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# Taxable and Nontaxable Income

For use in preparing  
**2001** Returns



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## Important Change for 2001

**Advance payment of the rate reduction credit.** If you received a check from the IRS during 2001 for the advance payment of the rate reduction credit, do not report it on your tax return. It is not taxable. For more information about the rate reduction credit, see Publication 553, *Highlights of 2001 Tax Changes* and the *Rate Reduction Credit Worksheet* in the instructions for Form 1040 (or Form 1040A or 1040EZ).

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## Important Changes for 2002

**Retirement planning services.** Beginning in 2002, if your employer has a qualified retirement plan, qualified retirement planning services provided for you (or your spouse) by your employer will not be included in your income. For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

**Elective deferrals.** Beginning in 2002, the limit on the amount of your wages you can elect to defer into certain retirement plans (such as section 401(k) plans) will increase each year over a 5-year period. If you are age 50 or older, you will also be able to make additional **catch-up** elective deferrals. See *Elective Deferrals* in the discussion on retirement plan contributions under *Employee Compensation*.

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## Important Reminders

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

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

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

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## Introduction

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

Generally, income is taxable unless it is specifically exempted by law. Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable may have to be shown on your tax return but is not subject to tax.

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

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

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

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

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

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

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## Useful Items

You may want to see:

### Publication

- 520** Scholarships and Fellowships
- 523** Selling Your Home
- 527** Residential Rental Property (Including Rental of Vacation Homes)
- 550** Investment Income and Expenses
- 559** Survivors, Executors, and Administrators
- 564** Mutual Fund Distributions

- 575** Pension and Annuity Income
- 915** Social Security and Equivalent Railroad Retirement Benefits

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

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## Employee Compensation

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

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

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

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

## Miscellaneous Compensation

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

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

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

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

**Back pay awards.** Include in income amounts you are awarded in a settlement or judgment for

back pay. These include payments made to you for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to you by your employer on Form W-2.

**Bonuses and awards.** Bonuses or awards you receive for outstanding work are included in your income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

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

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

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

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

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

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

**Note received for services.** If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

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

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

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

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. Attach to your tax return a copy of the receipt or statement given to you by the agency you repaid to explain the difference between the wages on your return and the wages on your Forms W-2.

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

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

**Sick pay.** Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

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

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

**Social security and Medicare taxes paid by employer.** If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting

them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. The payment is also treated as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

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

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

## Fringe Benefits

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

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

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

You do not have to be an employee of the provider to be a recipient of a fringe benefit. If you are a partner, director, or independent contractor, you can also be the recipient of a fringe benefit.

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

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

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

your employer reports the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

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

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

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

## Accident or Health Plan

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

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

**Archer MSA contributions.** Contributions by your employer to your Archer MSA (previously called a medical savings account) are not included in your income. Their total will be reported in box 12 of Form W-2 with code R. You must report this amount on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, and attach the form to your return.

## Adoption Assistance

You may be able to exclude from your income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. See Publication 968, *Tax Benefits for Adoption*, for more information.

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

## Athletic Facilities

If your employer provides you with the free or low-cost use of an employer-owned gym or other athletic club at your workplace, the value is

not included in your compensation. The gym must be used primarily by employees, their spouses, and their dependent children.

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

## De Minimis (Minimal) Benefits

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

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

## Dependent Care Benefits

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

- Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work, and
- The fair market value of care in a day-care facility provided or sponsored by your employer.

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

- The total amount of dependent care benefits you received during the year,
- The total amount of qualified expenses you incurred during the year,
- Your earned income,
- Your spouse's earned income, or
- \$5,000 (\$2,500 if married filing separately).

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

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

See the instructions for Form 2441 or Schedule 2 (Form 1040A) for more information.

## Educational Assistance

You can exclude from your income up to \$5,250 of qualified employer-provided educational assistance. The exclusion does not apply to graduate-level courses beginning before January 1, 2002. For more information, get Publication 508, *Tax Benefits for Work-Related Education*.

## Employee Discounts

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

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

## Financial Counseling Fees

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

**Note.** Beginning in 2002, qualified retirement planning services paid for you by your employer under a qualified plan will not be included in your income. For more information, see Publication 553, *Highlights of 2001 Tax Changes*.

## Group-Term Life Insurance

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

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

If your employer provided more than \$50,000 of coverage, the amount included in your income is reported as part of your wages in box 1 of your Form W-2. It is also shown separately in box 12 with code C.

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

- Provides a general death benefit,
- Is provided to a group of employees,

- Is provided under a policy carried by the employer, and
- Provides an amount of insurance to each employee based on a formula that prevents individual selection.

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

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

**Former employer.** If your former employer provides more than \$50,000 of group-term life insurance coverage during the year, the amount included in your income is reported as wages in box 1 of Form W-2. It is also shown separately in box 12 with code C. Box 12 will also show the amount of uncollected social security and Medicare taxes on the excess coverage, with codes M and N. You must pay these taxes with your income tax return. Include them in your total tax on line 58, Form 1040, and enter "UT" and the amount of the taxes on the dotted line next to line 58.

**Two or more employers.** Your exclusion for employer-provided group-term life insurance coverage cannot exceed the cost of \$50,000 of coverage, whether the insurance is provided by a single employer or multiple employers. If two or more employers provide insurance coverage that totals more than \$50,000, the amounts reported as wages on your Forms W-2 will not be correct. You must figure how much to include in your income. Reduce the amount you figure by any amount reported with code C in box 12 of your Forms W-2, add the result to the wages reported in box 1, and report the total on your return.

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

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

Age	Cost
Under 25 . . . . .	\$.05
25 through 29 . . . . .	.06
30 through 34 . . . . .	.08
35 through 39 . . . . .	.09
40 through 44 . . . . .	.10
45 through 49 . . . . .	.15
50 through 54 . . . . .	.23
55 through 59 . . . . .	.43
60 through 64 . . . . .	.66
65 through 69 . . . . .	1.27
70 and older . . . . .	2.06

If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you would otherwise include

in your income. However, you cannot reduce the amount to include in your income by:

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

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

Employer A coverage (in thousands) . . . . .	\$ 35
Employer B coverage (in thousands) . . . . .	+ 45
Total coverage (in thousands) . . . . .	\$ 80
Minus: Exclusion (in thousands) . . . . .	- 50
Excess amount (in thousands) . . . . .	\$ 30
Multiply by cost per \$1,000 per month, age 51 (from table) . . . . .	× .23
Cost of excess insurance for 1 month . . . . .	\$ 6.90
Multiply by number of full months coverage at this cost . . . . .	× 12
Cost of excess insurance for tax year . . . . .	\$82.80
Minus: Premiums you paid . . . . .	-49.80
<b>Cost to include in income as wages</b>	<b>\$33.00</b>

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

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

- 1) You are permanently and totally disabled and have ended your employment.
- 2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
- 3) A charitable organization to which contributions are deductible is the only beneficiary of the policy for the entire period the insurance is in force during the tax year. (You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.)
- 4) The plan existed on January 1, 1984, and:
  - a) You retired before January 2, 1984, and were covered by the plan when you retired, or
  - b) You reached age 55 before January 2, 1984, and were employed by the employer or its predecessor in 1983.

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

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

**Meals and Lodging**

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

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

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

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

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

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

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

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

- 1) 5% of the appraised value of the lodging, or

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

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

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

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

## Moving Expense Reimbursements

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

## No-Additional-Cost Services

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

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

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

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

## Transportation

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

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

- A transit pass, or
- Qualified parking.

