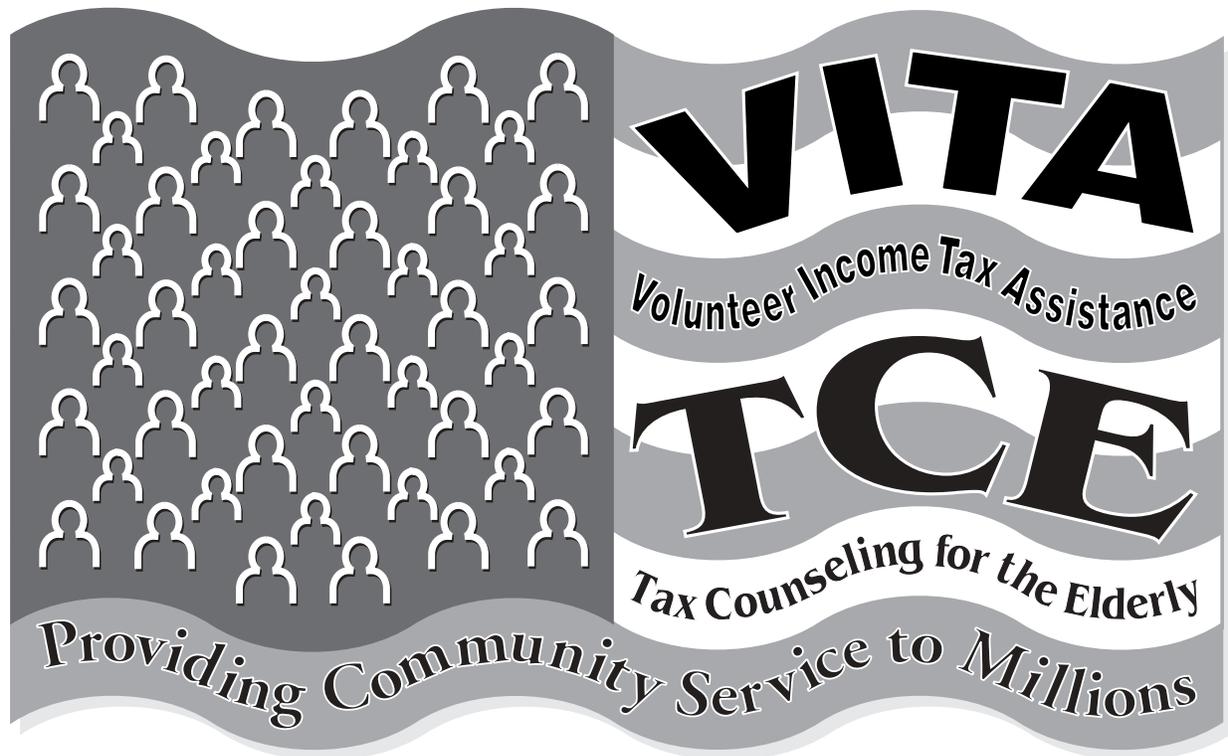


**MILITARY MODULE STUDENT TEXT**  
**For Use in Preparing Tax Year 2002 Returns**

# VOLUNTEER ASSISTOR'S GUIDE



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**FOR USE IN IRS VOLUNTEER PROGRAMS**

**VITA Volunteer Income Tax Assistance**

**TCE Tax Counseling for the Elderly**

# TABLE OF CONTENTS

Important Changes and Reminders for 2002.....	iii
Introduction .....	ix
Lesson 1. Gross Income .....	1-1
Lesson 2. Foreign Earned Income Exclusion.....	2-1
Lesson 3. Tax Benefits for Combat Zone Participants.....	3-1
Lesson 4. Aliens.....	4-1
Lesson 5. Filing Status.....	5-1
Lesson 6. Dependency Exemptions .....	6-1
Lesson 7. Claiming a Foreign Dependent or Spouse .....	7-1
Lesson 8. Taxpayer Identification Number and Other Entity Issues .....	8-1
Lesson 9. Foreign Tax Credit .....	9-1
Lesson 10. Earned Income Credit.....	10-1
Lesson 11. Sale of Home.....	11-1
Lesson 12. Moving Expenses .....	12-1
Lesson 13. Travel Expenses.....	13-1
Lesson 14. Miscellaneous Itemized Deductions.....	14-1
Lesson 15. Filing Returns .....	15-1
Lesson 16. Education Benefits.....	16-1
Lesson 17. IRAs/TSPs.....	17-1
Lesson 18. Other Income .....	18-1
Summary Problems .....	SP-1
Answers to Summary Problems .....	ASP-1
Comprehensive Test Questions for Military Issues .....	T-1
Answers to Comprehensive Test Questions for Military Issues.....	T-3



WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

**WELCOME, VOLUNTEERS!**

Through the assistance of trained tax preparers from the U.S. Armed Forces, the Internal Revenue Service is able to offer free tax assistance to members of the military in all regular and reserve units.

Publication 678M, the Military Supplement, when used with the Publication 678, Volunteer Assistor's Guide, will help you to acquire the skills to prepare tax returns for the military. The Military Supplement focuses on tax issues unique to the Armed Forces, such as the taxability of combat pay. The Publication 678 provides training on general tax issues faced by individuals in the low to moderate-income ranges.

**MC-VITA.** I am pleased this year to offer you another tax preparation tool. We developed a handy reference guide designed to be used with the Service's designated software. It includes screen shots for most entries on the Form 1040 and related forms and worksheets. This guide will be provided automatically with each Publication 678M.

**Comments and recommendations.** I welcome your comments and recommendations about our training material and suggestions for future editions. Your instructor or tax center coordinator can take your suggestions or you can write to us at the following address:

Internal Revenue Service  
Stakeholder Partnerships, Education and Communication  
W:CAR:SPEC:PPD:E, Stop 45-WI  
401 Peachtree Street, NW  
Atlanta, GA 30308

I thank you in advance for your willingness to volunteer your own time to provide this much needed service to your neighbors and your community.

Sincerely,

Mark E. Pursley  
Director, Stakeholder Partnerships,  
Education and Communication

# IMPORTANT CHANGES AND REMINDERS FOR 2002

This section summarizes important tax changes that take effect in 2002 and important reminders that could affect your income tax return.

## Standard Mileage Rate

For 2002, the optional standard mileage rate for operating your car for business purposes is 36.5 cents for each business mile. The mileage rate for operating your car to get medical care is 13 cents a mile.

## Afghanistan Designated a Combat Zone

By Executive Order No. 13239, Afghanistan is designated as a combat zone beginning September 19, 2001. When you file, write “Enduring Freedom” at the top of your return and on the envelope in which you mail it. For more information on benefits available to members of the Armed Forces serving in combat zones, see Publication 3, *Armed Forces’ Tax Guide*.

## Tax Benefits for Education

The following paragraphs explain the changes to tax benefits for education.

### Employer-Provided Educational Assistance

The tax-free status of up to \$5,250 of employer-provided educational assistance benefits each year for undergraduate-level courses was scheduled to end for courses beginning after 2001. This benefit has been extended indefinitely and, beginning in 2002, it also applies to graduate-level courses. For more information, see chapter 9 in Publication 970, *Tax Benefits for Higher Education*.

### Qualified Tuition Programs (QTPs)

Beginning in 2002, changes apply to what were formerly known as qualified state tuition programs. For more complete information on QTPs, see chapter 6 in Publication 970. Also see lesson 16.

**Name change.** Qualified state tuition programs are renamed qualified tuition programs (QTPs).

**Distributions from state-maintained QTPs.** A distribution from a QTP established and maintained by a state (or an agency or instrumentality of the state) can be excluded from

income if the amount distributed is used for higher education. Previously, the beneficiary was required to pay tax on any earnings from a QTP unless the earnings were tax-free under some other provision of the law.

**QTPs maintained by educational institutions.** You can make contributions to a QTP established and maintained by one or more eligible educational institutions. Any earnings distributed before January 1, 2004, will be taxable. Previously, contributions could only be made to a QTP established and maintained by a state (or an agency or instrumentality of the state).

**Rollovers of QTPs to family members.** For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary.

**Rollovers of QTPs without changing the beneficiary.** Amounts in a QTP can be rolled over, tax free, to another QTP set up for the same beneficiary. However, the rollover of credits or other amounts from one QTP to another QTP for the benefit of the same beneficiary cannot apply to more than one transfer within any 12-month period.

**Qualified expenses.** Calculation of the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for their qualified room and board costs.

**Special needs beneficiaries.** The definition of “qualified higher education expenses” has been expanded to include expenses of a special needs beneficiary that are necessary for that person’s enrollment or attendance at an eligible institution.

**Coordination with Coverdell ESAs.** You can make contributions to QTPs and Coverdell ESAs in the same year for the same beneficiary. Previously, you could only make contributions to one program or the other.

## Coverdell ESAs

Beginning in 2002, the following changes apply to Coverdell Education Savings Accounts (Coverdell ESAs). For more complete information on Coverdell ESAs, see chapter 5 in Publication 970. Also see lesson 16.

**Maximum contribution.** The most you can contribute each year to a Coverdell ESA is increased from \$500 to \$2,000.

**Income limits.** If you file a joint return, the amount you can contribute to a Coverdell ESA will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is more than \$190,000 but less than \$220,000. You will not be able to



contribute to a Coverdell ESA if your MAGI is \$220,000 or more.

**Contribution due dates.** The final date on which you can make contributions to a Coverdell ESA for any year has been extended to the due date of your return for that year (not including extensions). If you are a calendar year taxpayer, you generally will have until April 15, 2003, to make your contribution for the 2002 tax year. In previous years, contributions were required to be made by December 31.

**Correcting excess contributions.** The 6% excise tax on excess contributions will not apply to any excess contributions withdrawn by June 1 of the following year if the earnings on the excess are also withdrawn. Previously, these amounts had to be withdrawn by the due date for the beneficiary's return or, if no return was required, by April 15 of the following year.

**Qualified expenses.** The definition of qualified education expenses has been expanded to include elementary and secondary education expenses. Qualified elementary and secondary education expenses include expenses for:

- Tuition, fees, academic tutoring, special needs services in the case of a special needs beneficiary, books, supplies, and other equipment incurred in connection with enrollment or attendance as an elementary or secondary school student at a public, private, or religious school,
- Room and board, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with such enrollment or attendance, and
- The purchase of computer technology or equipment or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school (not including expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature).

**Special needs beneficiaries.** You can continue to make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday.

You can also leave assets in a Coverdell ESA set up for a special needs beneficiary after the beneficiary reaches age 30.

**Coordination with Hope and lifetime learning credits.** You can claim the Hope or lifetime learning credit in the same year you take a tax-free distribution from a Coverdell ESA, provided the distribution from the Coverdell ESA is not used



for the same expenses for which the credit is claimed. Previously, you could not claim the Hope or lifetime learning credit if you received a tax-free withdrawal from a Coverdell ESA and did not waive the tax-free treatment of the withdrawal.

**Coordination with qualified tuition programs (QTPs).**

You can make contributions to Coverdell ESAs and qualified tuition programs in the same year for the same beneficiary. Previously, you could only make contributions to one program or the other.

**Tuition and Fees Deduction  
(New Deduction for Higher Education Expenses)**

Beginning in 2002, you may be able to deduct qualified tuition and related expenses paid during the year for yourself, your spouse, or a dependent, even if you do not itemize deductions on Schedule A, Form 1040. See lesson 16.

**Maximum deduction.** For tax years beginning in 2002 and 2003, you may be able to deduct up to \$3,000 you paid for qualified tuition and related expenses as an adjustment to income.

**Coordination with credits and other deductions.** You cannot deduct any amount for qualified tuition and related expenses for a year if:

- A Hope credit or lifetime learning credit is claimed with respect to expenses of the individual for whom the tuition and related expenses were paid, or
- You can deduct the expense under any other provision of the law.

**Coordination with exclusions.** You must reduce your qualified tuition and related expenses by:

- Expenses you used to figure the amount of interest on qualified U.S. savings bonds that you excluded from income because you used it to pay qualified higher education expenses,
- Expenses you used to figure the amount of any tax-free withdrawals from a Coverdell ESA, and
- Expenses you used to figure the portion of any distribution of earnings from a qualified tuition program (QTP) you exclude from income because the earnings were used to pay the beneficiary's qualified higher education expenses.

**Limits on eligibility.** You cannot claim the deduction for qualified tuition and related expenses if any of the following apply.

- Another taxpayer is entitled to claim an exemption for you as a dependent on his or her return. This is true even if the



other taxpayer does not actually claim your exemption.

- Your filing status is married filing separate return.
- You are a nonresident alien and you have not elected to be treated as a resident alien for the tax year.

**Year of deduction.** Generally, you can deduct only those expenses for a year that are in connection with enrollment at an institution of higher education during the same year.

However, you can deduct expenses paid in a year if they are for an academic period beginning within the year or during the first three months of the next year.

**Student name and ID number.** To take the deduction, you must show on your income tax return the name and taxpayer identification number (usually the social security number) of the person for whom the expenses were paid.

## Student Loan Interest Deduction

If you pay interest on a student loan, you may be able to deduct the interest as an adjustment to income. For more complete information on the student loan interest deduction, see chapter 3 in Publication 970. Also see lesson 16.

**Elimination of 60-month limit.** Beginning in 2002, the requirement that you can only deduct student loan interest paid during the first 60 months that interest payments are required is eliminated.

**Limit on deduction based on modified adjusted gross income.** Beginning in 2002, the amount of your student loan interest deduction will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between \$50,000 and \$65,000 (\$100,000 and \$130,000 if you file a joint return). You will not be able to take a student loan interest deduction if you MAGI is \$65,000 or more (\$130,000 or more if you file a joint return).

**Modified Adjusted Gross Income (MAGI).** Prior to 2002, your MAGI for purposes of the student loan interest deduction was your adjusted gross income as shown on your return modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion or deduction,
- 3) Exclusion of income for bona fide residents of American Samoa, and
- 4) Exclusion of income from Puerto Rico.

Beginning in 2002, you must also add back any deduction of qualified tuition and related expenses.



## Earned Income Credit

The following paragraphs explain the changes to the earned income credit for 2002. The earned income credit is explained in Publication 596, *Earned Income Credit*. Also see lesson 10.

**New definition of earned income.** The amount of earned income credit you can claim is based, in part, on your **taxable earned income**. For tax years after 2001, earned income will no longer include nontaxable employee compensation. Nontaxable employee compensation includes amounts such as salary deferrals and reductions, excludable dependent care benefits, and excluded combat pay.

**Elimination of modified adjusted gross income (MAGI).** For tax years after 2001, you will no longer need to figure MAGI. Your earned income credit will be figured using your AGI, **not** MAGI.

**New rules for persons with same qualifying child.** Beginning with tax year 2002, if a child is a qualifying child of more than one taxpayer, the taxpayers may choose which of them will claim the credit on the basis of that child.

**New definition of foster child.** The definition of an eligible foster child is changed. The child will have to live with you only for more than half of the tax year. Previously, the child must have lived with you the entire year.

**Reduction of EIC by alternative minimum tax eliminated.** Your earned income credit no longer is reduced by the amount of alternative minimum tax shown on your return.

## Photographs of Missing Children

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



# INTRODUCTION

The *Military Supplement to the Volunteer Assistor's Guide* covers the special tax situations of active members of the U.S. Armed Forces. It does not cover military pensions or veterans' benefits. For information on military pensions and veterans' benefits, see Publication 525, *Taxable and Nontaxable Income*.

For federal tax purposes, the U.S. Armed Forces includes commissioned officers and enlisted personnel in all regular and reserve units under control of the Secretaries of Defense, Army, Navy, and Air Force. The Armed Forces also includes the Coast Guard. It does not include members of the U.S. Merchant Marine or the American Red Cross.

Generally, tax laws apply to all citizens and residents of the United States. However, some types of pay, exclusions, and other provisions of law are of special interest to members of the Armed Forces. Some lessons in this book apply material from the *Volunteer Assistor's Guide* to military situations. Other lessons cover topics that are not mentioned in the *Volunteer Assistor's Guide* (such as alien issues and moving and travel expenses).

Use Lesson 3, *Tax Benefits for Combat Zone Participants*, when looking for:

- Information on the extension of deadline to file returns and to take care of tax matters, and
- Answers to questions about persons who die in a combat zone or in a terrorist action.

Additional information for combat zone participants is included in Lesson 1, *Gross Income*; Lesson 11, *Sale of Home*; and Lesson 15, *Filing Returns*.

Read each lesson of this supplement carefully. When you are ready, check your understanding by working the exercises without referring to the answers. Finally, check your answers in the *Answers to Exercises* at the end of the lesson. If your answers are not correct, reread the related sections.

In addition to the material used with the regular VITA/TCE course, such as Publication 17, *Your Federal Income Tax*, and the instructions to Forms 1040, 1040A, and 1040EZ, other publications should be used with the military supplement. These include:

Publication 3, *Armed Forces' Tax Guide*

Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*

Publication 463, *Travel, Entertainment, Gift, and Car Expenses*

Publication 501, *Exemptions, Standard Deduction, and Filing Information*

Publication 508, *Tax Benefits for Work-Related Education*

Publication 516, *U.S. Government Civilian Employees Stationed Abroad*

Publication 519, *U.S. Tax Guide for Aliens*

Publication 521, *Moving Expenses*

Publication 523, *Selling Your Home*

Publication 553, *Highlights of 2002 Tax Changes*

Publication 555, *Community Property*

Publication 596, *Earned Income Credit*

Publication 970, *Tax Benefits for Education*

**Note:** In figuring a deduction for contributions to an IRA, Armed Forces members (including reservists on active duty for more than 90 days) are considered active participants in an employer-maintained retirement plan. See Lesson 17, *IRAs/TSPs*.

Individuals serving in the U.S. Armed Forces or in support of the U.S. Armed Forces in designated combat zones have additional time to make a qualified retirement contribution to an IRA. For more information on this extension of deadline provision, see Lesson 3, *Tax Benefits for Combat Zone Participants*, in this supplement.

Members serving in a qualified hazardous duty area, designated by statute, are afforded the same benefits as members serving in a combat zone designated by Executive Order. In this publication, the term **combat zone** applies to both areas.



# GROSS INCOME

## OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine which items received by Armed Forces members are includible in gross income.
2. Determine if an amended return must be filed for a taxpayer who received medical separation pay.
3. Determine who qualifies for exclusion of pay from income because of service in a combat zone.
4. Identify qualifying items of military pay received for service in a combat zone.

## INTRODUCTION

This lesson discusses whether to include specific items in gross income. You should be aware, however, that certain items related to moving or travel expenses generally must be accounted for even if they are not considered income. (See Lessons 12 and 13)

This lesson includes information about the combat zone exclusion. For additional tax benefits, see Lesson 3, *Tax Benefits for Combat Zone Participants*.

Note: For a quick reference, a glossary of military payroll terms located at the end of this chapter defines types of military pay and allowances.

## FORM W-2

Includible military income will generally be the amount shown in box 1 of Form W-2, *Wage and Tax Statement*. If this amount differs from the last Leave and Earnings Statement for 2002, advise the person to contact his or her local accounting and finance or payroll office for an explanation.

The wages shown in box 1 of the 2002 Form W-2 should not include military pay excluded from an individual's income under the combat zone exclusion provisions. Tax exempt earned income, basic allowance for subsistence (BAS), basic allowance for housing (BAH), and certain in-kind allowances are no longer reported in box 13 of Form W-2.

## ***INCLUDIBLE INCOME***

Members of the Armed Forces receive many different types of pay and allowances. Some are includible in gross income while others are excludable from gross income. Includible items are subject to tax and must be reported on the taxpayer's tax return. Excludable items are not subject to tax, but may have to be shown on the tax return. The following items are includible in gross income, **unless** the pay is for service in a combat zone declared by an executive order of the President or in a qualified hazardous duty area declared by statute:

Accrued Leave Payment	Aviation Career Incentive Pay
Basic Pay	Continuation Pay
Diving Pay	Enlistment Bonus *
Flight Duty Pay	Foreign Duty Pay
Hostile Fire Pay	Imminent Danger Pay
Medical/Dental Officer Pay	Medical Separation Pay
Nuclear Qualified Officer Pay	Overseas Extension Bonus
Personal Money Allowance	Proficiency Pay
Reenlistment Bonus *	Responsibility Pay
Scholarships (AFHPSP)	Sea Duty Pay
Separation Pay	Student Loan Repayments
Veterinary Officer Pay	

\* Enlistment and reenlistment bonuses fall under the category of taxable income. Income tax will be deducted from these entitlements before they are paid to the service member. Income tax is withheld at a flat rate of 27% as bonuses are treated as supplemental wages. Service member will not need to account for enlistment and reenlistment bonuses separately when preparing their tax returns as the payments and withholdings will be reflected on their W-2 form. If a service member feels this information is incorrect they will need to contact their local accounting and finance or payroll office.

A reenlistment bonus may be tax free if the voluntary extension or reenlistment occurs in a month the service member served in a combat zone.

