Even though Trisha is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for the minimum wage. She cannot take the credit because she is able to engage in substantial gainful activity.

Example 2. Tom, a bookkeeper, retired on disability. He is 59 years old and now drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

Example 3. John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive "make-work" nature. The activity was gainful because John was paid at least the minimum wage. But the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

Example 4. Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assists her sister for 1 or 2 hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time during the day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a "substantial and gainful" nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes. Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of the person's ability to engage in substantial gainful activity.

Physician's statement. If you are under 65, you must have your physician complete a statement certifying that you are permanently and totally disabled. Attach the statement to your return. You can use the physician's statement in Part II of either Schedule R (Form 1040) or of Schedule 3 (Form 1040A). However, check the box on line 2 and do not attach a physician's statement if:

1) You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, **and**

2) Due to your continued disabled condition, you were unable to engage in any substantial gainful activity during the tax year.

If you have not filed a physician's statement in a previous year, or if the statement you filed did not meet these conditions, your physician must complete the statement.

If you file a joint return and you checked box 5 in Part I of either Schedule R or Schedule 3, you and your spouse must each file a physician's statement. Attach a separate Schedule R or Schedule 3 for your spouse with only Part II filled out.

Disability income. If you are under age 65, you can qualify for the credit only if you have taxable disability income.

Disability income must meet the following two requirements:

1) The income must be paid under your employer's accident or health plan or pension plan.
2) The income must be wages or payments in lieu of wages for the time you are absent from work because of permanent and total disability.

Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does not include amounts you receive after you reach mandatory retirement age. Mandatory retirement age is the age set by your employer at which you would have had to retire had you not become disabled.

Income Limits

To determine if you can claim the credit, yoyu must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security or other nontaxable pensions you received. The limits are shown in *Figure B.*

If the amount of your AGI and nontaxable pensions are less than ther income limits, you may be able to claim the credit.

CAUTION *If the amount of your AGI or nontaxable pensions is equal to or more than the income limits, you cannot take the credit.*

Figuring the Credit

If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3 (if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3.

There are four steps in Part III to determine the amount of your credit:

1) Determine your overall income limit (lines 10–12).
2) Total any ***nontaxable social security*** or ***railroad retirement benefits*** and other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c).
3) Determine your ***excess adjusted gross income***, (lines 14–17).
4) Determine your credit (lines 18–20).

For more information on these steps, get Publication 524.

Amount of credit. If you can take the credit, subtract the total of step 2 and step 3 from the amount on step 1 and multiply the result by 15%. This is your credit. In certain cases the amount of your credit may be limited. See *Limits on Credit,* next.

Limits on Credit

The amount of your credit may be limited if:

1) You file Schedules C, C–EZ, D, E, or F (Form 1040), and
2) The amount on Form 1040, line 22, is more than:
   a) $33,750 if you are single or head of household,
   b) $45,000 if married filing jointly or qualifying widow(er) with dependent child, or
   c) $22,500 if married filing separately.

For purposes of (2), any **tax-exempt interest** from private activity bonds issued after August 7, 1986, and any net operating loss deduction must be added to the amount from Form 1040, line 22.

If both (1) and (2) do not apply, your credit is not subject to this limit. Enter the amount of the credit from Schedule R, line 20, on Form 1040, line 40. If you meet both (1) and (2), get **Form 6251**, *Alternative Minimum Tax—Individuals,* and complete it through line 24. The limit on your credit will be the smaller of:

1) Your credit as computed, or
2) Your regular tax (line 38, Form 1040) minus:
   a) Any credit for child and dependent care expenses, and
   b) Any amount shown on line 24, Form 6251.

Enter the smaller of (1) or (2) on Form 1040, line 40. If (2) is the smaller amount, also write “AMT” on the dotted line next to line 40, Form 1040, and replace the amount on Schedule R, line 20, with that amount.