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

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

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

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

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

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

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

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

## Tuition Reduction

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

## Working Condition Benefits

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

**Example.** You work as an engineer and your employer provides you with a subscription to an engineering trade magazine. The cost of the subscription is not included in your income

since the cost would have been deductible to you if you had paid for the subscription yourself.

## Valuation of Fringe Benefits

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

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

- 1) The amount, if any, you paid for the benefit, plus
- 2) The amount, if any, specifically excluded from your income by law.

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

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

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

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

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

**Flights on employer-provided aircraft.** Under the general valuation rules, if your flight on an employer-provided piloted aircraft is primarily personal and you control the use of the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.

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

**Special valuation rules.** You generally can use a special valuation rule for a fringe benefit only if your employer uses the rule. If your employer uses a special valuation rule, you cannot use a different special rule to value that benefit. You can always use the general valuation rule discussed earlier, based on facts and circumstances, even if your employer uses a special rule.

If you and your employer use a special valuation rule, you must include in your income the

amount your employer determines under the special rule minus the sum of:

- 1) Any amount you repaid your employer, plus
- 2) Any amount specifically excluded from income by law.

The special valuation rules are the following.

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

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

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

## Retirement Plan Contributions

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

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

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

## Elective Deferrals

If you are covered by certain kinds of retirement plans, you can choose to have part of your compensation contributed by your employer to a retirement fund, rather than have it paid to you. The amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan. It is not included in wages subject to income tax at the time contributed. However, it is included in wages subject to social security and Medicare taxes.

Elective deferrals include elective contributions to the following retirement plans.

- Cash or deferred arrangements (section 401(k) plans).

- Section 457 plans.
- The Thrift Savings Plan for federal employees.
- Salary reduction simplified employee pension plans (SARSEP).
- Simple retirement account (SIMPLE) plans.
- Tax-sheltered annuities.
- Section 501(c)(18)(D) plans. (But see *Reporting by employer*, later.)

**Limit on deferrals.** For 2001, you generally should not have deferred more than a total of \$10,500 for **all** qualified plans by which you are covered. This amount may be further limited if you are a highly compensated employee. The amount deferred by a highly compensated employee as a percentage of pay can be no more than 125% of the average deferral percentage (ADP) of all eligible nonhighly compensated employees. Your employer or plan administrator can probably tell you the amount of the deferral limit under this ADP test and whether it applies to you.

Your employer or plan administrator should apply the proper annual limit when figuring your plan contributions. However, you are responsible for monitoring the total you defer to ensure that the limit is not exceeded.



*Under new law, the general limit on elective deferrals for 2002 is \$11,000. This amount will increase by \$1,000 each year until it reaches \$15,000 in 2006. In addition, beginning in 2002, you generally can make an additional elective deferral if you are age 50 or older. For more information, see Publication 553, Highlights of 2001 Tax Changes.*

**Special limit for deferrals under SIMPLE plans.** If you are a participant in a SIMPLE plan, you generally should not have deferred more than \$6,500 in 2001. Amounts you defer under a SIMPLE plan count toward the general limit (\$10,500 for 2001) and may affect the amount you can defer under other elective deferral plans.



*Under new law, the special limit on elective deferrals for SIMPLE plans for 2002 is \$7,000. This amount will increase by \$1,000 each year until it reaches \$10,000 in 2005.*

**Special limit for deferrals under section 457 plans.** If you are a participant in a section 457 plan (a deferred compensation plan for employees of state or local governments or tax-exempt organizations), you should generally have deferred no more than  $\frac{1}{3}$  of your compensation, up to \$8,500 in 2001. Your plan may also allow a special catch-up limit of up to \$15,000 for each of your last 3 years of service before reaching normal retirement age. Amounts you defer under other elective deferral plans may affect your limits under section 457 plans. Amounts you defer under section 457 plans may affect the amount you can defer in tax-sheltered annuities under the special limit discussed next.



*Under new law, beginning in 2002, the special limit on elective deferrals for section 457 plans no longer applies. Deferrals under these plans are subject to the general limit for elective deferrals (\$11,000 for 2002). The special catch-up limit in the last 3 years before retirement is twice the general limit amount (twice \$11,000 for 2002, or \$22,000). Also, beginning in 2002, deferrals under section 457 plans are no longer coordinated with other plans in applying the deferral limit.*

### Special limit for tax-sheltered annuities.

If you are a participant in a tax-sheltered annuity plan with at least 15 years of service at an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches (or associated organization), the limit on elective deferrals to the plan is the general limit (\$10,500 for 2001) plus the **lesser** of the following amounts.

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

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

**Section 501(c)(18)(D) contributions.** Wages shown in box 1 of your Form W-2 should not have been reduced for contributions you made to a section 501(c)(18)(D) retirement plan. The amount you contributed should be identified with code "H" in box 12. You may deduct the amount deferred subject to the limits that apply. Include your deduction in the total on line 32 (Form 1040). Enter the amount and "501(c)(18)" on the dotted line next to line 32.

**Excess deferrals.** If your deferrals exceed the annual limit, you must notify your plan by the date required by the plan. If the plan permits, the excess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of any of the plans that permit these distributions. You must notify each plan by the date required by that plan of the amount to be paid from that particular plan. The plan must then pay you the amount of the excess, along with any income earned on that amount, by April 15 of the following year.

You must include the excess deferral in your income for the year of the deferral. File Form 1040 to add the excess deferral amount to your wages on line 7. Do not use Form 1040A or Form 1040EZ to report excess deferral amounts.

**Excess not distributed.** If you do not take out the excess amount, you cannot include it in the cost of the contract even though you included it in your income. Therefore, you are taxed twice on the excess deferral left in the

plan—once when you contribute it, and again when you receive it as a distribution.

**Excess distributed to you.** If you take out the excess after the year of the deferral and you receive the corrective distribution by April 15 of the following year, do not include it in income again in the year you receive it. If you receive it later, you must include it in income in both the year of the deferral and the year you receive it. Any income on the excess deferral taken out is taxable in the tax year in which you take it out. If you take out part of the excess deferral and the income on it, allocate the distribution proportionately between the excess deferral and the income.

You should receive a Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year in which the excess deferral is distributed to you. Use the following rules to report a corrective distribution shown on Form 1099–R for 2001.

- If the distribution was for a **2001 excess deferral**, your Form 1099–R should have the code “8” in box 7. Add the excess deferral amount to your wages on your 2001 tax return.
- If the distribution was for a **2000 excess deferral**, your Form 1099–R should have the code “P” in box 7. If you did not add the excess deferral amount to your wages on your 2000 tax return, you must file an amended return on Form 1040X. If you did not receive the distribution by April 16, 2001, you must also add it to your wages on your 2001 tax return.
- If the distribution was for a **1999 excess deferral**, your Form 1099–R should have the code “D” in box 7. If you did not add the excess deferral amount to your wages on your 1999 tax return, you must file an amended return on Form 1040X. You must also add it to your wages on your 2001 income tax return.
- If the distribution was for the **income earned** on an excess deferral, your Form 1099–R should have the code “8” in box 7. Add the income amount to your wages on your 2001 income tax return, regardless of when the excess deferral was made.

Report a **loss on a corrective distribution** of an excess deferral in the year the excess amount (reduced by the loss) is distributed to you. Include the loss as a negative amount on line 21 (Form 1040) and identify it as “Loss on Excess Deferral Distribution.”