## ***EXCLUDABLE INCOME***

The following qualified military benefits do not have to be reported as income on Form 1040, 1040A, or 1040EZ. The exclusion applies whether the item is furnished in kind or is a reimbursement or allowance. The personal use of a vehicle cannot be excluded from gross income as a qualified military benefit.

Basic Allowance for Housing (BAH)	Basic Allowance for Subsistence (BAS)
Combat Zone Compensation (including hostile fire pay or imminent danger pay) (limited amount for officers)	Congressional Medal of Honor Pension
Death Allowances	Defense Counseling
Dislocation Allowances	Evacuation Allowance
Family Allowances	Group-term Life Insurance
Interment Allowance	Medical Benefits
Moving and Storage	Other Quarters Allowances
Overseas Housing Allowance (OHA)	Per Diem (Including reservist)
Professional Education	Qualified Hazardous Duty Pay
ROTC Educational and Subsistence Allowances	Survivor and Retirement Protection Plan Premiums Deducted from Military Retired Pay
Trailer Allowance	Veterans' Benefits

**Note:** If the person you are helping is a member of the Armed Forces and was provided a commuter highway vehicle (such as a van) by his or her employer in 2002, refer the taxpayer to Publication 525, *Taxable and Nontaxable Income*, and to a paid professional preparer.

## ***MEDICAL SEPARATION PAY***

Service members who have been separated for medical reasons are given severance pay, which is included in the W-2 Form and is taxable as wages. The Veteran's Administration then determines the amount of the medical disability pension due. The service member does not receive the pension until the severance pay amount is offset.

Disability compensation is a monetary benefit paid to veterans who are disabled by injury or disease incurred or aggravated during active military service. The service of the veteran must have been terminated through separation or discharge under conditions that were other than dishonorable. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax. The payment of military retirement pay, disability severance pay and separation incentive payments known as SSB and VSI (Special Separation Benefits and Voluntary Separation Incentives) also affects the amount of VA compensation paid.

### **Example**

Anita Bennett, an active duty service member, was separated due to a medical condition. At the time of her separation she was given medical separation pay or severance pay in the amount of \$16,000.00. The severance pay was subject to 27% withholding and she received \$11,520. The withholding amount of \$4,320 was included on her W-2 Form. The next year the Veteran's Administration (VA) determined that due to her medical condition she was entitled to a VA disability pension of \$1,000.00 per month from the date of her discharge. However, the VA will not pay her disability pension until the severance pay has been offset. In this case, 16 months after her discharge. At the time she receives her determination letter from the VA, the tax return that includes her severance pay should be amended to exclude the \$16,000.00 severance pay and designate that pay as "disability pay included in wages".

## **COMBAT ZONE EXCLUSION**

Members of the U.S. Armed Forces who serve in a combat zone (defined later) may exclude certain pay from their income. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone. However, the entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized as a result of wounds, disease, or injury incurred while serving in the combat zone. The following military pay can be excluded from their income.

- Active duty pay earned in any month during which they served in a combat zone.
- Imminent danger/hostile fire pay
- A reenlistment bonus if the voluntary extension or reenlistment occurs in a month during which they served in a combat zone.

- Pay for accrued leave earned in any month during which they served in a combat zone. The Department of Defense must determine that the unused leave was earned during that period.
- Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month during which they served in a combat zone.
- Awards for suggestions, inventions, or scientific achievements to which members are entitled to because of a submission they made in a month during which they served in a combat zone.
- Student loan repayments that are attributable to their period of service in a combat zone.

Retirement pay does not qualify for the combat zone exclusion.

***Partial (month) service.*** Members of the U.S. Armed Forces who serve in a combat zone for one or more days during a particular month, are entitled to an exclusion for that entire month.

## Combat Zone

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order.

**Afghanistan area.** By Executive Order No. 13239, Afghanistan (and airspace above) is designated as a combat zone beginning September 19, 2001.

**Yemen area.** Executive Order No. 13239 was extended to include Yemen as a designated combat zone beginning April 10, 2002.

**The Kosovo area.** By Executive Order No. 13119 and Public Law 106-21, the following locations (including air space above) were designated as a combat zone and a qualified hazardous duty area beginning March 24, 1999.

- Federal Republic of Yugoslavia (Serbia/Montenegro)
- Albania
- The Adriatic Sea
- The Ionian Sea—north of the 39th parallel (including all of the airspace in connection with the Kosovo operation.)

**Persian Gulf area.** By Executive Order No. 12744, the following locations (and airspace above) were designated as a combat zone beginning January 17, 1991.

- The Persian Gulf,
- The Red Sea,
- The Gulf of Oman,
- The part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude,
- The Gulf of Aden, and
- The total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

**Qualified hazardous duty area.** Beginning November 21, 1995, a qualified hazardous duty area in the former Yugoslavia is treated as if it were a combat zone. The qualified hazardous duty area includes:

- Bosnia and Herzegovina,
- Croatia, and
- Macedonia.

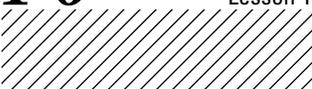
Members of the Armed Forces deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area, are treated as if they are in a combat zone solely for the purposes of the extension of deadlines discussed in Lesson 3. These personnel are not entitled to other combat zone tax benefits.

## **Serving in a Combat Zone**

Service in a combat zone includes any periods that military members are absent from duty because of sickness, wounds, or leave. If, as a result of serving in a combat zone, a person becomes a prisoner of war or is missing in action, that person is considered to be serving in the combat zone so long as he or she keeps that status for military pay purposes.

**Qualifying service outside combat zone.** Military service outside a combat zone is considered to be performed in a combat zone if:

- The service is in direct support of military operations in the combat zone, and
- The service qualifies a member for special military pay for duty subject to hostile fire or imminent danger.



Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

**Non-qualifying presence in combat zone.** The following military service does not qualify as service in a combat zone.

- Presence in a combat zone while on leave from a duty station located outside the combat zone,
- Passage over or through a combat zone during a trip between 2 points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience.

**Note.** Military Members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.

## Amount of Exclusion

**Enlisted members.** Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month, can exclude all of their military pay for that month from their income. They can also exclude military pay earned while they are hospitalized as a result of wounds, disease, or injury incurred in the combat zone. The exclusion of their military pay while they are hospitalized does not apply to any month that begins more than 2 years after the end of combat activities in that combat zone. Their hospitalization does not have to be in the combat zone.

**Officers.** Commissioned officers (including Limited Duty Officers), may exclude their pay according to the rules just discussed. However, the amount of their exclusion is limited to the highest rate of enlisted pay (plus imminent danger/hostile fire pay they received) for each month during any part of which they served in a combat zone or were hospitalized as a result of their service there.

**Hospitalized while serving in the combat zone.** If a member is hospitalized while serving in the combat zone, the wound, disease, or injury causing the hospitalization will be presumed to have been incurred while serving in the combat zone unless there is clear evidence to the contrary.

### Example

Ron Brady is hospitalized for a specific disease after serving in a combat zone for 3 weeks, and the disease for which he is hospitalized has an incubation period of 2 to 4 weeks. The disease is presumed to have been incurred while he was serving in the

combat zone. On the other hand, if the incubation period of the disease were one year, the disease would not have been incurred while he was serving in the combat zone.

**Hospitalized after leaving the combat zone.** In some cases the wound, disease, or injury may have been incurred while serving in the combat zone, even though the member was not hospitalized until after he/she left.

**Example**

Martha Mason was hospitalized for a specific disease 3 weeks after she left the combat zone. The incubation period of the disease is from 2 to 4 weeks. The disease was considered incurred while serving in the combat zone.

## ***COMMUNITY PROPERTY***

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Special rules apply to married persons who file separate returns or who were divorced during the tax year and were domiciled in a community property state.

For military personnel in community property states, the key word is “domicile.” Domicile describes someone’s legal, permanent residence. It is not always where the person presently lives.

Whether an item is subject to community property laws depends on the nature of the payment.

**Armed Forces pay.** State community property laws apply to active military pay. Generally, the character of the pay as separate to community income is determined by the marital status and domicile of the Armed Forces member and his or her spouse while the member is in active military service.

**Armed Forces retired or retainer pay.** Retired or retainer payments to a member of the Armed Forces may be subject to community property laws.

For more information, see Publication 555, *Community Property*.



### Exercise 1

Which of the following should be included in gross income?

- A. Basic Allowance for Subsistence (BAS)
- B. Overseas Housing Allowance
- C. Lump sum for accrued leave, paid on separation
- D. Foreign language proficiency pay
- E. Uniform allowance
- F. Foreign duty pay
- G. Reenlistment Bonus received while a service member was deployed to Qatar
- H. Hazardous duty pay
- I. Family Separation Allowance received while a service member was deployed to Italy

Answer \_\_\_\_\_

### Exercise 2

Sergeant James Walker was medically separated, in November 2001, from active duty military service due to a medical condition that interfered with his ability to perform his military duties. James was entitled to and received \$12,000 in medical separation pay. After taxes he received \$8,640. Prior to his separation he submitted the required documentation to the Veteran's Administration applying for disability pay. James filed his tax return in March 2002 and received a \$567 refund. In August of 2002 James received his determination letter from VA informing him he was entitled to an \$800 disability pension per month from the date of his discharge.

- A. Does James need to file an amended tax return?

Answer \_\_\_\_\_

- B. What amount of pay will James need to exclude from his pay when he files an amended tax return?

Answer \_\_\_\_\_

- C. When will James start receiving his disability pension?

Answer \_\_\_\_\_

## ▶▶ **SUMMING UP THIS LESSON** ◀◀

You have learned that certain items received by members of the Armed Forces are included in their gross income. Certain other items are specifically excluded by law. Pay for service in a combat zone is not taxed for an enlisted member of the U.S. military. The amount of income that is not taxed for commissioned officers serving in a combat zone is limited to the highest rate of enlisted pay plus the amount of imminent danger pay per month.



# **GROSS INCOME** ANSWERS TO EXERCISES

Exercise 1      C, D, F, and H

Exercise 2      A – Yes

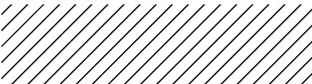
                    B – \$12,000

                    C – 15 months or March of 2003

# GLOSSARY OF MILITARY PAYROLL TERMS

**LEGEND**  
**I - Includible**  
**X - Excludable**

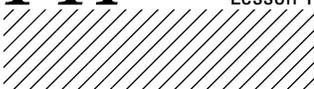
	<b>Term</b>	<b>Definition</b>
I	Accrued Leave Payment	Lump sum paid for unused accrued leave when term of service expires
I	Aviation Career Incentive Pay	Incentive pay for Aviation officers
X	Basic Allowance for Housing (BAH)	Paid to members of the Armed Forces for housing
X	Basic Allowance for Subsistence (BAS)	Paid for subsistence including rations furnished in-kind to enlisted members
I	Basic Pay	Pay for active duty
X	Combat Zone Exclusion (pay excludable up to the highest rate of enlisted pay per month for commissioned officers)	Pay received for service in a combat zone as designated by Executive Order (see previous discussion under "Combat Zone Exclusion")
I	Continuation Pay	Paid to certain personnel who extend their active duty period
X	Death Allowances	Death gratuity payments (up to \$3,000) made to eligible survivors and payments for burial services and travel of dependents to burial site
X	Defense Counseling	Provided by the Armed Forces to represent military personnel in their defense before a general or special court-martial or at an investigation or in a foreign criminal proceeding
X	Discharge Gratuity	Payments of not more than \$25, received if other than honorable discharge
X	Dislocation Allowances	Payments to defray extra costs of moving from a permanent duty station
I	Diving Pay	Pay for diving operations
I	Enlistment Bonus	Payable to certain "critical-skilled" enlistees upon entering the Service
X	Evacuation Allowance	Paid to offset expenses for dependents who must leave for a place of safety
X	Family Allowances	Paid when military families are separated due to overseas assignments, for emergencies, and for certain educational expenses for dependents



I	Flight Duty Pay	Monthly pay supplement for flight time
I	Foreign Duty Pay	Paid to enlisted personnel serving outside the 48 contiguous states and the District of Columbia
X	Group-term Life Insurance	Military life insurance
I	Hostile Fire Pay (exceptions may apply when earned in a combat zone)	Pay for hazardous duty
I	Imminent Danger Pay (exceptions may apply when earned in a combat zone)	Pay for duty in an area in which member is exposed to hostile fire or imminent danger
X	Interment Allowance	Burial and death allowances
X	Medal of Honor Pension	Pension for Congressional Medal of Honor holders
I	Medical and Dental Officers Pay	Pay given to certain medical and dental officers
X	Medical Benefits	Free medical services and medical insurance
X	Moving and Storage	In-kind transportation, storage of household goods, and travel allowances
I	Nuclear Qualified Officer Pay	Pay to certain nuclear naval officers
X	Other Quarters Allowances	Paid because of inadequate quarters or housing and cost of living allowances abroad (whether paid by the U.S. Government or by a foreign government)
I	Overseas Extension Bonus	Paid to certain enlisted personnel upon extending their overseas tour
X	Per Diem	An amount paid in place of subsistence and mileage when away from permanent duty stations
	Permanent Post of Duty (POD)	The duty station where the military personnel is assigned by permanent orders
I	Personal Money Allowance	Pay to high-ranking officers to defray expenses incurred in their official positions
X	Professional Education	Education costs paid by the U.S. Government for Armed Forces personnel



I	Proficiency Pay	Awards to enlisted personnel who show special proficiency in a military skill
X	Qualified Hazardous Duty Pay	Exclusion of all military pay per month for enlisted personnel and warrant officers, limited to maximum enlisted rate plus imminent danger pay for officers
I	Reenlistment Bonus	Multiple of monthly basic pay times additional years of re-enlistment service
I	Responsibility Pay	Earned in certain pay grades by officers serving in a position of unusual responsibility or critical nature
X	ROTC Educational and Subsistence Allowances	Paid for education and subsistence
I	Sea Duty Pay	Paid for duty on a vessel under orders of a competent authority operating outside the contiguous United States
I	Separation Pay	Lump-sum payment paid upon involuntary discharge or release in certain cases
I	Student Loan Repayment	Repayments from programs such as the Department of Defense Educational Loan Repayment Program
X	Survivor and Retirement Protection Plan Premium	Premiums taken from the gross pay of retired personnel of the Armed Forces to provide a survivor annuity
X	Trailer Allowance	Pay for moving a trailer from a permanent POD
X	Uniforms (In Kind or Allowances)	Uniforms furnished enlisted personnel and allowances paid to officers
X	Overseas Housing Allowance	Paid to personnel living in a high cost of living area outside the continental U.S. (except Hawaii and Alaska)
X	Veterans' Benefits	Benefits administered by the Department of Veterans Affairs, generally based on a combat-related disability
I	Veterinary Officer Pay	Pay given to certain Veterinary Corps Officers



# FOREIGN EARNED INCOME EXCLUSION

## LESSON 2

### OBJECTIVES

At the end of this lesson you will be able to:

1. Determine whether the taxpayer qualifies for the foreign earned income exclusion.
2. Calculate the foreign earned income exclusion.

### INTRODUCTION

In this lesson, we will discuss the *foreign earned income exclusion*. Certain taxpayers can exclude income earned in foreign countries. For 2002, the maximum exclusion amount is \$80,000. However, the foreign earned income exclusion **does not apply** to wages and salaries of military and civilian employees of the U.S. Government. Employees of the U.S. Government, include those who work at Armed Forces post exchanges, officers' and enlisted personnel clubs, and embassy commissaries. Other foreign income earned by military personnel or their spouses may be eligible for the exclusion.

To qualify for the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country throughout your period of stay. This lesson will explain this requirement.

### REQUIREMENTS

There are two requirements to qualify for the foreign earned income exclusion. First, the taxpayer must show that his or her **tax home** is in a foreign country. ("Foreign country" does not include Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, or U.S. possessions such as America Samoa, Wake Island, the Midway Islands and Johnston Island.) The second requirement is that the taxpayer must meet either the **bona fide residence test** or the **physical presence test**.

## Exercise 1

Miranda has lived in Puerto Rico since 1998. Is she eligible for the foreign earned income exclusion?

Answer \_\_\_\_\_

The requirements are applied separately to each individual. If a husband and wife are each working overseas, each must meet both requirements, to apply the exclusion. If they do so, each is entitled to an exclusion of up to \$80,000 (on qualified income) for 2002. **(Remember military pay is not eligible for the exclusion.)**

**Tax Home.** To claim the foreign earned income exclusion, the taxpayer's home must be in a foreign country. Generally, one's tax home is the area of the taxpayer's main place of business, employment or post of duty, regardless of where the taxpayer maintains his or her family home.

The tax home for military personnel is the permanent duty station, either land based or on a ship. This is true whether it is feasible or permissible for the taxpayer's family to live with him or her. **Generally, therefore most military personnel and their dependents will not qualify for the Foreign Earned Income exclusion.**

### Example 1

John and Mary are both in the armed forces and have been permanently stationed in Germany since August 2001. Their tax home for 2002 would be Germany.

## Exercise 2

Alan has lived and worked in China since August 16, 1999. For 2002, what country is his tax home?

Answer \_\_\_\_\_

If the taxpayer does not have a regular or main place of business because of the nature of the work, then the tax home is the place where the taxpayer regularly lives.

When the taxpayer has a tax home in the U.S. and goes overseas temporarily, or on business, the tax home has not changed. If the taxpayer is assigned overseas on business for an indefinite period, the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

### Example 2

Henry is in the Armed Forces. He was assigned to a post in Japan in 2002. This assignment was for an indefinite period. Margaret, his wife, accompanied him to Japan and has foreign earned income. Their tax home for 2002 would be Japan.

**Period of Stay.** Another qualification for the exclusion is the length of time the taxpayer stays overseas. This requirement can be satisfied in one of two ways. The taxpayer must be:

1. A U.S. citizen or resident alien from a tax treaty country who is a **bona fide resident** of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
2. A U.S. citizen or U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

### Exercise 3

Jennifer is a U.S. citizen who has lived in Israel since October 1, 2002. She expects to return to the U.S. in May, 2003. Does she meet either period of stay test?

Answer \_\_\_\_\_

**Bona Fide Resident Test.** To meet the test, the taxpayer must show that he or she has set up permanent quarters in a foreign country. The period must be for an uninterrupted period that includes an entire tax year. Taking a brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention is clear to return to the foreign country.

### Example 3

Jane is a military spouse who has lived in England since 1999. Her mother still lives in the U.S. Jane came to the U.S. for two weeks in 2002 to be with her mother after she had surgery. Jane's trip to the U.S. does not affect her status as a bona fide resident of a foreign country.

**Physical Presence Test.** The other test that may be met instead of the bona fide residence test is the physical presence test. To qualify, the taxpayer must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

#### Exercise 4

Shauntell is using the twelve months of 2002 to determine if she qualifies for the physical presence test. She arrived in Kenya on January 3, 2002 and worked there until August 12, 2002 when she returned to the U.S. for 6 weeks. On October 1, 2002 she returned to Kenya and worked there until she permanently returned to the U.S. on January 1, 2003. Does she meet the physical presence test for 2002?

Answer \_\_\_\_\_

**Waiver of Time Requirements.** The minimum time requirements for period of stay may be waived, if the taxpayer is forced to leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. The taxpayer must show that he/she could have met the minimum time requirements if it had not been for the adverse conditions.

### **QUALIFYING INCOME**

To qualify for the exclusion, income must be **earned income**. Examples of earned income are salaries, wages, commissions and professional fees. Earned income does not include dividends, interest, capital gains, alimony, social security benefits, pensions or annuities. To qualify for the exclusion, the earned income must be for services (other than military or U.S. government) performed in a foreign country.

Amounts paid by the United States or its agencies to its employees **do not qualify** for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

#### **Example 4**

Maria, a U.S. resident, is in the armed forces and has lived in Lisbon since 1999. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Lisbon and the surrounding area. The income from her self-employment may qualify for the exclusion.

### **Exercise 5**

Maurice is stationed in Germany. His only income is from his U.S. military salary. Does he qualify for the foreign earned income exclusion?

Answer \_\_\_\_\_

### **Exercise 6**

Juanita lives in Scotland. She is retired and her income consists of U.S. Social Security, a pension and several stock dividends. Does she qualify for the foreign earned income exclusion?

Answer \_\_\_\_\_

### **Exercise 7**

Jose and Kim live in a foreign country. Jose has wages from the U.S. military. Kim has wages from a bank that she works at in the foreign country. Do they have qualifying income for the foreign earned income exclusion?

Answer \_\_\_\_\_

## ***CHOOSING THE EXCLUSION***

The foreign earned income exclusion is voluntary. (There are times when it may be to the taxpayer's advantage to not claim the exclusion.) The initial choice of the exclusion on Form 2555 or Form 2555EZ must be filed with a timely return (including extensions). Exceptions do apply that allow the initial choice to be made after a return is filed. Taxpayers who wish to take advantage of these exceptions should seek professional tax assistance.