CAUTION *Your credit for the elderly or the disabled cannot be more than the amount of your tax liability. Therefore, you cannot get a refund for any part of the credit that is more than your tax.*

Child and Dependent Care Credit

If you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself, you may be able to get a credit of up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

CAUTION *You must include on line 2 of your 1997 Form 2441 or Schedule 2 (Form 1040A) the name and taxpayer identification number (generally the social security number) of each qualifying person. If the correct information is not shown, the credit may be reduced or disallowed.*

If you claim this credit, you must also show on your return the name, address, and the taxpayer identification number of the person who provided the care.

For information, see Publication 503, *Child and Dependent Care Expenses.*

Earned Income Credit

The earned income credit is available to persons with a qualifying child and to persons without a qualifying child. This section will list separately the rules that persons with a qualifying child and persons without a qualifying child must meet to get the credit. After you have read the rules and think you may qualify for the credit, get Publication 596, *Earned Income Credit.* You can also find information in the instructions for Form 1040 (lines 56a and 56b), Form 1040A (lines 29c and 29d), or Form 1040EZ (lines 8a and 8b).

Earned income credit is more. The amount of the credit for 1997 has increased. The maximum credit you can receive is:

- $2,210 with one qualifying child,
- $3,656 with two or more qualifying children, or
- $332 without a qualifying child.

Investment income more than $2,250. You cannot claim the earned income credit if your investment income is more than $2,250. For most people, **investment income** is taxable interest (line 8a of Form 1040 or 1040A), tax-exempt interest (line 8b of Form 1040 or 1040A), dividend income (line 9 of Form 1040 or 1040A), and capital gain net income (line 13 of Form 1040, if more than zero). If you have net rent and royalty income (if greater than zero) and net passive income (if greater than zero) that is not self-employment income, see Publication 596 for more information. Rents and royalties received in a trade or business are not investment income.

Modified AGI (adjusted gross income). Generally, you must know your earned income and modified AGI to figure the amount of your earned income credit. In many cases, your modified AGI will be the same as your AGI.

Modified AGI for most people is the amount on line 32 (Form 1040), line 16 (Form 1040A), and line 4 (Form 1040EZ). But if you are filing Schedule C, C-EZ, D, E, or F or you are claiming a loss from the rental of personal property not used in a trade or business, read *Modified AGI (Adjusted Gross Income) Limit* in Publication 596.

Credit has no effect on certain welfare benefits. The earned income credit and the advance earned income credit payments you receive will not be used to determine whether you are eligible for the following benefit programs, or how much you can receive from the programs.

- Temporary assistance for needy families,
- Medicaid and supplemental security income (SSI),
- Food Stamps and low-income housing.

Social security number. You must provide a correct and valid social security number (SSN) for yourself, your spouse, and any qualifying children. If an SSN is missing or incorrect, you may not get the credit. Publication 596 contains more detailed information.

CAUTION *The social security number must be issued by the Social Security Administration to a U.S. citizen or to a person who has permission from the Immigration and Naturalization Service to work in the United States.*

Self-employed persons. If you are self-employed and your net earnings are $400 or more, be sure to correctly fill out Schedule SE (Form 1040), Self-Employment Tax, and pay the proper amount of self-employment tax. If you do not, you may not get all the credit you are entitled to.

Who Can Claim the Credit?

The earned income credit is available to persons with a qualifying child and to persons without a qualifying child. Some of the rules are the same, but some of the rules only apply to persons with a qualifying child or to persons without a qualifying child.

Persons Who Work and Have One or More Qualifying Children

Generally, if you are a nonresident alien for any part of the year, you cannot claim the credit. To claim the earned income credit under this section, you must meet all the following rules:

1) You must have a qualifying child who lived with you in the United States for more than half the year (the whole year for an eligible foster child).

2) You must have earned income during the year.

3) Your earned income and modified AGI must each be less than:

   a) $25,760 if you have one qualifying child, or

   b) $29,290 if you have more than one qualifying child.

4) Your investment income cannot be more than $2,250.