 *Even though a corrective distribution of excess deferrals is reported on Form 1099–R, it is **not** otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.*

## Excess Contributions

If you are a highly compensated employee, the total of your elective deferrals and other contributions made for you for any year under a sec-

tion 401(k) plan or SARSEP can be, as a percentage of pay, no more than 125% of the average deferral percentage (ADP) of all eligible nonhighly compensated employees.

If the total contributed to the plan is more than the amount allowed under the ADP test, the excess contributions must be either distributed to you or recharacterized as after-tax employee contributions by treating them as distributed to you and then contributed by you to the plan. You must include the excess contributions in your income as wages on line 7 of Form 1040. You cannot use Form 1040A or Form 1040EZ to report excess contribution amounts.

If you receive excess contributions from a 401(k) plan and any income earned on the contributions within 2½ months after the close of the plan year, you must include them in your income in the year of the contribution. If you receive them later, or receive less than \$100 excess contributions, include the excess contributions and earnings in your income in the year distributed. If the excess contributions are recharacterized, you must include them in income in the year a corrective distribution would have occurred. For a SARSEP, the employer must notify you by March 15 following the year in which excess contributions are made that you must withdraw the excess and earnings. You must include the excess contributions in your income in the year of the contribution (or the year of the notification if less than \$100) and include the earnings in your income in the year withdrawn.

You should receive a Form 1099–R for the year in which the excess contributions are distributed to you (or are recharacterized). Add excess contributions or earnings shown on Form 1099–R for 2001 to your wages on your 2001 tax return if code “8” is in box 7. If code “P” or “D” is in box 7, you may have to file an amended 2000 or 1999 return on Form 1040X to add the excess contributions or earnings to your wages in the year of the contribution.

 *Even though a corrective distribution of excess contributions is reported on Form 1099–R, it is **not** otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.*

## Excess Annual Additions

The amount contributed in 2001 to a defined contribution plan is generally limited to the lesser of 25% of your compensation or \$35,000. Under certain circumstances, contributions that exceed these limits (excess annual additions) may be corrected by a distribution of your elective deferrals or a return of your after-tax contributions and earnings from these contributions.

 *Under new law, the dollar limit on contributions to a defined contribution plan for 2002 is \$40,000.*

A corrective payment of excess annual additions consisting of elective deferrals or earnings from your after-tax contributions is fully taxable in the year paid. A corrective payment consisting of your after-tax contributions is not taxable.

If you received a corrective payment of excess annual additions, you should receive a separate Form 1099–R for the year of the pay-

ment with the code “E” in box 7. Report the total payment shown in box 1 of Form 1099–R on line 16a of Form 1040 or line 12a of Form 1040A. Report the taxable amount shown in box 2a of Form 1099–R on line 16b of Form 1040 or line 12b of Form 1040A.

 *Even though a corrective distribution of excess annual additions is reported on Form 1099–R, it is **not** otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.*

## Stock Options

If you receive a nonstatutory option to buy or sell stock or other property as payment for your services, you will usually have income either when you receive the option or when you exercise the option (use it to buy or sell the stock or other property). However, if your option is a statutory stock option (defined later), you usually will not have any income until you sell or exchange your stock. Your employer can tell you which kind of option you hold.

## Nonstatutory Stock Options

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

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

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

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

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

stricted Property, later, for rules on how much income to include and when to include it. However, the rule described in that discussion for choosing to include the value of property in your income for the year of the transfer does not apply to a nonstatutory option.

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

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

## Statutory Stock Options

There are two kinds of statutory stock options.

- Incentive stock options (ISOs), and
- Options granted under employee stock purchase plans.

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

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

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

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

price that was less than the stock's fair market value at that time.

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

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

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

**Example.** Your employer, X Corporation, granted you an ISO on March 11, 1999, to buy 100 shares of X Corporation stock at \$10 a share, its fair market value at the time. You exercised the option on January 19, 2000, when the stock was selling on the open market for \$12 a share. On January 25, 2001, you sold the stock for \$15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 2001, you must report the difference between the option price (\$10) and the value of the stock when you exercised the option (\$12) as wages. The rest of your gain is capital gain, figured as follows:

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

**Alternative minimum tax (AMT).** For the AMT, you must treat stock acquired through the exercise of an ISO as if no special treatment applied. This means that, when your rights in the stock are transferable and no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price. Enter this adjustment on line 10 of Form 6251, *Alternative Minimum Tax—Individuals*. Increase your AMT basis in any stock you acquire by exercising the ISO by the amount of the adjustment. However, no adjustment is required if you dispose of the stock in the same year you exercise the option.

See *Restricted Property*, later, for more information.



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

**Example.** The facts are the same as in the previous example. On January 19, 2001, when the stock was selling on the open market for \$14 a share, your rights to the stock first became transferable. You include \$400 (\$1,400 value when your rights first became transferable minus \$1,000 purchase price) as an adjustment on line 10 of Form 6251.

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

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

**Example.** Your employer, Y Corporation, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Y Corporation for \$20 a share at a time when the stock had a value of \$22 a share. Eighteen months later, when the value of the stock was \$23 a share, you exercised the option, and 14 months after that you sold your stock for \$30 a share. In the year of sale, you must report as wages the difference between the option price (\$20) and the value at the time the option was granted (\$22). The rest of your gain (\$8) is capital gain, figured as follows:

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

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

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

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

## Restricted Property

Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you do not include the value of the property in your income until it has been **substantially vested**. (You can choose to include the value of the property in your income in the year it

is transferred to you, as discussed later, rather than the year it is substantially vested.)

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

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

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

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

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

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

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

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

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

not included in your compensation when the property becomes substantially vested. Your basis for figuring gain or loss when you sell the property is the amount you paid for it plus the amount you included in income as compensation.



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

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

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

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

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

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

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

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

of property that you did not choose to include in your income in the year transferred and that is not substantially vested.

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

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

**Example.** In 1998, you paid your employer \$50 for a share of stock that had a fair market value of \$100 and was subject to forfeiture until 2001. In 2000, you sold the stock to your spouse for \$10 in a transaction not at arm's length. You had wage income of \$10 from this transaction. In 2001, when the stock had a fair market value of \$120, it became substantially vested. For 2001, you must report additional wage income of \$60, figured as follows:

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

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

## Special Rules for Certain Employees

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

### Clergy

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

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings

in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. Get Publication 526, *Charitable Contributions*. Also, see *Members of Religious Orders*, later.

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

## Housing

Special rules for housing apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a housing allowance provided to you as part of your pay. The home or allowance must be provided as compensation for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040), *Self-Employment Tax*, if you are subject to the self-employment tax. For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

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

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

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

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

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

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

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

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



*If you live in faculty lodging as an employee of an educational institution or academic health center, all or part of the value of that lodging may be nontaxable under a different rule. See Faculty lodging in the discussion on meals and lodging under Fringe Benefits, earlier.*

If you serve as a minister of music or minister of education, or serve in an administrative or other function of your religious organization, but are not authorized to perform substantially all of the religious duties of an ordained minister in your church (even if you are commissioned as a **minister of the gospel**), the housing exclusion does not apply to you.

**Cantors.** If you are a cantor, the housing exclusion applies to you even if you are not ordained, provided you have a bona fide commission and are employed by a congregation on a full-time basis to perform substantially all religious functions.

**Theological students.** The housing exclusion does not apply if you are a theological student serving a required internship as an assistant pastor unless you are ordained, commissioned, or licensed as a minister.

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

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

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

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099-R, include them on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. Otherwise, include them on line 21 of Form 1040.