The taxpayer may revoke the election for any tax year. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

## **FORM 2555 OR FORM 2555EZ**

If the taxpayer is qualified to, and wishes to claim the foreign earned income exclusion, it is necessary to complete Form 2555 or 2555EZ and attach it to Form 1040. The tax return should be filed with Internal Revenue Service Processing Campus, Philadelphia, PA, 19255.

To be able to use Form 2555EZ, the taxpayer must be a U.S. citizen or resident alien who has wages and salaries, but not self-employment income. The total foreign earned income must be \$80,000 or less, and the person cannot be claiming any business or moving expenses. Taxpayers, who do not meet these restrictions, should file Form 2555 to claim the credit.

### **Example 5**

Michael and his wife Melissa have been stationed in Hong Kong since 2001. Michael is employed by the armed forces. Melissa operates a home day care business. Their tax home is Hong Kong. They meet the physical presence test. Melissa wants to exclude her self-employment income from U.S. taxation. She will need to complete Form 2555 instead of Form 2555EZ, because her income is from self-employment.

### **Exercise 8**

Assuming that the following taxpayers meet the period of stay test, should they file a Form 2555, or Form 2555EZ?

- a. Mallory has \$34,000 of foreign earned income. She has no other income. Which form should she file?

Answer \_\_\_\_\_

- b. Jacob has U.S. military wages and self-employment income he earned in a foreign country. Which form should he file?

Answer \_\_\_\_\_

- c. Ramie has \$86,000 of foreign earned income. Which form should he file?

Answer \_\_\_\_\_

Taxpayers, who are eligible to file Form 2555EZ, should complete all four sections of the form.

On the following two pages, you will find a blank copy of Form 2555EZ for your reference.

# Foreign Earned Income Exclusion

# 2002

Department of the Treasury  
Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach to Form 1040.

Attachment  
Sequence No. **34A**

Name shown on Form 1040

Your social security number

### You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of \$80,000 or less.
- Are filing a calendar year return that covers a 12-month period.

### And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

## Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

### 1 Bona Fide Residence Test

- a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)?  Yes  No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
  - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b Enter the date your bona fide residence began ▶ \_\_\_\_\_, and ended (see instructions) ▶ \_\_\_\_\_.

### 2 Physical Presence Test

- a Were you physically present in a foreign country or countries for at least 330 full days during—  
 { 2002 or any other period of 12 months in a row starting or ending in 2002? }  Yes  No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
  - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b The physical presence test is based on the 12-month period from ▶ \_\_\_\_\_ through ▶ \_\_\_\_\_.

### 3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies?

- Yes  No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
  - If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

## Part II General Information

4 Your foreign address (including country)		5 Your occupation
--	--	-------------------

6 Employer's name	7 Employer's U.S. address (including ZIP code)	8 Employer's foreign address
-------------------	--	------------------------------

- 9 Employer is (check any that apply):
- a A U.S. business
  - b A foreign business
  - c Other (specify) ▶ \_\_\_\_\_
- 10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ \_\_\_\_\_
- b If you did not file Form 2555 or 2555-EZ after 1981, check here  and go to line 11a now.
- c Have you ever revoked the foreign earned income exclusion?  Yes  No
- d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ \_\_\_\_\_
- 11a List your tax home(s) during 2002 and date(s) established. ▶ \_\_\_\_\_
- b Of what country are you a citizen/national? ▶ \_\_\_\_\_

**Part III Days Present in the United States**—Complete this part if you were in the United States or its possessions during 2002.

12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

**Part IV Figure Your Foreign Earned Income Exclusion**

13 Maximum foreign earned income exclusion . . . . .	13	\$80,000 00
14 Enter the number of days in your qualifying period that fall within 2002 . . . . .	14 days	
15 Did you enter 365 on line 14? <input type="checkbox"/> <b>Yes.</b> Enter "1.000." <input type="checkbox"/> <b>No.</b> Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	× .
16 Multiply line 13 by line 15 . . . . .	16	
17 Enter, in U.S. dollars, the total foreign earned income you earned and received in 2002 (see instructions). Be sure to include this amount on Form 1040, line 7 . . . . .	17	
18 <b>Foreign earned income exclusion.</b> Enter the <b>smaller</b> of line 16 or line 17 here and in parentheses on <b>Form 1040, line 21</b> . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 . . . . . ▶	18	



For those who must file Form 2555, the first section of the form is for general information, and must be completed by all taxpayers who claim the exclusion.

Taxpayers who claim the bona fide residence test must complete Part II of Form 2555. Taxpayers who qualify under the physical presence test must complete Part III.

Part IV of Form 2555 is completed by all taxpayers. This is the section where the foreign earned income is listed. Do not list military wages in this section; they are not considered foreign earned income.

Page 3 of the form is where the exclusion is computed. Generally, armed forces personnel and their spouses will not qualify for the housing exclusion (the housing allowance is already considered non-taxable income).

On the following three pages, you will find a blank Form 2555 for your reference.

### Foreign Earned Income

▶ See separate instructions. ▶ Attach to Form 1040.

#### For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040

Your social security number

#### Part I General Information

- 1 Your foreign address (including country) \_\_\_\_\_
- 2 Your occupation \_\_\_\_\_
- 3 Employer's name ▶ \_\_\_\_\_
- 4a Employer's U.S. address ▶ \_\_\_\_\_
- b Employer's foreign address ▶ \_\_\_\_\_
- 5 Employer is (check ▶):
  - a  A foreign entity
  - b  A U.S. company
  - c  Self
  - d  A foreign affiliate of a U.S. company
  - e  Other (specify) ▶ \_\_\_\_\_
- 6a If, after 1981, you filed Form 2555 to claim either of the exclusions or Form 2555-EZ to claim the foreign earned income exclusion, enter the last year you filed the form. ▶ \_\_\_\_\_
- b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶  and go to line 7.
- c Have you ever revoked either of the exclusions? . . . . .  Yes  No
- d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. ▶ \_\_\_\_\_
- 7 Of what country are you a citizen/national? ▶ \_\_\_\_\_
- 8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** on page 3 of the instructions . . . . .  Yes  No
- b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. ▶ \_\_\_\_\_
- 9 List your tax home(s) during your tax year and date(s) established. ▶ \_\_\_\_\_

**Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.**

#### Part II Taxpayers Qualifying Under Bona Fide Residence Test (See page 2 of the instructions.)

- 10 Date bona fide residence began ▶ \_\_\_\_\_, and ended ▶ \_\_\_\_\_
  - 11 Kind of living quarters in foreign country ▶ a  Purchased house b  Rented house or apartment c  Rented room  
d  Quarters furnished by employer
  - 12a Did any of your family live with you abroad during any part of the tax year? . . . . .  Yes  No
  - b If "Yes," who and for what period? ▶ \_\_\_\_\_
  - 13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? (See instructions.) . . . . .  Yes  No
  - b Are you required to pay income tax to the country where you claim bona fide residence? (See instructions.)  Yes  No
- If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.**
- 14 If you were present in the United States or its possessions during the tax year, complete columns (a)–(d) below. Do not include the income from column (d) in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

- 15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶ \_\_\_\_\_
- b Enter the type of visa under which you entered the foreign country. ▶ \_\_\_\_\_
- c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation  Yes  No
- d Did you maintain a home in the United States while living abroad? . . . . .  Yes  No
- e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶ \_\_\_\_\_

**Part III Taxpayers Qualifying Under Physical Presence Test** (See page 2 of the instructions.)

- 16** The physical presence test is based on the 12-month period from ► ..... through ► .....
- 17** Enter your principal country of employment during your tax year. ► .....
- 18** If you traveled abroad during the 12-month period entered on line 16, complete columns (a)–(f) below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter “Physically present in a foreign country or countries for the entire 12-month period.” **Do not** include the income from column (f) below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	(b) Date arrived	(c) Date left	(d) Full days present in country	(e) Number of days in U.S. on business	(f) Income earned in U.S. on business (attach computation)

**Part IV All Taxpayers**

**Note:** Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2002 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions. **Do not** include income from line 14, column (d), or line 18, column (f). Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.

**If you are a cash basis taxpayer, report on Form 1040 all income you received in 2002, no matter when you performed the service.**

2002 Foreign Earned Income	Amount (in U.S. dollars)	
<b>19</b> Total wages, salaries, bonuses, commissions, etc. . . . .	<b>19</b>	
<b>20</b> Allowable share of income for personal services performed (see instructions):		
<b>a</b> In a business (including farming) or profession . . . . .	<b>20a</b>	
<b>b</b> In a partnership. List partnership’s name and address and type of income. ► .....	<b>20b</b>	
<b>21</b> Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):		
<b>a</b> Home (lodging) . . . . .	<b>21a</b>	
<b>b</b> Meals . . . . .	<b>21b</b>	
<b>c</b> Car . . . . .	<b>21c</b>	
<b>d</b> Other property or facilities. List type and amount. ► .....	<b>21d</b>	
<b>22</b> Allowances, reimbursements, or expenses paid on your behalf for services you performed:		
<b>a</b> Cost of living and overseas differential . . . . .	<b>22a</b>	
<b>b</b> Family . . . . .	<b>22b</b>	
<b>c</b> Education . . . . .	<b>22c</b>	
<b>d</b> Home leave . . . . .	<b>22d</b>	
<b>e</b> Quarters . . . . .	<b>22e</b>	
<b>f</b> For any other purpose. List type and amount. ► .....	<b>22f</b>	
<b>g</b> Add lines 22a through 22f . . . . .	<b>22g</b>	
<b>23</b> Other foreign earned income. List type and amount. ► .....	<b>23</b>	
<b>24</b> Add lines 19 through 21d, line 22g, and line 23 . . . . .	<b>24</b>	
<b>25</b> Total amount of meals and lodging included on line 24 that is excludable (see instructions) . . . . .	<b>25</b>	
<b>26</b> Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your <b>2002 foreign earned income</b> . . . . .	<b>26</b>	



## ***DEDUCTIONS ALLOCABLE TO EXCLUDED INCOME***

In section VIII of Form 2555, the taxpayer is required to list the deductions allowed in figuring adjusted gross income that are allocable to the excluded income. To the extent a deduction that is allocable to the excluded income is claimed, the exclusion must be reduced by the deduction.

The three most common deductions that may affect the exclusion are **self-employment tax, itemized deductions and moving expenses.**

If the taxpayer has any deductions attributable to the excluded foreign earned income, follow the instructions in Form 2555 for how to allocate the expenses.

### **▶▶ SUMMING UP THIS LESSON ◀◀**

The foreign earned income exclusion does not apply to income from the U.S. government, regardless of the tax home. The exclusion can be up to \$80,000 for income earned in a foreign country. It is necessary to complete either Form 2555 or 2555EZ to claim the exclusion.

In this lesson, we have discussed the basic examples of the exclusion. When a taxpayer has a more complex situation, he or she will need to seek professional tax assistance.

# **FOREIGN EARNED INCOME EXCLUSION      ANSWERS TO EXERCISES**

1. No, Puerto Rico is not considered a foreign country.
2. His 2002 tax home is China.
3. No.
4. No, she was not present in the foreign country for a full 330 days.
5. No, U.S. military pay is not eligible.
6. No, only earned income is eligible.
7. Yes, Kim's salary.
8. **a.** Form 2555EZ
  - b.** Form 2555
  - c.** Form 2555

1. List the two forms that the foreign earned income exclusion can be claimed on.
2. Is a taxpayer required to take the exclusion on foreign earned income?
3. Are military wages eligible for the foreign earned income exclusion?
4. Complete the form 2555EZ on the next two pages using the following information.

Robert (000-00-0001) and Sara (000-00-0002) Johnson (both U.S. citizens) have lived in Germany since August, 2001. Robert is employed by the U.S. Armed Forces. In 2002, Sara worked at a local bakery (Gulden's, 349028 Gulden Lane, Munich, Germany) in Germany and earned the equivalent of \$12,000. Robert and Sara do not consider themselves bona fide residents of Germany. During 2002, they resided in Germany for the full year, except for a three day vacation period in France. Their address in Germany is 239084 Marzolf Lane, Munich, Germany. They have never claimed the foreign earned income exclusion before.

# Foreign Earned Income Exclusion

Department of the Treasury  
Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-1326

**2002**

Attachment  
Sequence No. **34A**

Name shown on Form 1040

Your social security number

### You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of \$80,000 or less.
- Are filing a calendar year return that covers a 12-month period.

### And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

## Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

### 1 Bona Fide Residence Test

- a** Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)?  Yes  No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
  - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b** Enter the date your bona fide residence began ▶ \_\_\_\_\_, and ended (see instructions) ▶ \_\_\_\_\_.

### 2 Physical Presence Test

- a** Were you physically present in a foreign country or countries for at least 330 full days during—  
 { 2002 or any other period of 12 months in a row starting or ending in 2002? }  Yes  No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
  - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b** The physical presence test is based on the 12-month period from ▶ \_\_\_\_\_ through ▶ \_\_\_\_\_.

### 3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies?

- Yes  No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
  - If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

## Part II General Information

4 Your foreign address (including country)	5 Your occupation
--	-------------------

6 Employer's name	7 Employer's U.S. address (including ZIP code)	8 Employer's foreign address
-------------------	--	------------------------------

**9** Employer is (check any that apply):

**a** A U.S. business.

**b** A foreign business.

**c** Other (specify) ▶ \_\_\_\_\_

**10a** If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ \_\_\_\_\_

**b** If you did not file Form 2555 or 2555-EZ after 1981, check here  and go to line 11a now.

**c** Have you ever revoked the foreign earned income exclusion?  Yes  No

**d** If you answered "Yes," enter the tax year for which the revocation was effective. ▶ \_\_\_\_\_

**11a** List your tax home(s) during 2002 and date(s) established. ▶ \_\_\_\_\_

**b** Of what country are you a citizen/national? ▶ \_\_\_\_\_

For Paperwork Reduction Act Notice, see page 3 of separate instructions.

Cat. No. 13272W

Form **2555-EZ** (2002)

**Part III Days Present in the United States**—Complete this part if you were in the United States or its possessions during 2002.

12	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

**Part IV Figure Your Foreign Earned Income Exclusion**

13	Maximum foreign earned income exclusion . . . . .	13	\$80,000	00
14	Enter the number of days in your qualifying period that fall within 2002 . . . . .	14	days	
15	Did you enter 365 on line 14? <input type="checkbox"/> <b>Yes.</b> Enter "1.000." <input type="checkbox"/> <b>No.</b> Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	×	.
16	Multiply line 13 by line 15 . . . . .	16		
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2002 (see instructions). Be sure to include this amount on Form 1040, line 7 . . . . .	17		
18	<b>Foreign earned income exclusion.</b> Enter the <b>smaller</b> of line 16 or line 17 here and in parentheses on <b>Form 1040, line 21</b> . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 . . . . . ▶	18		



# ***FOREIGN EARNED INCOME EXCLUSION***    *ANSWERS TO SUMMARY EXERCISES*

1. Form 2555 and Form 2555EZ.
2. No, it is voluntary.
3. No.
4. See the completed form on the next two pages.

# Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

Name shown on Form 1040

Sara Johnson

Your social security number

000 00 0002

**You May Use This Form If You:**

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of \$80,000 or less.
- Are filing a calendar year return that covers a 12-month period.

**And You:**

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

## Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

**1 Bona Fide Residence Test**

- a** Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)?  Yes  No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
  - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b** Enter the date your bona fide residence began ▶ \_\_\_\_\_, and ended (see instructions) ▶ \_\_\_\_\_.

**2 Physical Presence Test**

- a** Were you physically present in a foreign country or countries for at least 330 full days during—  
 { 2002 or any other period of 12 months in a row starting or ending in 2002? }  Yes  No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
  - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b** The physical presence test is based on the 12-month period from ▶ Jan. through ▶ Dec.

**3 Tax Home Test.** Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies?  Yes  No

- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
- If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

## Part II General Information

<p><b>4</b> Your foreign address (including country)</p> <p>239084 Marzolf Lane Munich, Germany</p>	<p><b>5</b> Your occupation</p> <p>baker</p>
---	--

<p><b>6</b> Employer's name</p> <p>Gulden's</p>	<p><b>7</b> Employer's U.S. address (including ZIP code)</p>	<p><b>8</b> Employer's foreign address</p> <p>349028 Gulden Lane Munich, Germany</p>
---	--	--

**9** Employer is (check any that apply):

**a** A U.S. business

**b** A foreign business

**c** Other (specify) ▶ \_\_\_\_\_

**10a** If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ \_\_\_\_\_

**b** If you did not file Form 2555 or 2555-EZ after 1981, check here ▶  and go to line 11a now.

**c** Have you ever revoked the foreign earned income exclusion?  Yes  No

**d** If you answered "Yes," enter the tax year for which the revocation was effective. ▶ \_\_\_\_\_

**11a** List your tax home(s) during 2002 and date(s) established. ▶ Germany

**b** Of what country are you a citizen/national? ▶ U.S.

**Part III Days Present in the United States**—Complete this part if you were in the United States or its possessions during 2002.

12	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

**Part IV Figure Your Foreign Earned Income Exclusion**

13	Maximum foreign earned income exclusion . . . . .	13	\$80,000	00
14	Enter the number of days in your qualifying period that fall within 2002 . . . . .	14	365	days
15	Did you enter 365 on line 14? <input checked="" type="checkbox"/> <b>Yes.</b> Enter "1.000." <input type="checkbox"/> <b>No.</b> Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	×	1.000
16	Multiply line 13 by line 15 . . . . .	16	\$80,000	
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2002 (see instructions). Be sure to include this amount on Form 1040, line 7 . . . . .	17	\$12,000	
18	<b>Foreign earned income exclusion.</b> Enter the <b>smaller</b> of line 16 or line 17 here and in parentheses on <b>Form 1040, line 21</b> . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 . . . . . ▶	18	\$12,000	



# TAX BENEFITS FOR COMBAT ZONE PARTICIPANTS

## LESSON 3

### OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine who qualifies for an extension of deadline to file returns and take care of tax matters.
2. Identify special tax benefits that are available to persons who die in a combat zone or from a terrorist or military action.
3. Explain how to file claims for tax forgiveness for these individuals.

### INTRODUCTION

This lesson describes some of the tax benefits that are available to those serving in a combat zone. Some of these tax benefits are also covered in Lesson 1, *Gross Income*; Lesson 11, *Sale of Home*; and Lesson 15, *Filing Returns*.

Service in the Persian Gulf area, the former Yugoslavia, Afghanistan and its airspace, and Yemen are eligible for combat zone tax treatment. In addition, U.S. military personnel located in the Federal Republic of Yugoslavia, Albania, the Adriatic Sea, and the northern Ionian Sea, including all of their air space in connection with the Kosovo operation, are eligible for combat zone tax treatment. Members of the Armed Forces deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, but outside the qualified hazardous duty area, are treated as if they are in a combat zone solely for the purposes of the extension deadlines. These personnel are not entitled to other combat zone tax benefits. Military members serving in these designated areas are automatically granted additional time to take action on any tax matter. The IRS will not impose penalties or interest on members during an extension period.

### EXTENSION OF DEADLINE

Members of the Armed Forces who served in a combat zone are allowed additional time to take care of tax matters. This extension also applies to any individual who is deployed from his or her permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area. The law provides that

certain periods of time are disregarded when determining whether certain tax matters have been taken care of on time. For ease of understanding, this publication refers to these provisions as “extensions of deadlines.” These deadline extensions should not be confused with other parts of the tax law that refer to extensions of time for performing acts.

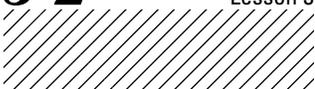
The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended if the taxpayer serves in the Armed Forces in a combat zone. The deadline for IRS to take certain actions, such as collection and examination actions, is also extended.

Additionally, if members of the Armed Forces are deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, but outside the qualified hazardous duty area, they also receive these extensions (but not other combat zone benefits). The deadline for IRS to take certain actions, such as collection and examination actions, is also extended. See Lesson 1 for the beginning dates for the Afghanistan area combat zone, the Kosovo area combat zone, the Persian Gulf area combat zone, and the qualified hazardous duty areas.

The deadline for taking actions with the IRS is extended for 180 days after the later of:

1. The last day the taxpayer is in a combat zone/qualified hazardous duty area or have qualifying service outside of the combat zone/qualified hazardous duty area (or the last day the area qualifies as a combat zone or qualified hazardous duty area), or
2. The last day of any continuous qualified hospitalization (defined later) for injury from service in the combat zone/qualified hazardous duty area or while performing qualifying service outside of the combat zone/qualified hazardous duty area.

In addition to the 180 days, the deadline is also extended by the number of days remaining for the member to take the action with the IRS when he/she entered a combat zone/qualified hazardous duty area (or began performing qualifying service outside the combat zone/qualified hazardous duty area). If a taxpayer entered the combat zone/qualified hazardous duty area (or began performing qualifying service outside the combat zone/qualified hazardous duty area) before the period of time to take the action began, the deadline is extended by the entire period of time he/she has to take the action.