5) Your filing status can be any filing status except married filing a separate return.

6) You cannot be a qualifying child of another person. If you file a joint return, neither you nor your spouse can be a qualifying child of another person.

7) Your qualifying child cannot be the qualifying child of another person whose modified AGI is more than yours.

8) You usually must claim a qualifying child who is married as a dependent.

9) You are not filing Form 2555, *Foreign Earned Income* (or Form 2555–EZ, *Foreign Earned Income Exclusion*).

Who Is a Qualifying Child?

You have a qualifying child if your child meets three tests. The tests are:

- Relationship,
- Residency, and
- Age.

Relationship test. To meet the relationship test for a qualifying child, the child must be your:

1) Son, daughter, or adopted child (or a descendant of your son, daughter, or adopted child — for example, your grandchild),
2) Stepson or stepdaughter, or
3) Eligible foster child (this could include a niece, nephew, brother, sister, cousin, etc.).

Residency test. To meet the residency test, there are two rules:

1) You must have a child who lived with you for more than half the year (the whole year if your child is an eligible foster child), and
2) The home must be in the United States (one of the 50 states or the District of Columbia). United States military personnel stationed outside the United States on extended active duty are considered to live in the United States for the purposes of the earned income credit.

Age test. To meet the age test, your child must be:

1) Under age 19 at the end of the year,
2) A full-time student under age 24 at the end of the year, or
3) Permanently and totally disabled at any time during the tax year, regardless of age.

Persons Who Work and Do Not Have a Qualifying Child

Generally, if you are a nonresident alien for any part of the year, you cannot claim the earned income credit. In order to take the earned income credit under this section, you must meet all the following rules:

1) You must have earned income during the year.
2) Your earned income and modified AGI must each be less than $9,770.
3) Your investment income cannot be more than $2,250.
4) Your filing status can be any filing status except married filing a separate return.
5) You cannot be a qualifying child of another person. If you file a joint return, neither you nor your spouse can be a qualifying child of another person.
6) You (or your spouse if filing a joint return) must be at least age 25 but ***under age 65*** at the end of your tax year (usually December 31).
7) You cannot be eligible to be claimed as a dependent on anyone else's return. If you file a joint return, neither you nor your spouse can be eligible to be claimed as a dependent on anyone else's return.
8) Your main home (and your spouse's if filing a joint return) must be in the United States for more than half the year.
9) You are not filing Form 2555, *Foreign Earned Income*, or Form 2555–EZ, *Foreign Earned Income Exclusion.*

CAUTION *To get the earned income credit you must have* **social security numbers** *for you and your spouse.*

Advance Earned Income Credit Payments

If you expect to qualify for the earned income credit in 1998, you can choose to receive advance payments of part of the credit in your regular paycheck.

You can request advance payments of the credit for 1998 by completing a 1998 Form W–5. See Publication 596 or the instructions for Form W–5 for more information on the advance earned income credit.

CAUTION *You must file a 1997 return to report what you already received as an advance payment in 1997 and to get any additional earned income credit.*

TIP *You must have at least one qualifying child and qualify for the earned income credit to get the advance payment of the credit in your pay.*

Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards.

Income tax is generally withheld from pensions and annuity payments you receive. However, if the tax withheld is not enough, you may have to pay estimated tax. If you do not pay enough tax through withholding or by making estimated tax payments, you may be charged a penalty.

Who Must Make Estimated Tax Payments

If you had a tax liability for 1997, you may have to pay estimated tax for 1998. Generally, you must make estimated tax payments for 1998 if you expect to owe at least $1,000 in tax for 1998 after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

1) 90% of the tax to be shown on your 1998 tax return, or

2) 100% of the tax shown on your 1997 tax return. The 1997 tax return must cover all 12 months.

If all of your 1998 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

For more information on estimated tax, see Publication 505, *Tax Withholding and Estimated Tax.*

How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our “800 number” telephone services in several ways.

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

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