## Members of Religious Orders

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

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

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

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

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

- They are the kind of services that are ordinarily the duties of members of the order.
- They are part of the duties that you must exercise for, or on behalf of, the religious order as its agent.

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

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

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

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

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

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

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

## Foreign Employer

Special rules apply if you work for a foreign employer.

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

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

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

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

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

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

## Military

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed. For more

information on the tax treatment of military allowances and benefits, get Publication 3, *Armed Forces' Tax Guide*.

**Military retirement pay.** If your retirement pay is based on age or length of service, it is taxable and must be included in your income as a pension on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. Do not include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

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

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

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

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

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

## Volunteers

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

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

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

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.
- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help,

laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.

- Leave allowances.
- Readjustment allowances or **termination payments**. These are considered received by you when credited to your account.

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

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

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

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

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

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

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

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## Business and Investment Income

This section provides information on the treatment of income from certain rents and royalties, and from interests in partnerships and S corporations. For additional information about business and investment income, you may want to see the following publications.

- Publication 334, *Tax Guide for Small Business*.
- Publication 527, *Residential Rental Property (Including Rental of Vacation Homes)*.
- Publication 541, *Partnerships*.
- Publication 544, *Sales and Other Dispositions of Assets*.

- Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses)*.

## Rents From Personal Property

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

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

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

### Reporting business income and expenses.

If you are in the business of renting personal property, report your income and expenses on Schedule C (Form 1040) or C-EZ (Form 1040). The related form instructions have information on how to complete them.

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

**Reporting nonbusiness expenses.** If you rent personal property for profit, include your rental expenses in the total amount you enter on line 32 of Form 1040. Also, enter the amount and "PPR" on the dotted line to the left.

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

## Royalties

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

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

**Copyrights and patents.** Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

**Oil, gas, and minerals.** Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and

are paid to you by a person or company who leases the property from you.

**Depletion.** If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 10 of Publication 535.

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

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

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

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

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

## Partnership Income

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

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

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

**Partnership return.** Although a partnership generally pays no tax, it must file an information return on Form 1065, *U.S. Return of Partnership*

*Income*. This shows the result of the partnership's operations for its tax year and the items that must be **passed through** to the partners.

**Schedule K-1 (Form 1065).** You should receive from each partnership in which you are a member a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, showing your share of income, deductions, credits, and tax preference items of the partnership for the tax year. Retain Schedule K-1 for your records. Do not attach it to your Form 1040.

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



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

## S Corporation Income

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

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

**Schedule K-1 (Form 1120S).** You should receive from the S corporation in which you are a shareholder a copy of Schedule K-1 (Form 1120S), *Shareholder's Share of Income, Credits, Deductions, etc.*, showing your share of income, losses, deductions, and credits, of the S corporation for the tax year. Retain Schedule K-1 for your records. Do not attach it to your Form 1040.

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



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

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

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

## Sickness and Injury Benefits

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

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

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

## Disability Pensions

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



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

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

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

**Accrued leave payment.** If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The

payment is not a disability payment. Include it in your income in the tax year you receive it.

## Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

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

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

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

- 1) You were entitled to receive a disability payment before September 25, 1975.
- 2) You were a member of a listed government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
- 3) You receive the disability payments for a combat-related injury. This is a personal injury or sickness that:
  - a) Results directly from armed conflict,
  - b) Takes place while you are engaged in extra-hazardous service,
  - c) Takes place under conditions simulating war, including training exercises such as maneuvers, or
  - d) Is caused by an instrumentality of war.
- 4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it. Your exclusion under this condition is equal to the amount you would be entitled to receive from the VA.

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

**Retroactive VA determination.** If you retire from the armed services based on years of service and are later given a retroactive service-connected disability rating by the VA, your retirement pay for the retroactive period is excluded from income up to the amount of VA disability benefits you would have been entitled to receive. You can claim a refund of any tax paid on the excludable amount (subject to the

statute of limitations) by filing an amended return on Form 1040X for each previous year during the retroactive period.

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

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



*As this publication was being prepared for print, Congress was considering legislation that would provide tax relief for any individual whose death or injuries resulted from a terrorist or military action outside or within the United States. For more information, see Publication 3920.*

## Long-Term Care Insurance Contracts

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

A long-term care insurance contract is an insurance contract that only provides coverage for qualified long-term care services. The contract must:

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

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

- Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabili-

tative services, and maintenance and personal care services, and

- Required by a chronically ill individual and provided pursuant to a plan of care prescribed by a licensed health care practitioner.

**Chronically ill individual.** A chronically ill individual is one who has been certified by a licensed health care practitioner within the previous 12 months as one of the following.

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

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

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

- The cost of qualified long-term care services during the period.
- The dollar amount for the period (\$200 per day for any period in 2001).

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

## Workers' Compensation

Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.



*If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For a discussion of the taxability of these benefits, see Other Income under Miscellaneous Income, later.*

**Return to work.** If you return to work after qualifying for workers' compensation, payments

you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

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

## Other Sickness and Injury Benefits

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

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

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

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

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

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

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See *Court awards and damages* under *Other Income*, later.
- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a **no-fault** car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfig-

urement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

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

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

## Miscellaneous Income

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

### Bartering

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

Generally, you report this income on Schedule C (Form 1040) or Schedule C-EZ (Form 1040). But if the barter involves an exchange of something other than services, such as in *Example 4* below, you may have to use another form or schedule instead.

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

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

**Example 3.** You are self-employed and a member of a barter club. The club uses **credit units** as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods or services offered by other members of the barter club. The club subtracts

credit units from your account when you receive goods or services from other members. You must include in your income the value of the credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

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

**Form 1099-B from barter exchange.** If you exchanged property or services through a barter exchange, you should receive Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange by January 31, 2002. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2001. The IRS will also receive a copy of Form 1099-B.

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

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

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

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

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



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

## Canceled Debts

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

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

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

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

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

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

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

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

## Exceptions

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

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

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

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

- 1) The federal government, a state or local government, or an instrumentality, agency, or subdivision thereof,

- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or

- 3) An educational institution:

- a) Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
- b) As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

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

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

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

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

**Exception.** You **do** have income if your student loan was made by an educational institution and is canceled because of services you performed for the institution or other organization that provided the funds.

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

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

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

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, *Bankruptcy Tax Guide*.
- The debt is canceled when you are insolvent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent. See Publication 908.
- The debt is qualified farm debt and is canceled by a qualified person. See chapter 4 of Publication 225, *Farmer's Tax Guide*.
- The debt is qualified real property business debt. See chapter 5 of Publication 334.

## 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 income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

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

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

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

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

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

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

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

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

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040, or on lines 12a and 12b 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 the part of the lump sum payment that is more than your cost in your income.

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

## Accelerated Death Benefits

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

**Viatical settlement.** This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

**Exclusion for terminal illness.** Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

**Exclusion for chronic illness.** If the insured is a chronically ill individual who is not terminally

ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts. For information on the limit and the definitions of **chronically ill individual**, **qualified long-term care services**, and **long-term care insurance contracts**, see *Long-Term Care Insurance Contracts under Sickness and Injury Benefits*, earlier.

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

- Is a director, officer, or employee of the person, or
- Has a financial interest in the person's business.

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

## Recoveries

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

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

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

**State income tax refund.** If you received a state or local income tax refund (or credit or offset) in 2001, you generally must include it in income if you deducted the tax in an earlier year. You should receive Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, from the payer by January 31, 2002. The IRS will also receive a copy of the Form 1099-G. Use the worksheet in the 2001 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income.