### Example

Captain Margaret Jones entered Saudi Arabia on December 1, 2000. She remained there through March 31, 2002, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Captain Jones' 2000, 2001, and 2002 returns are figured as follows.

- **The 2000 tax return.** The deadline is January 10, 2003. This deadline is 285 days (180 plus 105) after Captain Jones' last day in the combat zone (March 31, 2002). The 105 additional days are the number of days in the 3 1/2 month filing period that were left when she entered the combat zone (January 1 - April 15, 2001).
- **The 2001 tax return.** The deadline is January 10, 2003. The deadline is 285 days (180 plus 105) after Capt. Jones' last day in the combat zone (March 31, 2002).
- **The 2002 tax return.** The deadline is not extended because the 180-day extension period after March 31, 2002, ends on September 27, 2002, which is before the start of the filing period for her 2002 return (January 1 - April 15, 2003).

### Example

Petty Officer Leonard Brown's ship entered the Persian Gulf on January 5, 2001. On February 15, 2001, Leonard was injured and was flown to a U.S. hospital. He remained in the hospital through April 20, 2002. The deadlines for filing Petty Officer Brown's 2000, 2001, and 2002 returns are figured as follows.

- **The 2000 tax return.** The deadline is January 27, 2003. Petty Officer Brown has 280 days (180 plus 100) after his last day in the hospital (April 21, 2002) to file his 2000 return. The 100 additional days are the number of days in the 3 1/2 month filing period that were left when he entered the combat zone (January 5 - April 15).
- **The 2001 tax return.** The deadline is January 27, 2003. Petty Officer Brown has 280 days (180 plus 100) after April 21, 2002, to file his 2001 tax return. The 100 additional days are the number of days in the 2002 filing period that were left when he entered the combat zone.
- **The 2002 tax return.** The deadline is not extended because the 180-day extension period after April 21, 2002, ends on October 18, 2002, which is before the start of the filing period for his 2002 return (January 1 - April 15, 2003).

### Example

You generally have 3 years from April 15, 1998, to file a claim for refund against your timely filed 1997 tax return. This means that your claim normally must be filed by April 15, 2001. However, if you served in a combat zone from November 1, 2000, through March 23, 2001, and were not injured, your

deadline for filing that claim is extended 346 days (180 plus 166) after you leave the combat zone. This extends your deadline to March 4, 2002. The 166 additional days are the number of days in the 3-year period for filing the refund claim that were left when you entered the combat zone on November 1 (November 1, 2000 - April 15, 2001).

**Missing status.** Time in a missing status (missing in action or prisoner of war) counts as time in a combat zone or a qualified hazardous duty area.

**Support personnel.** The deadline extension provision also applies if a taxpayer is serving in a combat zone or a qualified hazardous duty area in support of the Armed Forces. This includes Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces.

**Qualified hospitalization.** The hospitalization must be the result of an injury received while serving in a combat zone or a qualified hazardous duty area. Qualified hospitalization means:

1. Any hospitalization outside the United States, and
2. Up to 5 years of hospitalization in the United States.

### **Actions Extended**

The actions to which the deadline extension provision applies include:

- Filing any return of income, estate, or gift tax (except employment and withholding taxes),
- Paying any income, estate, or gift tax (except employment and withholding taxes),
- Filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision,
- Filing a claim for credit or refund of any tax,
- Bringing suit for any claim for credit or refund,
- Making a qualified retirement contribution to an IRA,
- Allowing a credit or refund of any tax by IRS,
- Assessment of any tax by the IRS,
- Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax,
- Collection by the IRS of any tax due, and
- Bringing suit by the United States for any tax due.

If the IRS takes any actions covered by these provisions or sends the taxpayer a notice of examination before learning that

they are entitled to an extension of the deadline, the taxpayer should contact their legal assistance office. No penalties or interest will be imposed for failure to file a return or pay taxes during the extension period.

**Spouses.** Spouses of individuals who served in a combat zone are entitled to the same deadline extension with two exceptions.

1. The extension does not apply to a spouse for any tax year beginning more than 2 years after the date the area ceases to be a combat zone.
2. The extension does not apply to a spouse for any period the qualifying individual is hospitalized in the United States for injuries incurred in a combat zone.

**Not in a combat zone.** Reservists called to active duty or regular military member who are not in a combat zone may still qualify to defer the payment of back taxes. To qualify, these individuals must:

- Be serving their initial period of service and
- Show that their ability to pay the back taxes has been materially impaired.

**Initial period of service.** The initial period of service is defined as the period of active duty following recall to active duty from an inactive reserve or National Guard unit. For regular military personnel, it is the period following induction or first enlistment in the Armed Forces or the first period of reenlistment for a person who has been out of the service for a year or more. For an officer, the initial period of service is limited to two years of active service after one of the above occurrences.

**Material impairment.** To indicate material impairment, the taxpayer must show that his or her income dropped as a result of going into military service.

**Request for deferment.** Military members who have a current payment agreement or who have received a notice requesting payment must make a written request for deferment to the IRS office where you have the agreement.

**Information needed.** The request for deferment must include the member's name, social security number, monthly income and source of income before military service, current monthly income, military rank, date of entry into the military service, and date the member is eligible for discharge. Enclosing a copy of the military orders is helpful.

The IRS will review each request and advise the taxpayer in writing of its decision. Should the taxpayer need further assistance, they can call the IRS at **1-800-829-1040** to discuss their

situation. If the IRS grants the request for deferment, the taxpayer will be able to defer payment of back taxes until 6 months after the end of his/her initial period of service.

## **DECEDENTS**

Special tax forgiveness provisions apply to individuals who:

- Die while serving in a combat zone or from wounds, disease, or injury incurred while serving in a combat zone, or
- Die from wounds or injury incurred in a terrorist or military action while a U.S. employee.

### **Filing a Decedent Return**

The personal representative (executor, administrator, or anyone who is in charge of the decedent's property) must file the final income tax return (Form 1040) of the decedent for the year of death and any returns not filed for preceding years. A surviving spouse, under certain circumstances, may have to file the returns for the decedent. See *Joint Return*, later.

**Return for preceding year.** If an individual died after the close of the tax year, but before the return for that year was filed, the return for the year just closed will not be the final return. The return for that year will be a regular return and the personal representative must file it.

#### **Example**

Samantha Smith died on March 21, 2001, before filing her 2000 tax return. Her personal representative must file her 2000 return by April 16, 2001. Her final tax return is due April 15, 2002.

### **When and Where To File**

The final income tax return is due at the same time the decedent's return would have been due had death not occurred. A final return for a decedent who was a calendar year taxpayer is generally due on April 15 following the year of death, regardless of when during that year death occurred.

The tax return must be prepared on a form for the year of death regardless of when during the year death occurred.

Generally, you must file the final income tax return of the decedent with the Internal Revenue Service center for the place where you live. A tax return for a decedent cannot be electronically filed. A paper tax return must be filed for the decedent.

## Combat Zone Forgiveness

Federal income tax liability is forgiven for U.S. military personnel who die while serving in a combat zone or as a result of wounds, disease, or injury incurred while so serving. The forgiveness of tax applies for the year of death and for any prior year ending on or after the first day that the individual served in a combat zone in active service. Any forgiven tax liability that has already been paid will be refunded, and any unpaid tax liability at the date of death will be forgiven.

This forgiveness provision also applies to a member of the Armed Forces serving outside the combat zone if the service:

1. Was in direct support of military operations in the zone, and
2. Qualified the member for special military pay for duty subject to hostile fire or imminent danger.

**Missing status.** The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier.

## Tax Forgiveness for Deaths Due to Military or Terroristic Actions

A decedent's income tax liability may be forgiven if his or her death was due to service in a combat zone or to military or terroristic actions.

*The Victims of Terrorism Tax Relief Act of 2001 provides tax relief for those injured or killed as a result of terrorist attacks, certain survivors of those killed as a result of terrorist attacks, and others who were affected by terrorist attacks. For information on that Act, see Publication 3920.*

## Military or Terroristic Actions

The decedent's income tax liability is forgiven if, at death, he or she was a military or civilian employee of the United States who died because of wounds or injury incurred:

- While a U.S. employee, and
- In a military or terroristic action.

*For tax years ending after September 10, 2001, tax liability is forgiven for an individual who dies from wounds or injury incurred while a U.S. employee in a terroristic or military action regardless of where the action occurred.*

The forgiveness applies to the tax year in which death occurred and for any prior tax year in the period beginning with the year before the year in which the wounds or injury occurred.

**Military or terroristic action defined.** A military or terroristic action means the following.

- Any terroristic activity that most of the evidence indicates was directed against the United States or any of its allies.
- Any military action involving the U.S. Armed Forces and resulting from violence or aggression against the United States or any of its allies, or the threat of such violence or aggression.

Military action does not include training exercises. Any multinational force in which the United States is participating is treated as an ally of the United States.

### **Claims for Credit or Refund**

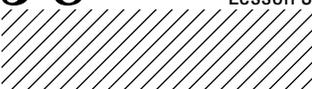
If any of these tax-forgiveness situations applies to a prior year tax, any tax paid for which the period for filing a claim has not ended will be credited or refunded. If any tax is still due, it will be canceled. The normal period for filing a claim for credit or refund is 3 years after the return was filed or 2 years after the tax was paid, whichever is later.

If death occurred in a combat zone or from wounds, disease, or injury incurred in a combat zone, the period for filing the claim is extended by:

- The amount of time served in the combat zone (including any period in which the individual was in missing status), plus
- The period of continuous qualified hospitalization for injury from service in the combat zone, if any, plus
- The next 180 days.
- Qualified hospitalization means any hospitalization outside the United States and any hospitalization in the United States of not more than 5 years.

**Filing a claim.** Use the following procedures to file a claim.

- File Form 1040, 1040A, or 1040EZ if an income tax return has not been filed for the tax year. Form W-2, *Wage and Tax Statement*, must accompany all returns.
- File Form 1040X if an income tax return has been filed. A separate Form 1040X must be filed for each year in question.



These returns and claims must be filed with the Internal Revenue Service, P.O. Box 4053, Woburn, MA 01888.

All returns and claims must be identified by writing “Enduring Freedom—KIA,” “Kosovo Operation — KIA,” “Desert Storm — KIA,” or “Former Yugoslavia — KIA” in bold letters on the top of page 1 of the return or claim. On Forms 1040 and 1040X, the phrase “Enduring Freedom—KIA,” “Kosovo Operation — KIA,” “Desert Storm — KIA,” or “Former Yugoslavia — KIA” must be written on the line for total tax. If the individual was killed in a terroristic or military action outside the United States, put “KITA” on the front of the return and on the line for total tax.

An attachment should accompany any return or claim that includes a computation of the decedent’s tax liability before any amount is forgiven and the amount that is to be forgiven. For joint returns, see *Joint returns*, later.

**Necessary documents.** The following documents must accompany all returns and claims for refund. For returns and claims relating to individuals who died as a result of a terrorist attack, see Publication 3920.

- Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer*.
- A certification from the Department of Defense or the Department of State that the death was due to a military or terroristic action.

For military employees and civilian employees of the Department of Defense, certification must be made by that department on Form DOD 1300, *Report of Casualty*. For other civilian employees who die as a result of wounds or injury incurred outside the United States, certification must be a letter signed by the Director General of the Foreign Service, Department of State, or his/her delegate. The certification must include the individual’s name and social security number, the date of injury, the date of death, and a statement that the individual died as the result of a military or terroristic action outside the United States and was an employee of the United States at the date of injury and at the date of death.

If the certification has been received, but you do not have enough tax information to file a timely claim for refund, file Form 1040X. Attach Form 1310 and a statement that an amended claim will be filed as soon as the required tax information is available.

**Joint returns.** Only the decedent’s part of the joint income tax liability is eligible for the refund or tax forgiveness. To determine the part for the decedent, the person filing the claim must complete the following steps:

1. Figure the income tax for which the decedent would have been liable if a separate return had been filed.
2. Figure the income tax for which the spouse would have been liable as if a separate return had been filed.
3. Multiply the joint tax liability by a fraction. The top number of the fraction is the amount in (1) above. The bottom number of the fraction is the total of (1) and (2).

The amount in (3) is the decedent's tax liability that is eligible for the refund or tax forgiveness. If a taxpayer is unable to complete this process, he or she should attach a statement of all income and deductions indicating the part that belongs to each spouse. The IRS will make the proper allocation.

**Residents of community property states.** If the member of the Armed Forces was domiciled in a community property state and the spouse reported half the military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the years involved. The forgiveness of unpaid tax on the military pay would also apply to the half owed by the spouse for the years involved.

### Exercise 1

Major Joe Wells entered Afghanistan on 6 January 2002. He remained there through 7 April 2002, when he departed for the United States. He was not injured and did not return to the combat zone.

What is the deadline for filing Major Wells' 2001 tax return?

Answer \_\_\_\_\_

## JANUARY 2002

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

## FEBRUARY 2002

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28		

## MARCH 2002

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
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31						

## APRIL 2002

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## MAY 2002

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## JUNE 2002

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## JULY 2002

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## AUGUST 2002

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## SEPTEMBER 2002

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## OCTOBER 2002

S	M	T	W	T	F	S
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## NOVEMBER 2002

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30	31					

## DECEMBER 2002

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22	23	24	25	26	27	28
29	30	31				

## JANUARY 2003

S	M	T	W	T	F	S
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31						

### Exercise 2

Mr. Tim Morris, a civilian employee of the United States, died in 2003 as a result of injuries he suffered during a terrorist attack in 2001.

What years are Mr. Morris' income liabilities forgiven?

Answer \_\_\_\_\_

## ▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson you have learned that:

- ▶ The deadline for filing tax returns, paying taxes, and taking other actions with the Internal Revenue Service is automatically extended if an individual serves in a combat zone.
- ▶ The income tax liability of a member of the Armed Forces is forgiven if a member dies as a result of service in a combat zone or from a terrorist or military action outside the United States.
- ▶ The terrorist or military action forgiveness also applies to an individual who is a U.S. employee at death and who dies from wounds or injury incurred while a U.S. employee in a terrorist or military action regardless of where the action occurred.



# **TAX BENEFITS FOR COMBAT ZONE PARTICIPANTS**

LESSON 3

**ANSWERS TO EXERCISES**

Exercise 1– **The 2001 tax return.** The deadline is 12 January 2003. The deadline is 280 days (180 plus 100) after Major West’s last day in the combat zone (7 April 2002). The 100 additional days are the number of days in the 3 1/2 month filing period that were left when he entered the combat zone (6 January - 15 April 2002).

Exercise 2– 2000-2003

**STUDENT NOTES**



### OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine whether an alien should file a resident, non-resident, or dual-status tax return.
2. Determine what sources of income an alien must report on his or her return.
3. Explain the special choice that permits a nonresident alien spouse of a U.S. citizen or resident to be treated as a resident alien and file a joint return.

### INTRODUCTION

Although the *Volunteer Assistor's Guide* discusses the filing status of a taxpayer, you will need more information to answer questions about aliens that members of the Armed Forces may ask. An alien may be classified in one of three categories: resident, nonresident, or dual-status. It is not always easy to determine the correct category. An alien's status, however, is crucial in determining what type of income he or she must report and what tax form to file. This is discussed in detail in Publication 519, *U.S. Tax Guide for Aliens*.

### NONRESIDENT ALIENS

A nonresident alien is an individual who is not a citizen or resident of the United States. A nonresident alien generally must pay tax only on income received from sources within the United States. If the income is connected with conducting a trade or business in the United States, the income (after allowable deductions) is taxed at regular U.S. tax rates. If other income from U.S. sources is not connected with conducting a trade or business in the United States, it is taxed at a flat 30% (or lower treaty) rate. For example, Survivor Benefit Plan payments made to a nonresident alien surviving spouse may be subject to a 30% withholding (or lower treaty) rate. In either case, the nonresident alien must file a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

## RESIDENT ALIENS

An alien may qualify as a U.S. resident for tax purposes by meeting either the *green card test* or the *substantial presence test* for the calendar year.

**Green card test.** An alien is a resident for tax purposes if he or she is a lawful permanent resident of the United States (holder of a green card) at any time during the calendar year. However, see the discussion on *Dual-Status Aliens*, later.

**Substantial presence test.** If the alien does not meet the green card test, the alien may still be a U.S. resident for tax purposes if the substantial presence test for the calendar year is met. To meet this test, the alien must have been physically present in the United States for at least 31 days during 2002 and for a **total** of at least 183 days in 2002, 2001, and 2000.

When you count the days for the substantial presence test, count:

1. All the days the alien was present in 2002,
2. One-third of the days present in 2001, and
3. One-sixth of the days present in 2000.

### Example

Ana Garcia was present in the United States for several years. She believes that she can qualify for the substantial presence test. Ana was here from December 1 through December 31 of 2002. She was present in the U.S. all of 2001. In 2000, she stayed in the United States from June 1 through December 31. Here's how to figure if Ana meets the substantial presence test:

<u>YEAR</u>	<u>MULTIPLY BY</u>	<u>DAYS PRESENT</u>	<u>TOTAL</u>
2002	1	31	= 31
2001	1/3	365	= 122
2000	1/6	214	= 36
			<hr/> 189

Since Ana was present in the United States at least 31 days in 2002 and at least 183 days during the current and last two years, she meets the test in 2002 to qualify as a resident of the U.S.

**Exceptions.** For purposes of counting days for the substantial presence test, there are exceptions for regular commuters from Canada or Mexico, persons in transit through the United States, persons who are unable to leave because of becoming ill while in the United States, diplomats, employees of international organizations, teachers, trainees, and students. Also, the substantial presence test does not apply if the alien was present in

the United States for fewer than 183 days during 2002 and establishes that he or she has a closer connection to a foreign country. Publication 519 has more details on these exceptions.

**First-year choice.** If the alien does not meet the green card test or the substantial presence test for 2001 or 2002, and did not choose to be treated as a resident for part of 2001, but will meet the substantial presence test for 2003, he or she can choose to be treated as a U.S. resident for part of 2002. To make this choice, he or she must have been:

1. Present in the U.S. for at least 31 consecutive days in 2002, and
2. Present in the U.S. for at least 75% of the days beginning with the first day of the 31-day period in (1) and ending with the last day of 2002.

The taxpayer should be referred to Publication 519 for complete details concerning this special first-year choice. This choice, once made, cannot be revoked without the consent of the Internal Revenue Service.

Resident aliens generally are taxed on their worldwide income, the same as U.S. citizens. Resident aliens use the same tax forms as U.S. citizens.

## ***DUAL-STATUS ALIENS***

An alien may be both a nonresident and resident alien during the same tax year. The most common dual-status tax years are the years of arrival and departure. Dual-status aliens are taxed on income from all sources for the part of the year they are resident aliens. They are taxed only on income from U.S. sources for the time they are nonresident aliens. They must file Form 1040 and mark it “Dual Status Return” if they are resident aliens on the last day of the tax year. If they are nonresident aliens at the end of the year, they must file Form 1040NR and mark it “Dual Status Return.” In either case, they must attach a separate statement to explain their income and compute the tax for the other part of their dual-status year. Dual-status aliens must either itemize their allowable deductions or claim zero deductions because they cannot use the standard deduction.

### Exercise 1

Sgt. Zapata is stationed in Korea and is married to a Korean citizen. Sgt. and Mrs. Zapata came to the United States for a 3-week visit and returned to his post of duty in Korea. Mrs. Zapata entered the United States on a non-immigrant visa.

- a. What is Mrs. Zapata's U.S. alien status?

Answer \_\_\_\_\_

- b. If the Zapatas moved to the United States in June 2002 and Mrs. Zapata got a green card, what would Mrs. Zapata's U.S. alien status be for 2002?

Answer \_\_\_\_\_

### Exercise 2

Karen is a British citizen and a U.S. resident alien (green card holder). She married Lt. Trimble, a U.S. citizen, who has a permanent residence in New York. The Trimbles moved to Germany in 2001 for a 2-year tour of duty. They plan to return to New York when his duty ends. Karen earned \$12,000 a year working for a German employer while they were stationed in Germany.

- a. If Lt. Trimble files a separate return, does Karen have to file a U.S. federal tax return?

Answer \_\_\_\_\_

- b. If the Trimbles were divorced in 2002 and Karen gave up her green card and moved to England, what would her U.S. alien status be for 2002?

Answer \_\_\_\_\_

## ***ALIEN MILITARY PERSONNEL***

As a general rule, most alien enlistees in the Armed Forces are resident aliens. This would almost certainly be true of an alien who has lived in the United States before enlistment. In peacetime, the enlistment requirements of the Armed Services state that no person may enlist unless that person is a citizen or has been lawfully admitted to the United States for permanent residence under the immigration laws. These two factors, voluntary enlistment and admittance for permanent residence, are usually enough to classify an alien enlistee as a resident alien. The United States has treaty agreements with certain nations that

allow a very limited number of their citizens to retain their nonresident alien status. Alien enlistees in this category should seek advice from their base legal officer. Other aliens who are present in the United States merely because of military assignment and who have a residence outside the United States are nonresident aliens.