**Mortgage interest refund.** If you received a refund or credit in 2001 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, *Mortgage Interest Statement*. Do not subtract the refund amount from the interest you paid in 2001. You may

have to include it in your income under the rules explained in the following discussions.

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

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

**Recovery for 2 or more years.** If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which you paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year.

**Example.** You paid 2000 estimated state income tax of \$4,000 in four equal payments. You made your fourth payment in January 2001. You had no state income tax withheld during 2000. In 2001, you received a \$400 tax refund based on your 2000 state income tax return. You claimed itemized deductions each year on your federal income tax return.

You must allocate the \$400 refund between 2000 and 2001, the years in which you paid the tax on which the refund is based. Since you paid 75% ( $\$3,000 \div \$4,000$ ) of the estimated tax in 2000, 75% of the \$400 refund, or \$300, is for amounts you paid in 2000 and is a recovery item. If all of the \$300 is a taxable recovery item, you will include \$300 on line 10, Form 1040, for 2001, and attach a copy of your computation showing why that amount is less than the amount shown on the Form 1099-G you received from the state.

The balance (\$100) of the \$400 refund is for your January 2001 estimated tax payment. When you figure your deduction for state and local income taxes paid during 2001, you will reduce the \$1,000 paid in January by \$100. Your deduction for state and local income taxes paid during 2001 will include the January net amount of \$900 ( $\$1,000 - \$100$ ), plus any estimated state income taxes paid in 2001 for 2001, and any state income tax withheld during 2001.

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

**Example.** You filed your 2000 federal income tax return on Form 1040A. In 2001 you received a refund of your 2000 state income tax. Do not report any of the refund as income because you did not itemize deductions for 2000.

## Itemized Deduction Recoveries

The following discussion explains how to determine the amount to include in your income from a recovery of an amount deducted in an earlier year as an itemized deduction. However, you generally do not need to use this discussion if the recovery is for state or local income taxes paid in 2000. Instead, use the worksheet in the

2001 Form 1040 instructions for line 10 to figure the amount (if any) to include in your income.

You cannot use the Form 1040 worksheet and must use this discussion if **any** of the following statements is true.

- The recovery is for a tax year other than 2000.
- The recovery is for a deducted item other than state or local income taxes, such as real property taxes.
- Your 2000 taxable income was less than zero.
- You made your last payment of 2000 state or local estimated tax in 2001.
- You owed alternative minimum tax for 2000.
- You could not deduct all your tax credits for 2000 because their total was more than the amount of tax shown on line 42 of your 2000 Form 1040 minus any foreign tax credit shown on line 43 of that form.
- You could be claimed as a dependent by someone else in 2000.



*If you also recovered an amount deducted as a non-itemized deduction, figure the amount of that recovery to include in your income and add it to your adjusted gross income before applying the rules explained here. See Non-Itemized Deduction Recoveries, later.*

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

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

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

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

**Example.** For 2000, you filed a joint return. Your taxable income was \$20,000 and you were not entitled to any tax credits. Your standard deduction was \$7,350, and you had itemized deductions of \$9,000. In 2001, you received the following recoveries for amounts deducted on your 2000 return:

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

None of the recoveries were more than the deductions taken for 2000.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ( $\$9,000 - \$7,350 = \$1,650$ ), you must include your total recoveries in your income for 2001. Report the state and local income tax refund of \$400 on line 10 of Form 1040, and the balance of your recoveries, \$525, on line 21 of Form 1040.

**Total recovery not included in income.** If one or more of the six statements listed in the preceding discussion is not true, you may be able to exclude at least part of the recovery from your income. If statements (4), (5), and (6) are true (your itemized deductions were not limited, you had no unused tax credits, and you were not subject to the alternative minimum tax), you can use **Table 1** to determine the part of your recovery of amounts deducted after 1986 to include in your income.

**Allocating the included part.** If you are not required to include all of your recoveries in your income, and you have both a state income tax refund and other itemized deduction recoveries, you must allocate the taxable recoveries between the state tax refund you report on line 10 of Form 1040 and the amount you report as other income on line 21 of Form 1040. If you do not use **Table 1**, make the allocation as follows.

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

**Example.** In 2001 you recovered \$2,500 of your 2000 itemized deductions, but the recoveries you must include in your 2001 income are only \$1,500. Of the \$2,500 you recovered, \$500 was due to your state income tax refund. The amount you report as a state tax refund on line 10 of Form 1040 is \$300 [ $(\$500 \div \$2,500) \times \$1,500$ ]. The balance of the taxable recoveries, \$1,200, is reported as other income on line 21 of Form 1040.

**Standard deduction limit.** You are generally allowed to claim the standard deduction if you do



Table 1. **Worksheet for Recoveries of Itemized Deductions—Deducted After 1986**

To determine whether you should complete this worksheet to figure the part of a recovery amount to include in income on your 2001 Form 1040, see "Total recovery not included in income" under "Itemized Deduction Recoveries." If you recovered amounts from more than one year, such as a state income tax refund from 2000 and a casualty loss reimbursement from 1999, complete a separate worksheet for each year. Use information from Schedule A (Form 1040) for the year the expense was deducted.

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

- 1. State/local income tax refund or credit.<sup>1</sup> 1) \_\_\_\_\_
- 2. Enter the total of all other Schedule A refunds or reimbursements (excluding the amount you entered on line 1).<sup>1</sup> 2) \_\_\_\_\_
- 3. Add lines 1 and 2. 3) \_\_\_\_\_
- 4. Itemized deductions for the prior year (for example, line 28 of Schedule A for 2000). 4) \_\_\_\_\_
- 5. Enter any amount previously refunded to you (do not enter an amount from line 1 or line 2). 5) \_\_\_\_\_
- 6. Subtract line 5 from line 4. 6) \_\_\_\_\_
- 7. Standard deduction for the prior year. (The standard deduction amounts for 2000, 1999, and 1998 are shown in Tables 2, 3, and 4.) 7) \_\_\_\_\_
- 8. Subtract line 7 from line 6. If the result is zero or less, stop here. The amounts on lines 1 and 2 are not taxable. 8) \_\_\_\_\_
- 9. Enter the smaller of line 3 or line 8. 9) \_\_\_\_\_
- 10. Taxable income for prior year<sup>2</sup> (for example, line 39, Form 1040 for 2000). 10) \_\_\_\_\_
- 11. **Amount to include in income for 2001:**
  - If line 10 is zero or more, enter the amount from line 9.
  - If line 10 is a negative amount, add lines 9 and 10 and enter the result (but not less than zero).<sup>3</sup> 11) \_\_\_\_\_

**If line 11 equals line 3—**

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

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

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

If there is an amount on line 1, enter the amount from line 11 on line 10, Form 1040.

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

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

- A. Divide the amount on line 1 by the amount on line 3. Enter the percentage. A) \_\_\_\_\_
- B. Multiply the amount on line 11 by the percentage on line A. Enter the result here and on line 10, Form 1040. B) \_\_\_\_\_
- C. Subtract the amount on line B from the amount on line 11. Enter the result here and on line 21, Form 1040. C) \_\_\_\_\_

<sup>1</sup>Do not enter more than the amount deducted for the prior year.

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

<sup>3</sup>For example, \$700 + (\$400) = \$300.

not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the lesser of:

- 1) Your recoveries, or

- 2) The amount by which your itemized deductions exceeded the standard deduction.