## ***CHOICE TO TREAT NONRESIDENT SPOUSE AS A RESIDENT***

A nonresident alien spouse may choose to be treated as a resident alien if all the following conditions are met.

1. The nonresident alien spouse must be married to a U.S. citizen or resident alien at the end of the tax year.
2. Both spouses must choose to treat the alien spouse as a resident alien.
3. One of the spouses must be a U.S. citizen or resident alien on the last day of the tax year.

### **How to Make the Choice**

A statement signed by both spouses must be attached to their joint return for the first tax year for which the choice applies. The statement should contain:

1. A declaration that one spouse was a nonresident alien and the other spouse was a U.S. citizen or resident alien on the last day of their tax year and that the nonresident alien spouse chooses to be treated as a U.S. resident for the entire tax year, and
2. The name, address, and social security number of each spouse. If the nonresident alien spouse is not eligible to get a social security number, he or she should file Form W-7, *Application for IRS Individual Taxpayer Identification Number*.

**Caution.** Once the choice is made, the worldwide income of the nonresident alien spouse is subject to U.S. tax. If the nonresident alien spouse has substantial foreign income, there may be no advantage to making the choice.

### **Ending the Choice**

Once made, this choice applies to all later tax years unless one of the following situations occurs.

- **Revocation**—Either spouse may revoke the choice for any tax year if both the choice and the revocation are made by the due date for filing the tax return for that tax year.

- **Death**—The death of either spouse will end the choice. This ordinarily begins with the first year following the year in which the spouse died. If the spouse who survived is a U.S. citizen or resident and is entitled to the joint return rates as a surviving spouse, the choice will not end until the close of the last year for which these joint rates may be used.
- **Legal separation**—A legal separation under a decree of divorce or separate maintenance will end the choice beginning January 1 of the tax year in which the legal separation occurs.
- **Inadequate records**—The Internal Revenue Service can end the choice for any year that either spouse fails to keep adequate tax records, to provide adequate access to those records, or to supply other information reasonably necessary to determine the correct income tax liability.

If the choice is ended for any of these reasons, neither spouse can make a choice for any future tax year. For example, divorced individuals who previously made the choice and later remarry cannot make another choice.

### **Choice Not Made**

If the choice is not made:

1. The nonresident alien spouse cannot file a joint return.
2. The nonresident alien spouse is generally not eligible for certain credits, such as the earned income credit or the education credits.
3. The spouse who is a U.S. citizen or resident may claim an exemption for the nonresident alien spouse if the nonresident alien has no gross income for U.S. tax purposes and is not another taxpayer's dependent. Check the box on line 6b of Form 1040 or Form 1040A and write "NRA" to the right of the word "spouse."
4. The nonresident alien spouse does not have to file a federal income tax return if he or she had no U.S. source income. He or she does not have to report any income from sources outside the United States so long as he or she remains a nonresident alien.

Questions concerning alien status and the special choice can be complex. Further information can be found in Publication 519.



### Exercise 3

Stephen Rowan is a Navy officer who resides in New York and is on duty in Japan. He has \$30,000 in taxable income for the year. His wife, to whom he has been married for 3 years, is a Japanese citizen who has never visited the United States. She earned \$5,000 from employment in Japan during the year.

**a.** Is he required to file a U.S. income tax return?

Answer \_\_\_\_\_

**b.** Is Mrs. Rowan required to file a U.S. income tax return?

Answer \_\_\_\_\_

**c.** Can the Rowans file a joint return?

Answer \_\_\_\_\_

### ▶▶ SUMMING UP THIS LESSON ◀◀

Questions of alien status can be difficult. To find answers to their questions and to learn whether they qualify for the option to treat the nonresident spouse as a U.S. resident, military personnel should see Publication 519, visit their base legal office, or call the IRS at 1-800-829-1040.

1.
  - a. Nonresident alien
  - b. Dual-status alien
2.
  - a. Yes. She is a resident alien.
  - b. Dual-status alien
3.
  - a. Yes
  - b. No
  - c. Yes. They can make the choice, but they should figure their tax both ways to determine which option is best for them.

# FILING STATUS

## OBJECTIVES

At the end of this lesson, you will be able to apply special rules for the Head of Household status when the spouse was a non-resident alien.

## INTRODUCTION

Many areas of the tax return are directly tied to the filing status of the taxpayer. Therefore, it is extremely important to select the correct status and to apply the special rule if applicable.

## HEAD OF HOUSEHOLD (H OF H)

The rules can get a little more complex here and may cause errors. In general, in order to claim H of H status, the taxpayer must be unmarried or considered unmarried on the last day of the year and pay more than half the cost of keeping up a home, for over six months, that includes the taxpayer and a qualifying individual.

## SPECIAL RULES

1. For H of H purposes, “you are considered unmarried if your spouse was a nonresident alien at any time during the year, and you do not choose to treat your spouse as a resident alien” (Pub. 17). All of the other qualifications for H of H must also be met.

### Example

Raul is in the U.S. Army. His wife and children live in Japan. His brother, who goes to high school in the U.S., lives with Raul. Raul claims his brother as his dependent and maintains the home. Even though Raul is married, he can claim H of H status because of the special rule above. If Raul lived by himself, or shared living costs with friends, he would not benefit from this rule and would have to file as a married person (either as Married Filing Separate or Married Filing Joint).

**2. Parents** - The one exception to having a relative live with the taxpayer concerns the taxpayer's parents. "If your dependent parent does not live with you, you must pay more than half the cost of keeping up a home that was the main home for the entire year for your mother or father..." (Pub. 17). The rules do not specify that the house the parents live in be in the United States. We've seen many returns that claim the parents as dependents and also indicate that the parents live in Canada or Mexico, yet the filing status is SINGLE. If the unmarried taxpayer, as part of support, meets the maintenance of the house rules, and claims the parents(s) as a dependent, the filing status should be H of H.

**Example**

Manuel is a U.S. citizen. He is not married and is in the U.S. military. His mother and father live in Mexico and he claims them as a dependent on his tax return. He provides more than half of the support of their household. Even though he is not married and his parents do not live with him (or even live in the U.S.), he can file as Head of Household.

**Example**

Gustav is a U.S. citizen and is in the U.S. military. He is not married but he provides more than half of his mother's support. His mother is a citizen and resident of Germany. Gustav cannot claim his mother on his tax return because of the Citizenship test. Since Gustav cannot claim his mother as his dependent, he cannot file as Head of Household.

**▶▶ SUMMING UP THIS LESSON ◀◀**

- ▶ The taxpayer may be considered unmarried if the spouse was a nonresident alien at any time during the year and the taxpayer does not choose to treat the spouse as a resident alien.
- ▶ If the taxpayer's parent is claimed as a dependent, the taxpayer may qualify for Head of Household filing status.



# DEPENDENCY EXEMPTIONS

## OBJECTIVE

At the end of this lesson, you will be able to apply the support test and citizen or resident test to certain military situations.

## INTRODUCTION

The *Volunteer Assistor's Guide* explains the tests that must be met before a person can be claimed as a dependent. In this lesson, you will find more information about the support and citizen or resident tests to help you assist members of the Armed Forces.

To claim an exemption for a dependent, taxpayers must provide a valid taxpayer identification number for their dependent on their tax return. This is usually a social security number (SSN) issued by the Social Security Administration. If the dependent is not eligible to receive an SSN, taxpayers can apply for an Individual Taxpayer Identification Number (ITIN) by filing Form W-7.

If taxpayers do not provide a number or if they list an incorrect number, the IRS may deny the exemption and bill them for additional tax.

For 2002, the deduction for each personal or dependency exemption is increased to \$3,000.

### Students Age 24 or Older

A taxpayer cannot claim an exemption for his or her child who is a full-time student and has reached the age of 24 by the end of the calendar year, even if all other dependency tests are met, unless the student's gross income is less than \$3,000. If his or her income is \$3,000 or more, the student can claim his or her own exemption. Remember, a person who can be claimed as a dependent on another person's return (for example, a child eligible to be claimed on a parent's return) cannot claim his or her own personal exemption for that tax year. This is true even if the other person does not actually claim the dependency exemption.

## **SUPPORT TEST**

### **Armed Forces Member as a Dependent**

A person who has been in the Armed Forces for the entire year cannot be claimed as a dependent because the support test will not have been met. A person in the Armed Forces for only part of the year can be claimed as a dependent if all the dependency tests are met. Amounts received from the Armed Forces that are used for the person's support must be taken into account.

If a person is appointed to one of the Armed Forces academies and is at the academy all year, he or she cannot be a dependent. An appointee at the academy for only part of the year may qualify as a dependent if all the tests are met.

#### **Exercise 1**

Kathleen Shannon is 18 and single. Kathleen graduated from high school in June 2002 and entered the U.S. Air Force in September 2002. Kathleen provided \$3,400 (wages of \$2,400 and \$1,000 for other items provided by the Air Force) for her own support, and her parents provided \$3,600. Can Kathleen's parents claim a dependency exemption for her for 2002?

Answer \_\_\_\_\_

### **Armed Forces Member Claiming a Dependent**

If a member of the military has authorized a dependency allotment and the allotment is used to support dependents who did not live with him or her for reasons other than divorce or separation, the member can claim exemptions for all of them if all the dependency tests are met.

#### **Example**

Army Pvt. Gary Fairfield authorized a dependency allotment for his mother. She used the amount received to support herself and Gary's 10-year-old sister. Gary provided no other funds for their support. If the allotment provides more than half of their total support for the year and all other dependency tests are met, Gary can claim exemptions for both his mother and his sister, even though the allotment was authorized for his mother only.

## Exercise 2

Cpl. Jim Meigs authorized a dependency allotment for his son, John. The allotment (\$150 a month) was in effect for all of 2002. How much support should Cpl. Meigs consider he provided for John in 2002?

Answer \_\_\_\_\_

## ***CITIZEN OR RESIDENT TEST***

To meet the citizen or resident test, the taxpayer's dependent must be a U.S. citizen, a U.S. resident, or a resident of Canada or Mexico for some part of the calendar year in which the taxpayer's tax year begins.

## Exercise 3

The wife of Col. William Banks is a Greek citizen. Her sister, Athena, who is also a Greek citizen, lived in the Banks' home in Greece for the entire tax year. Col. Banks provided more than 50% of Athena's total support.

- a. Can Col. Banks claim his sister-in-law as a dependent?

Answer \_\_\_\_\_

- b. What would be your answer to (a) if Athena were a Canadian citizen living in the Banks' home in Greece for the entire year?

Answer \_\_\_\_\_

If one parent of a child born in a foreign country is a U.S. citizen and the other parent is a nonresident alien, the child may qualify as a U.S. citizen. The U.S. citizen parent must have lived in the United States or its possessions for at least 5 years before the child's birth. Two of those years must have been after the child reached age 14. Periods of honorable service in the Armed Forces of the United States are counted as periods of living in the United States. The parent who is a U.S. citizen may claim the child's dependency exemption if the child is a citizen, even though the child lives abroad with the nonresident alien parent. The other dependency tests must, of course, be met.

A U.S. citizen who has legally adopted a child who is not a U.S. citizen or resident can claim the child as a dependent if the other dependency tests are met and if, for the entire tax year:

1. The taxpayer's home is the child's main home, and
2. The child is a member of the taxpayer's household.

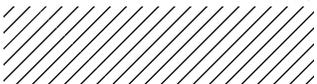
#### **Exercise 4**

Sgt. John Racine, a U.S. citizen who has been in the U.S. Army for 13 years, is stationed in Germany. His wife is a German citizen who has never lived in the United States. Their 2-year-old son was born in Germany. Sgt. Racine's stepdaughter, a German citizen whom Sgt. Racine has not adopted, also lives with them. The Racines provide total support for the two children. How many dependency exemptions can Sgt. Racine claim on a joint return?

Answer \_\_\_\_\_

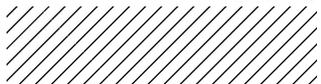
#### **▶▶ SUMMING UP THIS LESSON ◀◀**

In this lesson you have learned how the support and citizen or resident tests for the dependency exemption apply to some military situations.



1. Yes. The support test is met.
2. \$1,800.
3.
  - a. No. His sister-in-law was not a citizen or resident of the United States at any time during the year.
  - b. No. Athena would have to reside in Canada for at least some part of the year to qualify.
4. One. The stepdaughter does not qualify as a U.S. citizen or resident. The son qualifies because his father is a U.S. citizen.

**STUDENT NOTES**



# CLAIMING A FOREIGN DEPENDENT OR SPOUSE

## LESSON 7

### OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine if a taxpayer is entitled to claim a foreign spouse or dependent on his or her tax return.

### INTRODUCTION

This lesson discusses the special tax laws and filing procedures that must be followed in order to prepare and file federal income tax returns accurately for citizens or residents of the United States who have spouses and/or dependents in Canada or Mexico. The increasing amount of business with Canada and Mexico, and our growing Hispanic population, make it absolutely critical that volunteers know the tax and procedural issues involved in filing these returns.

### PERSONAL EXEMPTIONS

Generally, you are entitled to take one exemption for yourself and one exemption for your spouse, if you file a joint return. Your spouse is never considered your dependent. You may be able to take an exemption for your spouse, even if they do not live in the U.S.

If your spouse is a nonresident alien, he or she can choose to file a joint return with you (see Lesson 4 for more information). If the nonresident alien spouse makes this choice, they will be treated like a resident alien for tax purposes. This means that they will have to include all of their worldwide income on the joint U.S. tax return. Your spouse does **not** have to be from Canada or Mexico to make this choice.

#### Example 1

Pat Smith, a U.S. citizen, is married to Frank, a nonresident alien. Pat and Frank make the choice to treat Frank as a resident alien by attaching a statement to their joint return. Pat and Frank must report their worldwide income for the year they make the choice and for all later years unless the choice is ended or suspended. Although Pat and Frank must file a joint return for the year they make the choice, they can file either joint or separate returns for later years. If your nonresident alien spouse does not choose to be treated as a resident alien,

you may be able to claim an exemption for the spouse on your married filing separate return. Your nonresident spouse must not have any gross income for U.S. tax purposes and cannot be the dependent of another U.S. taxpayer. The spouse must have a Taxpayer Identification Number (explained later in this lesson).

## ***EXEMPTIONS FOR DEPENDENTS***

You can also claim exemptions for dependents that qualify under all of the dependency tests (see Lesson 6 for more information). The dependent must be a U.S. citizen or national or a resident of the United States, Canada or Mexico for some part of the calendar year.

Children are usually citizens or residents of the same country as their parents. If you were a U.S. citizen when your child was born, your child is generally a U.S. citizen. This is true even if the other parent is a nonresident alien, the child was born in a foreign country and the child lives abroad with the other parent.

If you are a U.S. citizen living abroad and you have adopted a child that is not a U.S. citizen or resident, you can claim an exemption for the child as a dependent if your home is the child's main home and the child is a member of your household for your entire tax year.

### **▶▶ SUMMING UP THIS LESSON ◀◀**

- ▶ In general, you can claim an exemption for your nonresident alien spouse if he or she chooses to file a joint return with you and be taxed as a resident alien.
- ▶ You can claim your nonresident alien spouse on your married filing separate return if your spouse has no income for U.S. tax purposes and is not the dependent of another U.S. taxpayer.
- ▶ You can claim nonresident dependents as long as they meet all five dependency tests.
- ▶ Every person you claim on your return must have a Taxpayer Identification Number.

# TAXPAYER IDENTIFICATION NUMBER AND OTHER ENTITY ISSUES

## LESSON 8

### OBJECTIVES

At the end of this lesson, you will be able to determine which taxpayers need an Individual Taxpayer Identification Number.

### INTRODUCTION

This lesson will discuss the Individual Taxpayer Identification and its use. It will also discuss other entity issues associated with federal income tax returns for those unable to obtain an SSN.

**NOTE:** As this publication went to print, a task force was studying various issues related to ITINs. The information provided in this publication was accurate at the time we went to print. For the most current information, visit our website [www.irs.gov](http://www.irs.gov).

### SOCIAL SECURITY NUMBERS

The Social Security Administration does not issue social security numbers to nonresident aliens unless they have legal permission to work in the United States. Social Security numbers will be issued to lawful permanent residents. Canadians have a number that is like a social security number, but it is for their old age pension. Do not use this number on a U.S. tax return. Canadians often have both a U.S. and Canadian Social Security Number.

### INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS

An Individual Taxpayer Identification Number (ITIN) is a tax processing number. The IRS issues an ITIN to individuals who are required to have a U.S. taxpayer identification number (TIN) but who do not have, and are not eligible to obtain an SSN. An ITIN is a 9-digit number, beginning with the number "9" and formatted like a SSN (XXX-XX-XXXX).

The ITIN is for tax purposes only. The issuance of an ITIN does not:

- Entitle the recipient to Social Security benefits or the Earned Income Tax Credit (EITC):
- Create an inference regarding the individual's immigration status:
- Give the individual the right to work in the U.S. Any individual who is legally eligible for employment in the U.S. must have an SSN.

### **Who Needs An ITIN**

If a taxpayer must file a U.S. tax return or is listed on a tax return as a spouse or dependent, and does not have and cannot obtain a valid SSN, the taxpayer must apply for an ITIN. IRS regulations require a valid TIN on all U.S. federal income tax returns. Each person listed on the return must have a valid TIN.

### **The Procedure for Acquiring an ITIN**

In general, to receive an ITIN the taxpayer files Form W-7 and supplies documentation that will establish foreign status and true identity. The W-7 and original documentation, or certified copies, must be presented to and validated by the IRS. Currently, this can be done in person at IRS taxpayer assistance centers or the papers can be submitted by mail to the Philadelphia Processing Campus. It takes about six weeks for the IRS to issue the numbers. (This process is currently under review. It is possible that all ITIN applications will have to be made in person in the future.)

## ***UNDOCUMENTED (ILLEGAL) ALIENS***

Undocumented aliens who meet the substantial presence test (explained in lesson 4) are considered resident aliens for tax purposes. They are not eligible for an SSN because they have no legal work authorization. These aliens should apply for an ITIN; however, the ITIN does not give them permission to work.

A common scenario is that the undocumented alien "acquires" (buys, trades etc.) an SSN to provide to their employer. The employer hires the alien and gives them a W-2 at the end of the year with the invalid SSN. The alien then files a tax return with their ITIN listed as their identification number. This causes a processing problem for the IRS. The refund will most likely be held until the issue can be resolved.

If the spouse of a U.S. citizen or resident is an illegal resident alien, he/she should have an ITIN. Again, this would not give the spouse permission to work.

## ***CHILDREN BORN ABROAD***

Military families living overseas who experience the birth of a child in a host nation hospital or “off base on the economy” should check with their base legal office or U.S. embassy officials for exact procedures for securing the Report of Birth Abroad. This document serves as proof of citizenship and can be used in the future. To formally register the birth of a child born abroad, the U.S. citizen parent or parents should bring the child to the Embassy/Consulate office along with:

- An original of the child’s birth certificate
- The parent’s marriage certificate
- Any divorce (original) decree or death certificate from any previous marriage
- Cash or bank check to pay the fee (usually \$65)

Parents should also apply for a passport for their child at the same time as the Report of Birth. Along with your application for Report of Birth and passport, it is also advisable to request the form to apply for an SSN for the child. The Social Security International Office in Baltimore, MD assigns an SSN. The SSN will be mailed directly to you. The process takes several months. But without an SSN the parents will NOT be able to claim the EITC even if all of the other prerequisites are met.

## ***OTHER ENTITY ISSUES***

When you are completing the entity section of the tax return, be careful to avoid some of the following common errors.

1. If you have selected the Married Filing Separate filing status, the spouse’s name should be listed on line 3 of the return. Do not list the spouse’s name in the first section of the return.
2. If you have selected the Head of Household filing status, be sure that the qualifying individual is listed on the return. This information will either appear on line 4 (if the qualifying person is the taxpayer’s child and not their dependent) or it will appear on line 6c, the area where you list dependents.
3. If you have selected the Married Filing Joint filing status, be sure that both spouse’s names and identification numbers appear at the top of the return. Also be sure that both spouses sign the return.

## ▶▶ **SUMMING UP THIS LESSON** ◀◀

- ▶ All taxpayers and dependents listed on a tax return must have an identification number.
- ▶ An Identification Number can be either a SSN or an ITIN.
- ▶ Use caution when completing the entity section of the tax return.

# FOREIGN TAX CREDIT

## INTRODUCTION

Generally, a U.S. citizen or resident alien is taxed on their world-wide income. This can lead to a situation where the taxpayer is paying tax twice on the same income – once to the foreign government and to the U.S. government. The **foreign tax credit** was created to help alleviate this situation. You do not have to live abroad to qualify for the credit.

## OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine which types of taxes qualify for the foreign tax credit.
2. Correctly complete a Form 1116.
3. List what types of income qualify for the credit.