**Standard deduction for earlier years.** To determine if amounts recovered in 2001 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed. The standard deduction tables for 2000, 1999, and 1998 are shown in **Tables 2, 3, and 4**. If you need the

standard deduction amounts for years before 1998, see the copy of your return for that year.

**Example.** You filed a joint return for 2000 with a taxable income of \$25,000. Your itemized deductions were \$8,700. The standard deduction that you could have claimed was \$7,350. In 2001, you recovered \$2,400 of your 2000 itemized deductions. None of the recoveries were more than the actual deductions for 2000. Include \$1,350 of the recoveries in your 2001

**Table 2. 2000 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 I. Standard Deduction Chart for Most People\***

If Your Filing Status is:	Your Standard Deduction is:
Single	\$4,400
Married filing joint return or Qualifying widow(er) with dependent child	7,350
Married filing separate return	3,675
Head of household	6,450

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

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

Check the correct number of boxes below. Then go to the chart.		
You	65 or older <input type="checkbox"/>	Blind <input type="checkbox"/>
Your spouse, if claiming spouse's exemption	65 or older <input type="checkbox"/>	Blind <input type="checkbox"/>
Total number of boxes you checked <input type="checkbox"/>		
If Your Filing Status is:	And the Number in the Box Above is:	Your Standard Deduction is:
Single	1	\$5,500
	2	6,600
Married filing joint return or Qualifying widow(er) with dependent child	1	8,200
	2	9,050
	3	9,900
	4	10,750
Married filing separate return	1	4,525
	2	5,375
	3	6,225
	4	7,075
Head of household	1	7,550
	2	8,650

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

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

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.	
You	65 or older <input type="checkbox"/> Blind <input type="checkbox"/>
Your spouse, if claiming spouse's exemption	65 or older <input type="checkbox"/> Blind <input type="checkbox"/>
Total number of boxes you checked <input type="checkbox"/>	
1. Enter your <b>earned income</b> (defined below). If none, enter -0-.	1. _____
2. Minimum amount	2. \$700
3. Enter the <b>larger</b> of line 1 or line 2.	3. _____
4. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> <li>• Single, enter \$4,400</li> <li>• Married filing separate return, enter \$3,675</li> <li>• Married filing jointly or Qualifying widow(er) with dependent child, enter \$7,350</li> <li>• Head of household, enter \$6,450</li> </ul>	4. _____
5. <b>Standard deduction.</b> <p>a. Enter the <b>smaller</b> 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.</p> <p>b. If 65 or older or blind, multiply \$1,100 (\$850 if married or qualifying widow(er) with dependent child) by the number in the box above.</p> <p>c. Add lines 5a and 5b. This is your standard deduction for 2000.</p>	5a. _____ 5b. _____ 5c. _____
<i>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.</i>	

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

income. This is the smaller of your recoveries (\$2,400) or the amount by which your itemized deductions were more than the standard deduction (\$8,700 - \$7,350 = \$1,350).

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

**Example.** The facts are the same as in the previous example except you had a negative taxable income of \$200 in 2000. You must include \$1,150 in your 2001 income, rather than \$1,350.

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

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

**Example.** During 2000, you paid \$1,700 for medical expenses. From this amount you subtracted \$1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was \$200. In 2001, you received a \$500 reimbursement from your medical insurance for your 2000 expenses. The only amount of the \$500 reimbursement that must be included in your income for 2001 is \$200—the amount actually deducted.

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

- For 2000, \$128,950 (\$64,475 if married filing separately),
- For 1999, \$126,600 (\$63,300 if married filing separately), and
- For 1998, \$124,500 (\$62,250 if married filing separately).

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

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

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

To determine the part of the recovery you must include in income, follow the four steps below. If your earlier tax year does **not** involve

**Table 3. 1999 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 I. Standard Deduction Chart for Most People\***

IF Your Filing Status is . . .	Your Standard Deduction is . . .
Single	\$4,300
Married filing joint return or Qualifying widow(er) with dependent child	7,200
Married filing separate return	3,600
Head of household	6,350

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

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

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 . . .	THEN your Standard Deduction is . . .
Single	1	\$5,350
	2	6,400
Married filing joint return or Qualifying widow(er) with dependent child	1	8,050
	2	8,900
	3	9,750
	4	10,600
Married filing separate return	1	4,450
	2	5,300
	3	6,150
	4	7,000
Head of household	1	7,400
	2	8,450

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

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

If you were 65 or older or blind, check the 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 <b>earned income</b> (defined below). If none, enter -0-.	1. _____
2. Additional amount	2. <u>    \$250    </u>
3. Add lines 1 and 2	3. _____
4. Minimum standard deduction	4. <u>    \$700    </u>
5. Enter the <b>larger</b> of line 3 or line 4.	5. _____
6. Enter the amount shown below for your filing status. ● Single, enter \$4,300 ● Married filing separate return, enter \$3,600 ● Married filing jointly or Qualifying widow(er) with dependent child, enter \$7,200 ● Head of household, enter \$6,350	6. _____
7. <b>Standard deduction.</b> a. Enter the <b>smaller</b> of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b. b. If 65 or older or blind, multiply \$1,050 (\$850 if married or qualifying widow(er) with dependent child) by the number in the box above. c. Add lines 7a and 7b. This is your standard deduction for 1999.	7a. _____  7b. _____  7c. _____

*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).

negative taxable income or an unused tax credit, skip steps 1 and 2 and start with step 3.

- 1) If your taxable income for the earlier year was a negative amount, reduce your recovery by the negative amount.
- 2) If your tax for the earlier year was reduced to zero by a tax credit that was not fully used in that year, and if reducing your deduction for that year by the recovery would result in tax for that year, reduce your recovery to an amount equal to your recovery multiplied by the following fraction:
  - a) Your tax for the earlier year, determined after reducing your deductions by the recovery and applying the credit, over
  - b) The total increase in your tax for the earlier year, determined by subtracting your actual tax before applying the

credit from the tax in (a) before applying the credit.

- 3) Figure the greater of:
  - a) The standard deduction for the earlier year, or
  - b) The amount of itemized deductions you **would have been allowed** for the earlier year (after taking into account the limit on itemized deductions) if you had figured them using only the net amount of the recovery item. The net amount is the amount you actually paid reduced by the recovery amount (as reduced in steps 1 and 2, if they apply).  
**Note.** If you were required to itemize your deductions in the earlier year, use step 3(b) and not step 3(a).
- 4) Subtract the amount in step 3 from the amount of itemized deductions **actually al-**

**lowed** in the earlier year after applying the limit on itemized deductions.

The result of step 4 is the amount of the recovery to include in your income for the year you receive the recovery.

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

**Example.** Eileen Martin is single. She had an AGI of \$1,128,950 and itemized her deductions on her federal income tax return for 2000. She was not subject to alternative minimum tax and was not entitled to any credit against income tax. Her only allowable deduction was \$40,000 of state income taxes. However, Eileen deducted only \$10,000 in 2000 because her otherwise allowable deductions of \$40,000 were reduced by \$30,000. In 2001, she received a \$5,000 refund of her state income taxes for 2000.