## WHAT TYPES OF TAXES QUALIFY FOR THE CREDIT

The taxpayer must have income from a foreign country on which he or she is taxed by a foreign country. The tax imposed on the income must be similar to the income tax imposed in the U.S.

### Example 1

Robb and Betty Grant are U.S. citizens who are on TDY in France. They have \$500 of interest income from a U.S. bank. They also have \$600 of interest income from a French bank. They are required to pay taxes in France on the interest they earned there. On their U.S. tax return, they can compute a foreign tax credit against the taxes that they pay to the U.S. on the interest earned in France.

If the tax imposed by the foreign country is considered a payment for a specific economic benefit, it does not qualify for the credit. For example, real estate taxes paid to a foreign government do not qualify for the credit.

### Example 2

Marie Elliott is a U.S. citizen who lives in Hong Kong. She is the fiancée of one of the men in your unit. You are trying to help her with her returns. She owns a house in Hong Kong and paid \$2,000.00 in real estate taxes for her home and \$1,000.00

in personal property taxes. She also paid \$300.00 in income taxes to the government of Hong Kong. She is not able to claim the foreign tax credit on either the real estate taxes or personal property taxes paid. Income taxes are the only type of tax that qualifies for the foreign tax credit. You can use the \$300.00 of income tax to compute her foreign tax credit. (Note – If she itemizes, she can deduct the real estate taxes. The personal property tax would only be deductible if it is related to the production of income.)

**Country Restrictions.** There are also certain countries to which a taxpayer may pay foreign taxes but cannot claim a foreign tax credit. Generally, the reason a credit may not be claimed for tax paid to one of these countries is because the Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism. The credit can also be denied to countries with which the United States has no diplomatic relations or countries whose government the U.S. does not recognize. Income taxes paid to the following countries are not eligible for the foreign tax credit:

CUBA  
IRAN  
IRAQ  
LIBYA  
NORTH KOREA  
SYRIA  
SUDAN

**Example 3**

Ralph, an armed forces member, is a U.S. citizen who has investments in both Belgium and Iran. On these investments Ralph pays income tax in the foreign countries. Ralph can claim the taxes paid to Belgium in computing his foreign tax credit. The taxes paid to Iran do not qualify for the credit.

***WHAT TYPES OF INCOME QUALIFY FOR THE CREDIT?***

The tax paid on the following types of income can qualify for the foreign tax credit:

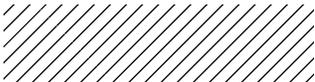
**Passive Income**

**High withholding tax interest**

Financial services income

Shipping income

Dividends from a DISC or former DISC



Certain distributions from a foreign sales corporation or former foreign sales corporation

Lump-sum distributions

Section 901(j) income

Certain income re-sourced by treaty

### **General limitation income**

A separate Form 1116, Foreign Tax Credit, must be completed for each category of income. The income items listed in bold type above are the most common. They are more fully explained below.

**Passive Income.** Passive income generally includes the following types of income: dividends, interest, royalties, rents and annuities. If you are assisting a taxpayer who has one (or more) of these types of passive income from a foreign country, and he or she paid taxes to a foreign country, you should compute the foreign tax credit. If the foreign tax paid on the passive income exceeds 38.6%, the passive income category is not used. The appropriate classification for this type of income is the **general limitation** category.

#### **Example 4**

Darlene, a U.S. army employee, has a bank account in Venezuela, where her mother lives. In 2002, she received \$3800 in interest income for the Venezuelan bank. She had to pay \$380 of income tax to the Venezuelan government. She is not filing a joint return. She will need to attach form 1116 to her U.S. income tax return. The “passive income” category should be marked.

**High Withholding Tax Interest.** Certain interest income is not included in the passive income category. If the taxpayer you are helping had interest income on which at least 5% foreign gross income tax was withheld, then this is classified as high withholding tax interest and not passive income.

#### **Example 5**

Regina has been a member of your unit for two years. She is single and a U.S. citizen. She maintains a bank account in Singapore where she used to live. In 2002, the foreign bank withheld 15% of her interest income for income taxes. This falls into the category of “high withholding tax interest” on form 1116, even though it is passive income.

**General Limitation Income.** The final income category on form 1116 is the “general limitation income” category. If the person you are helping has foreign income that does not come under any of the other categories on Form 1116, then that foreign income comes under the general limitation income cate-

gory. Most often, this would be wages earned in a foreign country that an individual does not exclude under the foreign earned income exclusion (Lesson 2).

If the person you are assisting has passive income which is taxed by a foreign government at a rate that is higher than the highest U.S. income tax rate, then the foreign tax credit for that income would be computed under the general limitation category.

**Example 6**

Siegfried has been your best friend since third grade. He is a U.S. citizen who now lives and works in Switzerland. He does not elect to take the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid on his earnings to the Swiss government. You tell him that he should mark the “general limitation income” category on his Form 1116.

## ***COMPLETING FORM 1116***

The rest of this lesson is dedicated to the mechanics of completing Form 1116, Foreign Tax Credit. You will see that some of the lines on the form are considered to be beyond the scope of the VITA/TCE program. The provided instructions assume that you are completing the form by hand. Many tax software packages (including TaxWise®) will assist you in determining how to complete the form.

You should also keep in mind that Form 1116 is not required if the total Foreign Tax Credit is less than \$300 per taxpayer and only qualified passive foreign sourced income is involved. When this exception applies, the taxpayer can claim the credit without attaching the form.



**Foreign Tax Credit**  
 (Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.  
 ▶ See separate instructions.

Name \_\_\_\_\_ Identifying number as shown on page 1 of your tax return \_\_\_\_\_

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- a  Passive income
- b  High withholding tax interest
- c  Financial services income
- d  Shipping income
- e  Dividends from a DISC or former DISC
- f  Certain distributions from a foreign sales corporation (FSC) or former FSC
- g  Lump-sum distributions
- h  Section 901(j) income
- i  Certain income re-sourced by treaty
- j  General limitation income

k Resident of (name of country) ▶ \_\_\_\_\_

**Note:** If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

**Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)**

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
<b>1</b> Enter the name of the foreign country or U.S. possession . . . . . ▶				
<b>1</b> Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):				<b>1</b>
<b>Deductions and losses (Caution: See pages 9, 12, and 13 of the instructions):</b>				
<b>2</b> Expenses <b>definitely related</b> to the income on line 1 (attach statement) . . . . .				
<b>3</b> Pro rata share of other deductions <b>not definitely related:</b>				
<b>a</b> Certain itemized deductions or standard deduction (see instructions) . . . . .				
<b>b</b> Other deductions (attach statement) . . . . .				
<b>c</b> Add lines 3a and 3b . . . . .				
<b>d</b> Gross foreign source income (see instructions)				
<b>e</b> Gross income from all sources (see instructions)				
<b>f</b> Divide line 3d by line 3e (see instructions) . . . . .				
<b>g</b> Multiply line 3c by line 3f . . . . .				
<b>4</b> Pro rata share of interest expense (see instructions):				
<b>a</b> Home mortgage interest (use worksheet on page 12 of the instructions) . . . . .				
<b>b</b> Other interest expense . . . . .				
<b>5</b> Losses from foreign sources . . . . .				
<b>6</b> Add lines 2, 3g, 4a, 4b, and 5 . . . . .				<b>6</b>
<b>7</b> Subtract line 6 from line 1. Enter the result here and on line 14, page 2 . . . . . ▶				<b>7</b>

**Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)**

Country	Credit is claimed for taxes (you must check one) (m) <input type="checkbox"/> Paid (n) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued							
		In foreign currency				In U.S. dollars			
		Taxes withheld at source on:			(s) Other foreign taxes paid or accrued	Taxes withheld at source on:			(w) Other foreign taxes paid or accrued
(o) Date paid or accrued	(p) Dividends	(q) Rents and royalties	(r) Interest		(t) Dividends	(u) Rents and royalties	(v) Interest		
<b>A</b>									
<b>B</b>									
<b>C</b>									
<b>8</b> Add lines A through C, column (x). Enter the total here and on line 9, page 2 . . . . . ▶									<b>8</b>

For Paperwork Reduction Act Notice, see page 16 of the instructions.

Cat. No. 11440U

Form **1116** (2002)

**Part III Figuring the Credit**

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I . . . . .	9		
10	Carryback or carryover (attach detailed computation) . . . . .	10		
11	Add lines 9 and 10 . . . . .	11		
12	Reduction in foreign taxes (see page 13 of the instructions) . . . . .	12		
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit . . . . .			13
14	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see page 14 of the instructions) . . . . .	14		
15	Adjustments to line 14 (see page 14 of the instructions) . . . . .	15		
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.) . . . . .	16		
17	<b>Individuals:</b> Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. <b>Estates and trusts:</b> Enter your taxable income without the deduction for your exemption . . . . . <i>Caution: If you figured your tax using the special rates on capital gains, see page 15 of the instructions.</i>	17		
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1" . . . . .			18
19	<b>Individuals:</b> Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. <b>Estates and trusts:</b> Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37 . . . . .			19
20	Multiply line 19 by line 18 (maximum amount of credit) . . . . .			20
21	Enter the <b>smaller</b> of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) . . . . . ▶			21

**Part IV Summary of Credits From Separate Parts III** (see page 16 of the instructions)

22	Credit for taxes on passive income . . . . .	22		
23	Credit for taxes on high withholding tax interest . . . . .	23		
24	Credit for taxes on financial services income . . . . .	24		
25	Credit for taxes on shipping income . . . . .	25		
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC . . . . .	26		
27	Credit for taxes on lump-sum distributions . . . . .	27		
28	Credit for taxes on certain income re-sourced by treaty . . . . .	28		
29	Credit for taxes on general limitation income . . . . .	29		
30	Add lines 22 through 29 . . . . .			30
31	Enter the <b>smaller</b> of line 19 or line 30 . . . . .			31
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 13 . . . . .			32
33	Subtract line 32 from line 31. This is your <b>foreign tax credit</b> . Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a . . . . . ▶			33



## Part 1 – Taxable Income

This part of the form is used to figure the taxable income from foreign sources in each country. You will note that there is room for up to 3 countries to be listed. If the taxpayer paid foreign taxes to more than 3 countries, an additional Form 1116 will be needed. Also, remember that only one type of foreign income can be reported on each Form 1116.

On the first line in Part 1, list the name of the foreign country. On line 1, enter all of the foreign income that fits under the category checked at the top of the form. Be sure to list that income separately for each country. Total the three columns and put the figure on line 1 in the “Total” column (on the far right of the form).

**Lines 2-5 in Part 1** are more challenging. Therefore, several of the lines or situations are considered to be outside of the scope of the VITA/TCE program. We will not cover the following items:

**Line 2 – Expenses directly related to the income on Line 1.** If the person you assisting has expenses that are related directly to the income on line 1, such as employee business expenses, and the income claimed on line 1 was earned income, you should tell the taxpayer to seek professional tax assistance.

**Line 4 – Interest Expense.** If the taxpayer borrowed money in order to purchase investment property, such as stock, then some allocations may need to be done. You should tell the taxpayer to seek professional tax assistance. Other interest expense that is related to the foreign sourced income will require allocations. Again, the taxpayer should seek professional tax assistance.

**Line 5 – Foreign Losses.** If the person you are helping had any type of foreign losses, such as net losses from selling capital assets, they should seek professional tax assistance.

**Line 3.** You will complete line 3a if you completed a Schedule A (Itemized Deductions) for the person you are assisting. The total of the itemized deductions (except for qualified residence and personal interest) not directly related to foreign income from line 26 of Schedule A is entered on line 3a. If the taxpayer does not itemize, the standard deduction should be entered on line 3a.

Line 3b is considered to be outside of the scope of the VITA/TCE program. Taxpayers who need to make entries on this line should seek professional tax assistance. Therefore, for returns that you are preparing, line 3c should be the same as line 3a.

All income from foreign sources in the category checked at the top of Form 1116 is listed on line 3d. If the foreign earned income exclusion was claimed and the Form 1116 is for the general limitation category, then the amount of the claimed exclusion is entered here as well. Under most circumstances, line 3d will be the same as line 1.

Line 3e is gross income from all sources. Usually, this line will be the same as line 22 of the Form 1040. If the foreign income exclusion was claimed, then the amount of the exclusion must be added on this line.

Lines 3f and 3g are mathematical. If you are not using tax software to prepare the return, be sure to check your math on these lines.

Line 6 will be the same as line 3g on the returns you prepare. (Remember that the VITA/TCE programs do not cover lines 2, 4 and 5.)

On line 7, subtract line 6 from 1. Put the answer in the "Total" column on line 7. Also put the amount on line 14 of Form 1116.

## **Part II – Foreign Taxes Paid or Accrued.**

Part II of form 1116 covers the computation of foreign taxes paid or accrued on the foreign income. Even though most taxpayers are considered to be on the cash basis, they can choose to calculate the foreign tax credit using the accrual basis.

Many foreign countries have a different tax system from the U.S. In some cases, the individual simply reports his or her taxable income and the government involved computes the tax and bills the taxpayer. In other instances, taxpayers may make in one year for income made in the previous year. ( In these instances, a cash basis taxpayer may wish to use the accrual basis for calculating the foreign tax credit.)

On Part II of the Form 1116, you must indicate if the credit is being claimed for foreign taxes actually paid in 2002 or if it is being claimed on foreign taxes accrued in 2002. Part II also has two separate sections in which you indicate the amounts withheld, paid or accrued in the foreign currency and then convert these amounts to U.S. dollars.

One of the questions that frequently arises is what currency exchange rate should be used. If you are using the cash basis, then the exchange rate that is the most accurate for the date of the payment should be used. If the taxpayer you are assisting had foreign taxes withheld throughout the year, then you can use the annual average exchange rate. Exchange rates can usually be obtained from major international banks and international currency exchanges. If the taxpayer you are assisting is

using the accrual method to calculate the foreign taxes paid, you must generally use the average exchange rate for the tax year.

Total foreign taxes paid or accrued should be listed in column x. The total of all three lines in column x should be entered on line 8. This completes page 1 of Form 1116.

### Part III – Figuring the Credit

Part III of the form 1116 is the actual computation of the Foreign Tax Credit. Below are line-by-line instructions for this part of the form.

**Line 9.** This is the same as line 8.

**Line 10.** This is beyond the scope of the VITA/TCE program. If the taxpayer you are assisting has a carry back or carryover of unused foreign tax credit, they should seek professional tax assistance.

**Line 11.** This is a total of lines 9 and 10. Since you will not be completing line 10, line 11 should be the same as line 9.

**Line 12.** A reduction to the foreign taxes paid or accrued has to be made under certain circumstances. One of the most common situations is the reduction for taxes allocable to income excluded under the foreign earned income exclusion. Use the following formula to determine the amount to enter on line 12.

$$\frac{\text{Excluded Foreign Earned Income}}{\text{Total Foreign Income}} \times \text{Foreign Tax} = \text{Reduction}$$

Any other type of reduction that may need to be entered on line 12 is beyond the scope of the VITA/TCE program.

**Line 13.** This is a mathematical computation. The answer represents the amount of foreign taxes which is still eligible for the credit computation.

**Line 14.** If you have not already entered the amount from line 7 in Part I of the form, do so now.

**Line 15.** This line is considered to be beyond the scope of the VITA/TCE program. Taxpayers who feel that they need to enter an amount on line 15 should seek professional tax assistance.

**Line 16.** For the returns that you prepare, this will be the same as line 14 (which is the same as line 7).

**Line 17.** Enter the amount from line 37 of Form 1040.

**Line 18.** This is a mathematical line. Carry your answer to four decimal points. If line 16 is larger than line 17, then enter the whole number 1 on this line.

**Line 19.** Enter the amount from line 40 of the U.S. Form 1040 less any amounts on Line 41 and 42 of Form 1040.

**Line 20.** Again, this is a mathematical line.

**Line 21.** Compare the amounts on lines 13 and 20. Enter the smaller of the two amounts on line 21.

If you only have to complete one form 1116 for the taxpayer, enter the amount from line 21 on lines 29 as well as 31.

### **Part IV – More than one Form 1116**

Part IV of the Form 1116 is used as a summary of the foreign tax credit. You will need to complete this section if you complete more than one form 1116 for the taxpayer. You complete Part IV on only one of the multiple forms 1116 that you are attaching to the return. It does not matter which of the forms 1116 you use. You would indicate in Part IV of the summary Form 1116 the amount of the credit computed on line 21 of Part iii from each Form 1116. Line 30 is a total of all Forms 1116. Since line 32 is beyond the scope of the VITA/TCE program, enter the amount from line 30 on line 32.

## ***ITEMIZED DEDUCTION VS. CREDIT***

The taxpayer may choose to claim the amount of foreign taxes paid as an itemized deduction rather than a tax credit. The taxpayer cannot claim both an itemized deduction and tax credit on the same foreign tax. Taxpayers who receive a deduction on their state returns for federal itemized deductions may consider claiming their foreign tax as an itemized deduction rather than a credit. However, in most cases, the credit will provide a better benefit on the federal return.



## ▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ In order to qualify for a foreign tax credit, income on which the taxes are paid must be foreign source.
- ▶ The tax being paid must be similar to U.S. income tax.
- ▶ The individual paying the tax cannot derive a specific economic benefit from the tax paid.
- ▶ The foreign tax credit is computed on Form 1116.
- ▶ Form 1116 is not required if the foreign tax credit is less than \$300 per taxpayer and all of the income is from passive sources.
- ▶ A separate Form 1116 must be completed for each type of income. Only one income category can be marked on each form 1116.
- ▶ If passive income is subject to tax at a rate that is higher than 38.6%, then it falls into the general limitation category.
- ▶ A cash basis taxpayer may calculate the credit based on the actual foreign taxes paid or accrued.
- ▶ If there is more than one Form 1116 for the same person, Part IV only needs to be completed on one of the forms.
- ▶ For additional information and examples, refer to publication 514, Foreign Tax Credit for Individuals.

**STUDENT NOTES**



# EARNED INCOME CREDIT

## OBJECTIVE

At the end of this lesson you will be able to determine a person's eligibility for the earned income credit.

## INTRODUCTION

The *Volunteer Assistor's Guide* gives the basic requirements of the earned income credit. In this lesson you will see how the earned income credit affects members of the military. In particular, you will learn how military members who are stationed outside the United States may qualify for the earned income credit. The credit amount has increased and is available to taxpayers who have both earned income and adjusted gross income (AGI) less than \$29,201 (\$30,201 if married filing jointly) if they have one qualifying child or \$33,178 (\$34,178 if married filing jointly) if they have two or more qualifying children. The credit is also extended to some taxpayers who earn under \$11,060 (\$12,060 if married filing jointly) and do not have a qualifying child.

## CAUTION

Any taxpayer who fraudulently claims the EIC is ineligible to claim the credit for a period of 10 years. In addition, a taxpayer who erroneously claims the EIC by a reckless or intentional disregard of rules or regulations is ineligible to claim the credit for two years. These sanctions are in addition to any other penalty imposed by law.

If the earned income credit was disallowed as a result of deficiency procedures, taxpayers cannot claim the credit again unless Form 8862, *Information To Claim Earned Income Credit After Disallowance*, is attached to the return; if the credit is claimed without attaching Form 8862, it will be automatically denied.

A deficiency procedure occurs when the IRS questions the taxpayer's eligibility for the earned income credit for reasons other than a mathematical or clerical error. If the credit was disallowed because of a mathematical or clerical error, Form 8862 should not be completed. For more information on deficiency procedures, see Publication 596, *Earned Income Credit*.

## EARNED INCOME CREDIT

The earned income credit is a refundable tax credit for certain workers. A refundable credit can be greater than the tax on the taxpayer's income. If the credit is greater than the tax, the taxpayer will receive a refund of the excess credit amount.

For a detailed discussion of the rules and an explanation of the earned income credit, see Publication 596.

### Eligibility

In order to take the credit, taxpayers must meet **all** of the following rules:

1. They must have taxable earned income during the year.
2. Their earned income and AGI must both be less than \$29,201 (\$30,201 if married filing jointly) if they have one qualifying child, \$33,178 (\$34,178 if married filing jointly) if they have two or more qualifying children, or \$11,060 (\$12,060 if married filing jointly) if they have no qualifying children. Eligible taxpayers without a qualifying child must be at least age 25 and under age 65 at the end of the tax year and cannot be eligible to be a dependent on another person's return.
3. A qualifying child must live with them in the United States for more than half the year. Eligible taxpayers without a qualifying child must have their main home in the U.S. for more than half the year. See *Residency Test*, later, for an exception for taxpayers stationed overseas on extended active duty.
4. They must provide a social security number (SSN) issued by the Social Security Administration for themselves, their spouse (if married), and each qualifying child. The taxpayers cannot use an SSN if it was issued solely to apply for or receive federally funded benefits or if "Not valid for employment" is on the card. Additionally, the child cannot have an ITIN (Individual Taxpayer Identification Number) or ATIN (Taxpayer Identification Number for Pending Adoptions).

**Note:** If the taxpayers do not provide correct and valid SSNs, the IRS may deny the credit and bill them for additional tax, penalties, and interest.