**Table 4. 1998 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 I. Standard Deduction Chart for Most People\***

If Your Filing Status is:	Your Standard Deduction is:
Single	\$4,250
Married filing joint return or Qualifying widow(er) with dependent child	7,100
Married filing separate return	3,550
Head of household	6,250

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

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

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	\$5,300
	2	6,350
Married filing joint return or Qualifying widow(er) with dependent child	1	7,950
	2	8,800
	3	9,650
	4	10,500
Married filing separate return	1	4,400
	2	5,250
	3	6,100
	4	6,950
Head of household	1	7,300
	2	8,350

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

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

If you were 65 or older or blind, check the 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**

<b>1.</b> Enter your <b>earned income</b> (defined below). If none, enter -0-.	<b>1.</b> _____
<b>2.</b> Additional amount	<b>2.</b> <u>    \$250    </u>
<b>3.</b> Add lines 1 and 2	<b>3.</b> _____
<b>4.</b> Minimum standard deduction	<b>4.</b> <u>    \$700    </u>
<b>5.</b> Enter the <b>larger</b> of line 3 or line 4.	<b>5.</b> _____
<b>6.</b> Enter the amount shown below for your filing status. • Single, enter \$4,250 • Married filing separate return, enter \$3,550 • Married filing jointly or Qualifying widow(er) with dependent child, enter \$7,100 • Head of household, enter \$6,250	<b>6.</b> _____
<b>7. Standard deduction.</b> <b>a.</b> Enter the <b>smaller</b> of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b. <b>b.</b> If 65 or older or blind, multiply \$1,050 (\$850 if married or qualifying widow(er) with dependent child) by the number in the box above. <b>c.</b> Add lines 7a and 7b. This is your standard deduction for 1998.	<b>7a.</b> _____  <b>7b.</b> _____  <b>7c.</b> _____

***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).

The following table shows how Eileen figured the \$30,000 reduction and other amounts from the *Itemized Deduction Worksheet* in the 2000 Schedule A (Form 1040) instructions. These amounts are needed to figure the part of the \$5,000 refund that Eileen must include in her income for 2001.

AGI for 2000	\$1,128,950
State income taxes paid in 2000	\$40,000
3% reduction (amount on line 8 of 2000 <i>Itemized Deduction Worksheet</i> ) [(\$1,128,950 - \$128,950) × 3%]	\$30,000
80% reduction not applied (amount on line 4 of 2000 <i>Itemized Deduction Worksheet</i> ) (\$40,000 × 80%)	\$32,000
2000 deduction (amount on line 10 of 2000 <i>Itemized Deduction Worksheet</i> ) (\$40,000 - \$30,000)	\$10,000
Refund received in 2001 of 2000 state income tax	\$5,000
Net amount of 2000 state income tax (\$40,000 - \$5,000)	\$35,000

If Eileen had used the \$35,000 net amount of state income tax to figure her itemized deductions for 2000, the deduction allowed would have been \$7,000. This is her otherwise allowable deduction of \$35,000 reduced by \$28,000 (\$35,000 × 80%). By deducting the full \$10,000 paid in 2000, she derived a tax benefit of \$3,000 (\$10,000 - \$7,000). Therefore, only \$3,000 of the \$5,000 refund is included in her income for 2001.

**Unused tax credits.** If you recover an item deducted in an earlier year in which you had unused tax credits, you must refigure the earlier year's tax to determine if you must include the recovery in your income. To do this, add the amount of the recovery to your earlier year's taxable income and refigure the tax and the credits on the recomputed amount. If the recomputed tax, after application of the credits, is more than the actual tax in the earlier year, include the recovery in your income up to the amount by which it reduced the tax in the earlier year. For

this purpose, any increase to an amount carried over to the current year that resulted from deducting the recovered amount in the earlier year is considered to have reduced your tax in the earlier year. If the recovery is for an itemized deduction claimed in a year in which the deductions were limited, see *Itemized deductions limited*, earlier.

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

**Example.** In 2000, Jean Black filed as head of household and itemized her deductions. Her taxable income was \$5,260 and her tax was \$791. She claimed a child care credit of \$1,200. The credit reduced her tax to zero and she had an unused tax credit of \$409 (\$1,200 - \$791). In 2001, Jean recovered \$1,000 of her itemized deductions. She reduces her 2000 itemized deductions by \$1,000 and recomputes that year's

tax on taxable income of \$6,260. However, the child care credit exceeds the recomputed tax of \$941. Jean's tax liability for 2000 is not changed by reducing her deductions by the recovery. She did not have a tax benefit from the recovered deduction and does not include any of the recovery in her income for 2001.

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

## Non-Itemized Deduction Recoveries

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

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

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

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

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

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

## Amounts Recovered for Credits

If you received a recovery in 2001 for an item for which you claimed a tax credit in an earlier year, you must increase your 2001 tax by the amount of the recovery, up to the amount by which the credit reduced your tax in the earlier year. You had a recovery if there was a downward price adjustment or similar adjustment on the item for which you claimed a credit.

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

## Survivor Benefits

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

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

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

**Qualified employee retirement plans.** Lump-sum distributions from qualified employee retirement plans are subject to special tax treatment. For information on these distributions, get Publication 575 (or Publication 721 if you are the survivor of a federal employee or retiree).

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

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

## Unemployment Benefits

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

**Unemployment compensation.** You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

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

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a **substitute** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are not unemployment compensation. See *Workers' Compensation under Sickness and Injury Benefits*, earlier.)
- Trade readjustment allowances under the Trade Act of 1974.
- Benefits under the Airline Deregulation Act of 1978.
- Unemployment assistance under the Disaster Relief Act Amendments of 1974.

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

**Repayment of unemployment compensation.** If you repaid in 2001 unemployment compensation you received in 2001, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. On the dotted line next to your entry, write "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2001 that you included in your income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040) if you itemize deductions. See *Repayments*, later.

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

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

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

**Repayment of benefits.** You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the

total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits in your income for the year you received them.

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

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

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

**Guaranteed annual wage.** Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages. Include them on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

**State employees.** Payments similar to a state's unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment compensation. Report these payments on line 21 of Form 1040.

## Welfare and Other Public Assistance Benefits

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

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

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

**Persons with disabilities.** If you have a disability, you must include in income compensation

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

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

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

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

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

## Other Income

The following brief discussions are arranged in alphabetical order. Income items that are discussed in greater detail in another publication include a reference to that publication.

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

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

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

Publication 504, *Divorced or Separated Individuals*.

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

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

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

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

The borrower may have to report this payment as income, depending on its classification.

For more information on below-market loans, see chapter 1 of Publication 550.

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

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

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

**Car pools.** Do not include in your income amounts you receive from the passengers for driving a car in a car pool to and from work. These amounts are considered reimbursement for your expenses. However, this rule does not apply if you have developed car pool arrange-

ments into a profit-making business of transporting workers for hire.

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

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

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

**Charitable gift annuities.** If you are the beneficiary of a charitable gift annuity, you must include the yearly annuity or fixed percentage payment in your income.

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

**Child support payments.** You should not report these payments on your return. Get Publication 504 for more information.

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

- 1) Interest on any award.
- 2) Compensation for lost wages or lost profits in most cases.
- 3) Punitive damages. It does not matter if they relate to a physical injury or physical sickness.
- 4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
- 5) Damages for:
  - a) Patent or copyright infringement,
  - b) Breach of contract, or
  - c) Interference with business operations.
- 6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

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

**Emotional distress.** Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must

include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

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

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

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

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

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

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

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

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

- All income that is required to be distributed to you, whether or not it is actually distributed, plus

- All other amounts actually paid or credited to you,

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

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

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

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

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

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

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

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



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

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

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

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

**Election precinct official.** You should receive a Form W-2 showing payments for services performed as an election official or election worker. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

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

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

A qualified foster individual is a person who:

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

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

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

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

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

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

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

value on Schedule C (Form 1040) or Schedule C-EZ (Form 1040).

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

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

**Installment payments.** Generally, if you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amounts you receive designated as **interest** on the unpaid installments. If you sell future lottery payments for a lump sum, you must report the amount you receive from the sale as ordinary income (line 21, Form 1040) in the year you receive it.

**Form W-2G.** You may have received a Form W-2G, *Certain Gambling Winnings*, showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 59 of Form 1040.

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

**Inherited pension or IRA.** If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See *Survivors and Beneficiaries* in Publication 575 if you inherited a pension. See *Inherited IRAs* in Publication 590, *Individual Retirement Arrangements (IRAs)*, if you inherited an IRA.

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

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

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

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



*If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. However, if*

*you sell items from your collection at a loss, you cannot deduct the loss.*

**Holocaust victims restitution.** Under new law enacted in 2001, the federal tax treatment of payments received by Holocaust victims (or their heirs) as restitution for Nazi persecution has been clarified. Restitution payments received after December 31, 1999 (and interest earned on the payments, including interest earned on amounts held in certain escrow accounts or funds) are not taxable. You also do not include them in any computations in which you would ordinarily add excludable income to your adjusted gross income, such as the computation to determine the taxable part of social security benefits. If the payments are made in property, your basis in the property is its fair market value when you receive it.

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

**Amending your 2000 return.** If your treatment of restitution payments received in 2000 was different from the treatment described above and caused you to pay more tax, you should file an amended return for 2000 on Form 1040X, *Amended U.S. Individual Income Tax Return*. To claim a refund of tax, you should generally file the amended return by April 15, 2004. See the form instructions for more information.

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

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

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

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

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

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

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

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

**Interest on state and local government obligations.** This interest is usually exempt from federal tax. However, you must show the amount of any tax-exempt interest on your federal income tax return. For more information, see *State or Local Government Obligations* in chapter 1 of Publication 550.

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

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

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

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

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

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

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

**Moving expense reimbursements.** You generally should not report these benefits on your return. Get Publication 521 for more information.

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

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

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

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

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

- 1) You were selected without any action on your part to enter the contest or proceeding.
- 2) You are not required to perform substantial future services as a condition for receiving the prize or award.
- 3) The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you. The following conditions apply to the transfer.
  - a) You cannot use the prize or award before it is transferred.
  - b) You should provide the designation before the prize or award is presented

to prevent a disqualifying use. The designation should contain:

- i) The purpose of the designation by making a reference to section 74(b)(3) of the Internal Revenue Code,
  - ii) A description of the prize or award,
  - iii) The name and address of the organization to receive the prize or award,
  - iv) Your name, address, and taxpayer identification number, and
  - v) Your signature and the date signed.
- c) In the case of an unexpected presentation, you must return the prize or award before using it (or spending, depositing, investing it, etc., in the case of money) and then prepare the statement as described in (b).
  - d) After the transfer, you should receive from the payer a written response stating when and to whom the designated amounts were transferred.

These rules do not apply to scholarship or fellowship awards. See *Scholarships and fellowships*, later.

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

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

**Rate reduction credit.** If you received a check from the IRS during 2001 for the advance payment of the rate reduction credit, do not report it on your tax return. It is not taxable. For more information about the rate reduction credit, see Publication 553, *Highlights of 2001 Tax Changes* and the *Rate Reduction Credit Worksheet* in the instructions for Form 1040 (or Form 1040A or 1040EZ).

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

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

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

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

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

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

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



*Beginning in 2002, scholarship amounts you receive under the National Health Service Corps (NHSC) Scholarship Program or the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the Armed Forces Scholarship Program) are not included in your income even if you must agree to perform certain services to get the scholarship. See Publication 553, Highlights of 2001 Tax Changes for details.*

For information about the rules that apply to a tax-free qualified tuition reduction provided to employees and their families by an educational institution, see Publication 520.

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

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

**Social security and equivalent railroad retirement benefits.** Social security or equivalent railroad retirement benefits, if taxable, must be included in the income of the person who has the legal right to receive the benefits. Whether any of your benefits are taxable, and the amount that is taxable, depends on the amount of the benefits and your other income.

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

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

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

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

Form RRB-1099, *Payments by the Railroad Retirement Board*.

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

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

**Joint return.** If you are married and file a joint return, you and your spouse must combine your incomes and your social security and equivalent railroad retirement benefits when figuring 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 when figuring if any of your benefits are taxable.

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

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

**Benefits may affect your IRA deduction.** You must use the special worksheets in Appendix B of Publication 590 to figure your taxable benefits and your IRA deduction if all of the following conditions apply.

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

**How to report.** If any of your benefits are taxable, you must use either Form 1040 or Form 1040A to report the taxable part. You cannot use Form 1040EZ. Report your net benefits (the amount in box 5 of your Forms SSA-1099 and RRB-1099) on line 20a of Form 1040, or line 14a of Form 1040A. Report the taxable part (from the last line of the worksheet) on line 20b of Form 1040, or on line 14b of Form 1040A.

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

A qualified state tuition program is one that is established and maintained by a state or an agency or instrumentality of a state and that is set up to provide for a student's qualified higher educational expenses at an eligible educational institution. See Publication 970, *Tax Benefits for Higher Education*, for more information.

**Transporting school children.** Do not include in your income a school board mileage

allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

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

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

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

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

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

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

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

## Repayments

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

**Type of deduction.** The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C (Form 1040) or C-EZ (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form

1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040).

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

**Repayment—\$3,000 or less.** If the amount you repaid was \$3,000 or less, deduct it from your income in the year you repaid it. If you must deduct it as a miscellaneous itemized deduction, enter it on line 22 of Schedule A (Form 1040).

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

**Method 1.** Figure your tax for 2001 claiming a deduction for the repaid amount. If you must deduct it as a miscellaneous itemized deduction, enter it on line 27 of Schedule A (Form 1040).

**Method 2.** Figure your tax for 2001 claiming a credit for the repaid amount. Follow these steps.

- 1) Figure your tax for 2001 **without** deducting the repaid amount.
- 2) Refigure your tax from the earlier year without including in income the amount you repaid in 2001.
- 3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
- 4) Subtract the answer in (3) from the tax for 2001 figured without the deduction (step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim a credit for the amount repaid on line 65 of Form 1040, and write "I.R.C. 1341" next to line 65.

**Example.** For 2000 you filed a return and reported your income on the cash method. In 2001 you repaid \$5,000 included in your 2000 income under a claim of right. Your filing status in 2001 and 2000 is single. Your income and tax for both years are as follows:

	2000	2000
	With Income	Without Income
Taxable Income	\$15,000	\$10,000
Tax	\$ 2,254	\$ 1,504
	2001	2001
	Without Deduction	With Deduction
Taxable Income	\$49,950	\$44,950
Tax	\$10,362	\$ 8,987

Your tax under method 1 is \$8,987. Your tax under method 2 is \$9,612, figured as follows:

Tax previously determined for 2000	\$2,254
Less: Tax as refigured	- 1,504
Decrease in 2000 tax	\$750
Regular tax liability for 2001	\$10,362
Less: Decrease in 2000 tax	- 750
Refigured tax for 2001	\$9,612

Because you pay less tax using method 1, you should take a deduction for the repayment in 2001.

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

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

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

## How To Get Tax Help

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

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

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

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.

- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

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

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

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

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

 **TaxFax Service.** Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.

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

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

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give

accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

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



**Walk-in.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products avail-

able to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



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

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



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

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

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

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

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