5. Their filing status can be any filing status EXCEPT married filing a separate return. Most married taxpayers must file a joint return to get the credit. However, see *Married taxpayers living apart*, later, for an exception to the joint return rule.
6. They cannot be a qualifying child of another person.

7. They usually must claim as a dependent a qualifying child who is married.
8. They did not file Form 2555, *Foreign Earned Income*, or Form 2555-EZ, *Foreign Earned Income Exclusion*, to exclude from gross income any income earned in foreign countries, or deduct or exclude a foreign housing amount. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, for more information.
9. They must be a U.S. citizen or resident. Nonresident aliens may qualify for the credit only if they are married to a U.S. citizen or resident and agree to be treated as U.S. residents. If the nonresident alien spouse filed a joint return using an ITIN, the couple is not eligible for the credit. See *Choice to Treat Nonresident Spouse as a Resident* in Lesson 4.
10. They cannot have more than \$2,550 in investment income during the year. For most people, investment income is taxable interest and dividends, tax-exempt interest, and capital gain net income.

Use the eligibility questions to determine if the taxpayer can claim the earned income credit. The questions are found in the forms instructions (line 8, Form 1040EZ, line 41, Form 1040A, and line 64, Form 1040). After answering the questions, complete the *Earned Income Credit (EIC) Worksheet*. Completion of the EIC Worksheet is dependent upon completion of the eligibility questions. Do not attach either the eligibility questions or the EIC Worksheet to the return.

**Married taxpayers living apart.** Married taxpayers usually must file a joint return to claim the earned income credit. Even though a taxpayer is married, he or she can file as head of household if:

1. The taxpayer's spouse did not live in the taxpayer's home at any time during the last 6 months of the year,
2. The taxpayer paid more than half the cost to keep up the home for the entire year, and
3. The child and the taxpayer lived in the same main home for more than half the year and the child is the taxpayer's dependent. If the taxpayer cannot claim the qualifying child as a dependent because he or she signed an agreement giving the exemption to the other parent or if a pre-1985 agreement grants the exception to the other parent, the taxpayer will still meet the requirements for the EIC.

## QUALIFYING CHILD

Taxpayers have a qualifying child if the child meets three tests:

- Relationship,
- Residency, and
- Age.

### Relationship test

To meet the relationship test, the qualifying child must be one of the following:

1. Son, daughter, adopted child, stepson, stepdaughter or a descendant of the taxpayer's son, daughter, adopted child, stepson, or stepdaughter.
2. Brother, sister, stepbrother, stepsister or a descendant of the taxpayer's brother, sister, stepbrother, or stepsister, who the taxpayer cares for as his or her own child.
3. Eligible foster child.

An **eligible foster child** is any individual that is not described in number 1 or 2, above who has been placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child.

A married child must also be the taxpayer's dependent. However, if the taxpayer cannot claim the married qualifying child as a dependent because he or she signed an agreement giving the exemption to the other parent or if a pre-1985 agreement grants the exemption to the other parent, the married child will be considered to have met the relationship test.

### Residency test

To meet the residency test, the qualifying child must live in the same home with the taxpayer in the United States for more than half the year.

**Exception:** For determining whether a qualifying child meets the residency test, during any time a taxpayer is stationed outside the U.S. on extended active duty (more than 90 days or indefinitely), the taxpayer is considered to be maintaining a residence in the U.S.

**Birth or death of a child.** Taxpayers will meet the rule for a child living with them for more than half the year if:

- The child was born or died during the tax year, and
- The child lived with the taxpayer for the entire time the child was alive.

**Temporary absences.** The taxpayer will meet the residency test if the taxpayer or the qualifying child is away from home on a temporary absence due to a special circumstance.

Examples of a temporary absence include:

- Illness,
- Attending school,
- Detention in a juvenile facility,
- Business,
- Vacation, or
- Military service.

**Note:** The taxpayer may be eligible for the earned income credit if absent temporarily only because of military service. To be eligible for the credit, the taxpayer must plan to return to the home where the taxpayer's qualifying child lives at the end of the assignment. Service in a combat zone is a temporary absence.

### Exercise

Cpl. Graves is stationed in Japan. After his tour of duty, he intends to return to the United States where his wife and 6-month-old daughter (qualifying child) live. The Graves will file a joint return. Does he meet the residency test?

Answer \_\_\_\_\_

**Age test.** The age test is met if the taxpayer's child is:

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

### Qualifying child of more than one taxpayer

Beginning with tax year 2002, if a child is a qualifying child of more than one taxpayer, the taxpayers may choose which of them will claim the credit on the basis of that child. Review Publication 678, Lesson 10, for additional information.

## **EARNED INCOME**

**Earned income** for purposes of the earned income credit is defined as wages, salaries, tips, and other employee compensation (but only if includible in gross income for the tax year), plus net earnings from self-employment. (Employee compensation that is not currently taxable is not considered earned income for purposes of figuring the earned income credit.)

Earned income includes:

- Wages, salaries, tips,
- Taxable long-term disability benefits the taxpayer receives prior to minimum retirement age,
- Taxable pay for service in a combat zone, and
- Net Earnings from self-employed.

Earned income does not include:

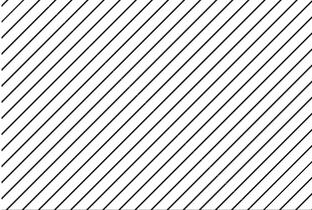
- Interest and dividends,
- Social security benefits,
- Pensions or annuities,
- Veterans' benefits,
- Workers' compensation benefits,
- Alimony,
- Child support,
- Nontaxable foster care payments,
- Unemployment compensation,
- Variable housing allowance,
- Salary deferrals,
- Quarters and subsistence allowances and in-kind quarters and subsistence received by military members,
- Excludable pay for service in a combat zone,
- Workfare payments from state or local welfare agencies.

**Note:** Workfare payments are cash payments low-income taxpayers receive from a state or local agency that administers public assistance programs funded under the Federal Temporary Assistance for Needy Families (TANF) program. These payments are for:

- Work experience activities (including remodeling or repairing public housing) if sufficient private sector employment is not available, or
- Community service program activities.

## ***ADVANCE EARNED INCOME CREDIT***

If taxpayers expect to qualify for the earned income credit for 2003, they can choose to receive part of the credit regularly in their pay. They should fill out the 2003 Form W-5, *Earned Income Credit Advance Payment Certificate*, and give it to their appropriate finance office. Only persons eligible for the credit who have a qualifying child can receive advance payments.



# ***EARNED INCOME CREDIT***

## **LESSON 10**

### ***ANSWER TO EXERCISE***

Yes. He is temporarily absent because of military service.

#### **▶▶ SUMMING UP THIS LESSON ◀◀**

In this lesson, you have learned how the earned income credit rules apply to some military situations. This refundable credit, which can be greater than the tax, is claimed on Form 1040EZ, Form 1040A or Form 1040.

### OBJECTIVE

At the end of this lesson you will be able to determine if a taxpayer who sells a main home qualifies to exclude all or part of any gain from his or her income.

### INTRODUCTION

This lesson generally discusses tax rules that apply when a taxpayer sells his or her main home in 2002. For more detailed discussion get Publication 523, *Selling Your Home*.

**Gain.** If the sale of a main home results in a gain, the taxpayer should follow the rules discussed below. See also, Publication 523 and Lesson 13 of the Volunteer Assistor's Guide. ***The taxpayer cannot deduct a loss from the sale of a main home.***

**Form 1099-S.** If the taxpayer receives a Form 1099-S, *Proceeds From Real Estate Transactions*, the date of sale is shown in box 1. If a form was not received, the date of sale is the earlier of (a) the date title transferred or (b) the date the economic burdens and benefits of ownership shifted to the buyer. In most cases, these dates are the same. Form 1099-S, box 2, shows the gross proceeds the taxpayer received on the sale.

If a taxpayer sold or exchanged a main home in 2002, he or she may qualify to exclude all or part of any gain from his or her income. The qualified homeowner will not have to pay tax on the gain up to the limit described next, under *Amount of Exclusion*. To qualify for this exclusion, the ownership and use tests, described later, must be met.

**Amount of Exclusion.** A single homeowner can generally exclude up to \$250,000 of gain from the sale of his or her main home. A married couple can exclude up to \$500,000 if they meet all the following conditions.

- a. A joint return is filed for the married couple for the year.
- b. Either spouse or both meet the ownership test.
- c. Both individuals meet the use test.
- d. Neither spouse excluded gain from the sale of another home in the 2 years before the current sale of home.

For married individuals filing jointly who do not qualify for the \$500,000 exclusion of gain on the sale of a home because they do not satisfy the two-year ownership test, two-year use test, and the prohibition on any other sale or exchange of a residence within the last two years, the limit on the amount of excludable gain should be calculated separately for each spouse. In that case, the maximum exclusion for the couple is equal to the sum of the exclusions to which the spouses would otherwise be entitled if they had not been married.

**Ownership and Use Tests.** The exclusion is allowed each time a taxpayer sells or exchanges his or her principal residence, but generally no more frequently than once every two years. To be eligible, the property must have been:

## ***OWNERSHIP TEST***

1. **Owned** and used as the taxpayer's main home for a combined period of at least 2 years out of a 5-year period ending on the date of the sale or exchange.

## ***USE TEST***

2. **Lived in** as a main home for at least 2 years of that 5-year period.

**Period of ownership and use.** The required 2 years of ownership and use (during the 5-year period ending on the date of the sale) do not have to be continuous. Taxpayers can meet the tests if they can show that they owned and lived in the property as their main home for either 24 full months or 730 days (365 x 2) during the 5-year period. Short temporary absences for vacations or other seasonal absences (even if the property is rented out during the absences) are counted as periods of use.

If the property was owned and used as a main home for less than 2 years, a reduced exclusion can be claimed. If this situation applies to a taxpayer, get Publication 523, which has a worksheet that allows a homeowner to figure how to claim the reduced exclusion.

### **▶▶ SUMMING UP THIS LESSON ◀◀**

In this lesson you have learned the general rules that apply to homeowners that sell or exchange their main home in 2002. There are no special provisions for members of the Armed Forces. For more information, see Publication 523.

# MOVING EXPENSES

## OBJECTIVES

At the end of this lesson you will be able to:

1. Identify qualifying moves.
2. Determine when allowances and reimbursements must be included in income.
3. Identify deductible moving expenses.
4. Compute the moving expense deduction using Form 3903, *Moving Expenses*, for moves within or outside the United States.

## INTRODUCTION

This lesson covers the moving expenses of military personnel. When a member of the Armed Forces is transferred to a new permanent duty station, he or she may deduct certain moving expenses.

Military personnel who have moved will need to determine whether:

1. The move qualifies as a permanent change of station (PCS).
2. Moving expenses exceed allowances or reimbursements.
3. Allowances or reimbursements exceed moving expenses.

## PERMANENT CHANGE OF STATION

For military moves, only expenses incurred as a result of a permanent change of station are deductible. A permanent change of station includes:

- A move from home to the area of the first post of active duty.
- A move from one permanent post of duty to another.
- A move from the last post of duty to home or to a nearer point in the United States. The member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

**Spouse and dependents.** If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependents includes a move to the place of enlistment, the home of record, or any nearer point in the United States.

If the Armed Forces moves a member and his or her spouse or dependents to or from separate locations, the moves are treated as a single move to the member's post of duty. The qualified expenses of both moves are combined and deducted on the same tax return.

### **Exercise 1**

Which of the following is a permanent change of station?

- A.** A move by an Air Force pilot to an airbase for a 6-month detail.
- B.** A move by an Army sergeant to his home 2 years after he ended active duty.
- C.** A move by a new enlistee from her home to her first post of duty.

Answer \_\_\_\_\_

## **REQUIREMENTS**

The moving expense deduction includes only expenses that are reasonable for the circumstances of the move. For example, the costs of any side trips for sightseeing are not deductible. The cost of lavish and extravagant lodging also is not deductible.

Although civilians must meet a distance test and a time test to deduct moving expenses, members of the military can disregard such tests for moves required by a permanent change of station.

## **PAYMENTS IN KIND, ALLOWANCES, AND REIMBURSEMENTS**

The service member must include in gross income any payments he or she receives from the government for a do-it-yourself (DITY) permanent change of station (PCS) move. A DITY move payment is based on government estimates of the cost to move household goods, not on actual expenses and receipts. The service member will receive a separate Form W-2 for the DITY payment. The amount in box 1 of the Form W-2 must be included on line 7 of Form 1040. He or she must also complete Form 3903 to compute total qualified moving expenses that can be deducted on line 28, Form 1040. These line 7 and line 28 entries on Form 1040 will report the income and applicable related expenses for the move on the Form 1040.

The service member does not include any of the following in his or her gross income.

- Moving or storage services furnished to the member

- Non-taxable allowances such as:
  - Dislocation allowance
  - Temporary Lodging Allowance
  - Mileage Allowance in Lieu of Transportation
  - Per Diem Allowance

Generally, if total reimbursements or allowances received by the service member are more than his or her qualified moving expenses, the excess will be included with his or her wages in box 1 of Form W-2. However, if reimbursements or allowances (other than nontaxable allowances like the ones listed above) exceed the cost of moving and they are not included in the Form W-2, the service member must still include the excess on line 7 of Form 1040.

Use Form 3903 to deduct qualified expenses that exceed reimbursements and allowances (including nontaxable allowances like the ones listed above).

### Exercise 2

- A.** A member of the Armed Forces must include in gross income all reimbursements, allowances, and the value of moving and storage services that the military organization furnishes. True or false?

Answer \_\_\_\_\_

- B.** If a member of the Armed Forces receives reimbursements or allowances (that are not excludable from gross income) in excess of the actual moving expenses, he or she must include in income only the amount that exceeds actual expenses. True or false?

Answer \_\_\_\_\_

## ***DEDUCTIBLE MOVING EXPENSES***

Any qualifying moving expenses that exceed allowances or reimbursements from the government are deductible.

Members of the military will need to determine whether they have excess expenses and, if so, whether the expenses are deductible on their federal tax return.

Qualifying moving expenses are:

- **The cost of moving household goods and personal effects**, including hauling a trailer and packing, storage, and insurance. It does not include the expense of moving furniture or other goods that the taxpayer bought on the way from the old home to the new home.

- **The cost of reasonable travel and lodging expenses** from the old home to the new home, including actual automobile expenses (or 13 cents per mile), airfare, and lodging for the taxpayer and members of his or her household. Members cannot deduct the cost of meals while traveling from the old home to the new home.

**Foreign moves.** A foreign move is one from the United States or its possessions to a foreign country or from one foreign country to another. It is not a move from a foreign country to the United States or its possessions.

### Exercise 3

Which of the following are deductible moving expenses for Major Boone? (Assume the member received no reimbursements from the government.)

- A. Payment to Fulton Construction Company for home improvements made to Major Boone's former home.
- B. Security deposit to Towner Apartments on the Boones new apartment.
- C. Commission to Mercer Real Estate for the sale of the Boones' former home.
- D. Payment to Shelby Transport Company to ship a piano that the Boones bought on the way to their new home.
- E. Cost of transporting Major Boone's second car to the new job location.
- F. Payment for meals while on the way to the new permanent duty station.

Answer \_\_\_\_\_

## REPORTING MOVING EXPENSES

Moving expenses are deductible as an adjustment to income on Form 1040, line 28. Only deductible expenses that are more than reimbursements and allowances can be claimed.

If the service member was not reimbursed, he or she can deduct allowable moving expenses either in the year incurred and paid or in the year they were paid.

If the member was reimbursed for expenses, he or she can deduct allowable expenses either in the year incurred or in the year paid.



**Note:** The \$5,000 expense for transporting her household goods was not included because the Armed Forces paid for this service.

The travel and lodging expenses for moving from the old home to the new home are shown on line 2 of Form 3903.

Reimbursements are shown on line 4.

To figure the moving expense deduction on Form 3903, subtract the total reimbursements on line 4 from the amount on line 3. Check the "Yes" box and enter the result on line 5 and on Form 1040, line 28.

### Exercise 4

Greg T. (SSN 000-00-4567) and Diane E. Carr are filing a joint return. Greg T. Carr, an airman in the Air Force, was transferred from Maxwell Air Force Base to Scott Air Force Base. The government reimbursed Greg \$400 for travel expenses incurred on the way to his new job location. He also received a \$1,000 dislocation allowance. The travel and lodging reimbursements and the dislocation allowance were not reported as wages on Form W-2. Using the following information furnished by the Carrs, complete Form 3903.

Dislocation expenses:	\$1,000
Travel and lodging en route:	\$ 575
Meals en route:	\$ 200
Security deposit for new apartment:	\$ 350

Form 3903

<p>Form <b>3903</b> (Rev. October 2002) Department of the Treasury Internal Revenue Service</p>	<p><b>Moving Expenses</b></p> <p>► Attach to Form 1040.</p>	<p>OMB No. 1545-0062</p> <p>Attachment Sequence No. <b>62</b></p>															
Name(s) shown on Form 1040		Your social security number															
<p><b>Before you begin:</b> ✓ See the <b>Distance Test</b> and <b>Time Test</b> in the instructions to find out if you can deduct your moving expenses.</p> <p>✓ If you are a member of the armed forces, see the instructions to find out how to complete this form.</p>																	
<p><b>1</b> Enter the amount you paid for transportation and storage of household goods and personal effects (see instructions) . . . . .</p> <p><b>2</b> Enter the amount you paid for travel and lodging expenses in moving from your old home to your new home. <b>Do not</b> include the cost of meals (see instructions) . . . . .</p> <p><b>3</b> Add lines 1 and 2 . . . . .</p> <p><b>4</b> Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is <b>not</b> included in the wages box (box 1) of your W-2 form. This amount should be identified with code <b>P</b> in box 12 of your W-2 form . . . . .</p> <p><b>5</b> Is line 3 <b>more than</b> line 4?</p> <p><input type="checkbox"/> <b>No.</b> You <b>cannot</b> deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on the "Wages, salaries, tips, etc." line of Form 1040.</p> <p><input type="checkbox"/> <b>Yes.</b> Subtract line 4 from line 3. Enter the result here and on the "Moving expenses" line of Form 1040. This is your <b>moving expense deduction</b> . . . . .</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="text-align: center;">1</td><td style="width: 50px;"></td><td style="width: 50px;"></td></tr> <tr><td style="text-align: center;">2</td><td></td><td></td></tr> <tr><td style="text-align: center;">3</td><td></td><td></td></tr> <tr><td style="text-align: center;">4</td><td></td><td></td></tr> <tr><td style="text-align: center;">5</td><td></td><td></td></tr> </table>	1			2			3			4			5			
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1. c.
2. a. False  
b. True
3. e.
4. See completed Form 3903. The Carrs are entitled to a \$175 moving expense deduction. Only the travel and lodging en route can be claimed on Form 3903, line 2. The security deposit and the meals are not deductible expenses. In addition, the dislocation allowance is netted against dislocation expenses. Only if the dislocation expenses exceeded the dislocation allowance would the Carrs have reported the difference as an additional moving expense on Form 3903.

**▶▶ SUMMING UP THIS LESSON ◀◀**

In this lesson you learned what moves qualify for tax benefits, what expenses are deductible, and how to use Form 3903 to compute the moving expense deduction. These expenses are deductible as an adjustment to income on Form 1040, line 28.

Form **3903**

(Rev. October 2002)  
Department of the Treasury  
Internal Revenue Service

**Moving Expenses**

▶ Attach to Form 1040.

OMB No. 1545-0062

Attachment  
Sequence No. **62**

Name(s) shown on Form 1040

Greg T. and Diane E. Carr

Your social security number

000 : 00 : 4567

**Before you begin:** ✓ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.  
✓ If you are a member of the armed forces, see the instructions to find out how to complete this form.

<b>1</b> Enter the amount you paid for transportation and storage of household goods and personal effects (see instructions) . . . . .	<b>1</b>		
<b>2</b> Enter the amount you paid for travel and lodging expenses in moving from your old home to your new home. <b>Do not</b> include the cost of meals (see instructions) . . . . .	<b>2</b>	575	00
<b>3</b> Add lines 1 and 2 . . . . .	<b>3</b>	575	00
<b>4</b> Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is <b>not</b> included in the wages box (box 1) of your W-2 form. This amount should be identified with code <b>P</b> in box 12 of your W-2 form . . . . .	<b>4</b>	400	00
<b>5</b> Is line 3 <b>more than</b> line 4?  <input type="checkbox"/> <b>No.</b> You <b>cannot</b> deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on the "Wages, salaries, tips, etc." line of Form 1040.  <input checked="" type="checkbox"/> <b>Yes.</b> Subtract line 4 from line 3. Enter the result here and on the "Moving expenses" line of Form 1040. This is your <b>moving expense deduction</b> . . . . .	<b>5</b>	175	00



# TRAVEL EXPENSES

## OBJECTIVE

At the end of this lesson you will be able to identify travel and transportation expenses (including meals) deductible by Armed Forces members.

## INTRODUCTION

This lesson identifies and explains how to apply the rules concerning travel and transportation expenses for members of the Armed Forces.

## GENERAL INFORMATION

Fully reimbursed employee business expenses, such as travel and transportation expenses, generally are not reported on your tax return if an adequate accounting is made to the employer and any excess reimbursement is returned to the employer.

Armed Forces employees must substantiate their expenses to the federal government and return any excess reimbursement. The records must be adequate and complete. Adequate records include documents such as receipts and checks, account books, diaries, trip sheets, or similar items. To be considered adequate, the records should show the business purpose, time, place, and amount of the expense. If automobile expenses are involved, the records must include the total miles driven and total business miles driven.

## FORM 1040

Deductible employee business expenses are reported generally on Form 2106, *Employee Business Expenses*, and can only be taken as an itemized deduction on Schedule A, Form 1040. Only expenses that exceed 2% of adjusted gross income (AGI) can be deducted.

Excess reimbursements for employee business expenses that are not returned to the employer must be included in income on line 7 of Form 1040. These reimbursements do not include any “qualified military benefit,” such as per diem, as defined in Lesson 1.

## **FORM W-2**

If the employee is reimbursed under a plan which requires the employee to adequately account for all business connected expenses and return any funds that are more than the substantiated expenses, the reimbursement should not be included as income in Box 1 of Form W-2. Therefore, the employee cannot deduct these expenses.

Temporary duty (TDY) and temporary additional duty (TAD) allowances for travel and transportation are not reported as income on Form W-2. If there are excess expenses on some trips and the employee wants to claim them as employee business expenses, the employee must report all TAD and TDY trip expenses incurred during the year on Form 2106 and include all TAD and TDY allowances received as reimbursements.

## **FORM 2106**

To claim unreimbursed job related expenses, such as travel or transportation expenses, Armed Forces personnel must complete Form 2106 and attach it to their Form 1040. Form 2106 will not have to be used if the Armed Forces member is claiming only unreimbursed employee business expenses for professional dues, subscriptions to professional journals, educational expenses, and uniform expenses. These expenses are reported on line 20 on Schedule A as miscellaneous itemized deductions subject to the 2% AGI limit.

### **Example**

Capt. Grand traveled from his duty station in California to Washington, DC, for a conference. He was away for 5 days. The Army advanced Capt. Grand \$700 for the trip. Capt. Grand’s actual expenses were \$625. When he filed his travel voucher with the Army, he returned the excess of \$75. The captain does not have to complete Form 2106.

**Remember, if the Armed Forces member does not claim reimbursement for expenses that he or she is entitled to, no deduction for those expenses is allowed.**

## MEALS

The cost of meals can be an employee business expense. This includes meals while on business travel away from home and for business-related entertainment. The deduction for meals is generally limited to 50% of the actual expenses.

The deduction is taken on Form 2106 where the 50% limit is applied before the amount is carried to line 20 on Schedule A where it is subject to the 2% AGI limit.

If the employee is fully reimbursed for the meals under an accountable plan that excludes reimbursement from gross income, there is no amount to deduct and, therefore, no amount subject to the 50% limit. For information on using the standard meal allowance instead of actual expenses, see Publication 463, *Travel, Entertainment, Gift, and Car Expenses*.

## TRAVEL EXPENSES

To be deductible, travel expenses must be ordinary and necessary expenses of traveling away from home temporarily for your job and must be greater than the total of any advances, allowances, and reimbursements you receive for such expenses. “Ordinary” expenses are customary or usual in the employee’s field, trade, business, or profession. “Necessary” expenses are appropriate or helpful in the employee’s job or business. Such expenses include airfares, the costs of operating and maintaining a car, and meals and lodging. For a more complete list, see Publication 463.

Deductible travel expenses are reported on Form 2106 (or Form 2106-EZ, if you qualify) and are deductible as a miscellaneous itemized deduction on Schedule A of Form 1040.

### Away From Home

For costs other than local transportation to be deductible, the traveler must be away from home. The term “away from home” has a special meaning for tax purposes.

“Home,” for this purpose, generally is the taxpayer’s main place of business or post of duty. This includes the entire city or general area where his or her business or work is located, regardless of where the taxpayer or his or her family lives. For the military, “home” is the permanent duty station. A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

“Away from home” means away for a period substantially longer than an ordinary day’s work, during which taxpayers need time off for sleep or rest to meet the demands of work.

(For examples, see *Traveling away from home* in Publication 463.) Members of the Armed Forces are away from home if they are away from their permanent duty stations long enough to require significant rest or sleep in order to be able to conduct and complete their duties.

**Note:** Away from home assignments that last, or are realistically expected to last more than one year are not temporary in nature. Therefore, taxpayers cannot deduct travel expenses incurred while on an assignment of more than one year. See Publication 463, for more details.

### **No Deduction for Personal Expenses**

For travel expenses to be deductible, there must be a work-related purpose for the travel. The taxpayer may not deduct expenses for personal travel, such as vacations, sightseeing, entertaining, or family visits.

### **Allowable Expenses**

Common travel expenses for a member of the Armed Forces include:

- Expenses incurred while on TDY or TAD if away from home (ship, base, or station).
- Expenses of a reservist attending drills away from home overnight.
- Meals and lodging of a reservist temporarily called to active duty.
- Travel expenses, including meals and lodging, incurred in connection with deductible educational activities.
- Travel expenses incurred when carrying on official business while on “No Cost” (to the government) orders.

Mess bills afloat are not deductible by an officer assigned to permanent duty aboard a ship. Bills may be deductible as travel expenses by individuals and members of mobile units in a travel or TAD status while away from their permanent ships or stations.

Travel expense deductions are available to air squadron personnel when away from the squadron’s home base on TAD and to Army personnel when on field duty or maneuvers in a TDY status. Air squadron personnel and members of staffs permanently embarked on ships on extended deployments may not deduct expenses of living aboard ships as travel expenses.

Officers assigned permanent duty afloat may deduct the cost of meals and lodging incurred while on travel or TAD ashore if the ship is not berthed at the temporary duty station, or if the ship is berthed at the temporary duty station but quarters



aboard are not available. No deduction is permitted for meals or lodging furnished or available in kind at the place of TAD, even if they are not used.

## **RESERVISTS**

Unreimbursed travel expenses, including meals and lodging, are deductible for military reservists who, under competent orders and with or without compensation, must remain away from their main place of business to perform authorized drills and training duty.

**Temporary active duty.** Reservists temporarily called to active duty may deduct meals and lodging while on active duty if they kept their regular job while on active duty, returned to it after release, and were stationed away from the general area of that job or business. These expenses are deductible only if the reservists pay for meals and lodging at their official military post and only to the extent the expenses exceed BAH and BAS.

### **Exercise 1**

**A.** Sgt. Meeker's permanent duty station is in Korea. His wife and children could not accompany him and have remained at their home in the United States. Can he deduct the cost of his meals and lodging?

Answer \_\_\_\_\_

**B.** Can Sgt. Meeker, in the circumstances above, deduct the cost of meals and lodging for his wife and children?

Answer \_\_\_\_\_

**C.** Can Sgt. Meeker take a deduction for the cost of returning home to visit his family?

Answer \_\_\_\_\_

## **EDUCATIONAL EXPENSES**

In Lesson 16, you will learn about deductions for educational expenses. Taxpayers cannot deduct as a business expense the cost of travel that in itself constitutes a form of education. If educational expenses qualify for a deduction under the rules

given in Lesson 16, travel for that education is travel for a business purpose, and the unreimbursed transportation and meals and lodging expenses may be deducted according to the relevant rules discussed in this lesson.

### **Example**

Airman Dawes is sent from his permanent duty station to a technical school 500 miles away to learn the latest uses of computers for diagnosing engine performance and maintenance requirements. If his expenses for travel exceed the allowances and reimbursements he receives, he can take the excess as a miscellaneous itemized deduction, subject to the 2% AGI limit.

Lesson 14 will explain which other educational expenses can be deducted.

### **Exercise 2**

Which of the following can be taken as deductions?

- A.** Travel expenses in excess of allowances and reimbursements when the taxpayer is on TAD trips.
- B.** Mess bills of an officer permanently assigned to a ship.
- C.** Meals that are not lavish or extravagant, but cost more than allowances or reimbursements while the taxpayer attends assigned schooling away from his or her permanent station.
- D.** Laundry expenses the taxpayer incurs while traveling on TAD and for which no allowance or reimbursement is received.

Answer \_\_\_\_\_

## ***LOCAL TRANSPORTATION EXPENSES***

Local transportation expenses are generally the expenses of getting from one work place to another while not traveling away from home. Such expenses include the costs of operating and maintaining a car, but not meals and lodging. If taxpayers are required during their time on duty to go from one place to another (for example, as a courier or to attend meetings) without being away from home, their unreimbursed transportation expenses are deductible. When they must use their own vehicle, they can deduct transportation expenses. You may be able to use the standard mileage rate to figure the deductible costs of operating your car for business purposes. Beginning January 1,

2002, the standard mileage rate is **36.5 cents a mile** for all business miles driven on or after that date. This rate is adjusted periodically for inflation. Commuting expenses are usually not deductible. However, you may be able to deduct certain daily transportation expenses, as explained next, under *Temporary Work Location*.

## **TEMPORARY WORK LOCATION**

A taxpayer can deduct local transportation expenses.

Local transportation expenses include the ordinary and necessary costs of all of the following.

- Getting from one workplace to another in the course of the taxpayer's business or profession when he or she is traveling within the city or general area that is his or her tax home.
- Visiting clients or customers.
- Going to a business meeting away from the taxpayer's regular workplace.
- Getting from the taxpayer's home to a temporary workplace when he or she has one or more regular places of work. These temporary workplaces can be either within the area of his or her tax home or outside that area.

Local business transportation does **not** include expenses the taxpayer has while traveling away from home overnight. Those expenses are deductible as travel expenses.

If the taxpayer's employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise. If the taxpayer's employment at a work location is realistically expected to last for more than one year or if there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually lasts for more than one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the employment is expected to last for more than one year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until the taxpayer's expectation changes. It will not be treated as temporary after the date the taxpayer determines it will last for more than one year.

## ▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson you have learned that:

- ▶ Travel and transportation expenses can be taken as miscellaneous itemized deductions on Schedule A, subject to the 2% AGI limit.
- ▶ Travel expenses for meals, lodging, and incidentals must be incurred while temporarily away from home on business to be deductible. Assignments that last, or are realistically expected to last more than one year are not considered temporary.
- ▶ Commuting and other personal expenses are not deductible.
- ▶ Travel costs associated with deductible educational expenses are treated like other business travel costs.
- ▶ Form 2106 and Schedule A (Form 1040) are used to figure and claim the itemized deduction for employee business expenses that exceed reimbursement.

# ***TRAVEL EXPENSES*** *ANSWERS TO EXERCISES*

1. a. No.  
b. No.  
c. No.
2. a., c., and d.

**STUDENT NOTES**



# MISCELLANEOUS ITEMIZED DEDUCTIONS

## LESSON 14

### OBJECTIVE

At the end of this lesson you will be able to identify miscellaneous itemized deductions of particular interest to the military.

### INTRODUCTION

Certain miscellaneous itemized deductions, including unreimbursed employee business expenses and investment expenses, are deductible only if the total deductions are more than 2% of the taxpayer's adjusted gross income (AGI). All deductible miscellaneous itemized deductions discussed in this lesson are subject to the 2% AGI limit. A general discussion of miscellaneous deductions appears in the *Volunteer Assistor's Guide*. This lesson explains some additional itemized deductions of special interest to members of the military. To claim miscellaneous deductions, a taxpayer must use Schedule A (Form 1040), *Itemized Deductions*.

### UNIFORMS

Taxpayers can deduct the cost of buying and maintaining uniforms if the uniforms are specifically required as a condition of employment and they are not adaptable to general use as regular clothing.

Generally, members of the Armed Forces are required to wear uniforms when they are on duty but may be allowed to wear them when they are off duty. Because their uniforms can be worn in place of regular civilian clothing, members of the military cannot claim a deduction for uniform cost and upkeep. However, if military regulations prohibit off-duty wear of certain uniforms, the member can deduct the cost and upkeep of these uniforms. But he or she must reduce any deductible uniform costs incurred by any nontaxable uniform allowances or reimbursements received to pay for these expenses.

## Active Duty Uniforms

Members of the Armed Forces on active duty can deduct amounts spent to buy and maintain required military battle dress uniforms and utility uniforms if local military regulations prohibit their off-duty wear. The member must reduce the expense by any nontaxable uniform allowance or reimbursement received.

## Reservists' Uniforms

A reservist in the Armed Forces can deduct the cost and upkeep of uniforms if military regulations prohibit their wearing the uniform except when performing duties as a reservist. The reservist must, however, reduce the uniform expense by any nontaxable uniform allowance or reimbursement received.

## Articles Not Replacing Regular Clothing

A member of the Armed Forces can deduct the cost of required items that do not replace regular clothing. Such items include insignia of rank, corps devices, epaulets, aiguillettes, and swords.

### Exercise 1

Indicate if the following are deductible or nondeductible by a member of the Armed Forces.

- A.** The cost of an Army dress blue uniform (without shoulder boards or gold stripe on pants), including cape. Off-duty wear is not prohibited.

Answer \_\_\_\_\_

- B.** The cost of a full Army green uniform (without braid) that can be worn anytime.

Answer \_\_\_\_\_

- C.** The cost of gold braid for decoration of a cap and uniform.

Answer \_\_\_\_\_

- D.** The cost of battle dress uniforms and utility uniforms that can be worn only while on duty or while traveling to and from duty.

Answer \_\_\_\_\_

## ***PROFESSIONAL DUES***

Taxpayers, including members of the Armed Forces, can deduct dues paid to professional societies that are directly related to their trade or business. For example, Lt. Margaret Allen, an electrical engineer at Maxwell Air Force Base, can deduct professional dues paid to the American Society of Electrical Engineers.

However, members of the Armed Forces cannot deduct amounts paid to an officers' club or a noncommissioned officers' club.

## ***EDUCATIONAL EXPENSES***

Travel and transportation expenses for educational purposes were discussed in Lesson 13. In this lesson, you will learn what educational expenses can be claimed as miscellaneous deductions on Schedule A. Certain rules must be met, however, for the expenses to qualify as a deduction.

### **Qualifications**

A member of the Armed Forces can deduct expenses for education, even though the education may lead to a degree, if the education:

- Is required by the taxpayer's employer or by law or regulations for the taxpayer to keep salary, status, or job (if these requirements serve a business purpose of his or her employer); or
- Maintains or improves the skills required in the taxpayer's present work.

A taxpayer cannot deduct educational expenses, even though the above requirements are met, if the education:

- Is to meet the minimum educational requirements needed to qualify the taxpayer in his or her trade or business, or
- Is part of a program of study that will qualify the taxpayer for a new trade or business, even if he or she has no plans to enter that trade or business.

Some examples will help illustrate the various rules.

### **Example 1**

Warrant Officer Nolan, an Army pilot, incurred educational expenses to obtain an accounting degree. He cannot deduct these expenses because they qualify him for a new trade or business.

### **Example 2**

Lieutenant Commander Mason, who has a degree in financial management, is in charge of base finance at her post of duty. She incurred educational expenses when taking an advanced finance course. She can deduct educational expenses that were more than the educational allowance she received because she had already met the minimum qualifications of her job. By taking the course, she improved skills in her current position. The course did not qualify her for a new trade or business.

### **Deductible Expenses**

Educational expenses and certain travel and transportation expenses related to education may be claimed on Form 2106, *Employee Business Expenses*. Expenses in excess of reimbursement are deductible only as a miscellaneous itemized deduction on Schedule A, subject to the 2% AGI limit discussed earlier. For more information, see Publication 508, *Tax Benefits for Work-Related Education*, and Lesson 13, *Travel Expenses*, in this publication.

Deductible educational expenses include amounts spent for tuition, books, supplies, laboratory fees, correspondence courses, costs of research, and typing as part of an educational program, and travel. Educational expenses of a personal nature are not deductible. For example, a taxpayer cannot deduct the cost of dinner on campus while he or she attends evening classes. Also, deductible educational expenses do not include items of a capital nature, such as computers or desks.

### **Treatment of Allowances and Reimbursements**

A member of the Armed Forces must reduce deductible educational expenses by any allowance or reimbursement he or she receives. Any educational services provided in kind are not deductible. For example, base-provided transportation to or from class cannot be claimed.

#### **Exercise 2**

Sgt. Stephen Baker is a mess sergeant. On his own, he takes courses at the local university in early childhood education. Does he have deductible educational expenses? Why?

Answer \_\_\_\_\_

### Exercise 3

Specialist Bates is a qualified X-ray technician. Would he have deductible educational expenses if he took a course required by the Army in new radiology techniques? Assume his expenses exceed reimbursement or allowance received.

Answer \_\_\_\_\_

### Exercise 4

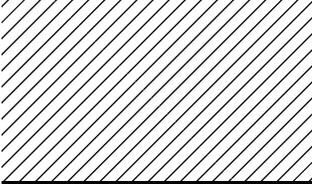
Which of the following can be claimed as miscellaneous itemized deductions by a member of the Armed Forces?

- a. Payment to an officers' club.
- b. Expenses incurred by a flight operations officer to obtain an accounting degree.
- c. Cost of epaulets.
- d. Cost and upkeep of a reservist's uniform when local military regulations prohibit off-duty wear. (No uniform allowance received.)
- e. Expenses incurred by a Navy disbursing clerk to learn television repair.

Answer \_\_\_\_\_

### ►► SUMMING UP THIS LESSON ◀◀

In this lesson, you learned about some of the more common itemized deductions of special interest to military members. The total of these miscellaneous deductions must be more than 2% of adjusted gross income to be deductible.



**MISCELLANEOUS**  
**ITEMIZED DEDUCTIONS ANSWERS TO EXERCISES**

**LESSON 14**

1.
  - a. Nondeductible
  - b. Nondeductible
  - c. Deductible
  - d. Deductible
2. No. The courses were not required, do not improve Sgt. Baker's skills as a mess sergeant, and could lead to qualifying him for a new trade or business.
3. Yes. The course is required by Specialist Bates' employer, improves his skills in his present job, is not needed to meet the minimum educational requirements for his job, and will not lead to qualifying him for a new trade or business.
4. c. and d.

### OBJECTIVES

At the end of this lesson you will be able to:

1. Determine where and when to file a federal tax return.
2. Identify situations in which extensions of time to file are granted and determine the length of these extensions.
3. Identify the deadline extension for combat zone participants.

### INTRODUCTION

General rules for filing returns may be found in the *Volunteer Assistor's Guide*. This lesson addresses special concerns of members of the Armed Forces and includes information for combat zone participants.

### TAXPAYER IDENTIFICATION

A member of the Armed Forces should include his or her name, social security number, and permanent home address on his or her return. A member who is due a refund and does not want it mailed to his or her permanent home address should enter a current address on the return. If the postal service does not deliver to the member's street address and the member has a post office box, he or she should enter the post office box number on the line for the present home address. A military person living overseas should use an APO or FPO address.

### CHANGE OF ADDRESS

If a taxpayer changed his or her mailing address during the year, the taxpayer should notify the Internal Revenue Service of the change on Form 8822, *Change of Address*. However, if the taxpayer moves after filing a tax return, he or she should fill out and mail Form 8822 to the Internal Revenue Service Center where his or her returns were previously filed. Addresses for the service centers are listed on the back of the form.

## WHERE TO FILE

Taxpayers should send their federal returns to the service center for the place where they reside. For example, Sgt. Kane, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the service center for Maine. The tax form instructions give the addresses for the service centers, including the Philadelphia Service Center for APO and FPO addresses.

Taxpayers who live outside the United States and have no legal residence or principal place of business in the United States should send their returns to the address listed in the forms instructions. Those who live in Guam or the Virgin Islands should also use the addresses in the instructions.

## WHEN TO FILE

Most individual tax returns cover a calendar year, January through December. Taxpayers who live in the United States or Puerto Rico and who use the calendar-year period should file their individual tax returns by April 15 of the following year. If April 15 falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. (For 2002 tax returns, the due date is April 15, 2003.)

If a taxpayer has a balance due, they can pay by check, money order, direct debit (automatic withdrawal) or credit card. See Form 1040, 1040A, or 1040EZ instructions for complete details.

Taxpayers who cannot pay the tax due with their tax return should attach Form 9465, *Installment Agreement Request*. The Internal Revenue Service will try to arrange an installment payment agreement that reflects the taxpayer's ability to pay the tax owed. However, taxpayers should pay as much as possible with their return to reduce the amount of interest and penalties that will be charged on the unpaid balance.

## EXTENSIONS

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the United States and those who live outside the United States. Deadline extensions are also available to members of the Armed Forces who served in a combat zone.

IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted, unless the combat zone extension is applicable.

## Within the United States

A taxpayer living in the United States can receive an automatic 4-month extension of time to file his or her federal tax return. To get the automatic extension, the taxpayer must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by the due date for the tax return. Also see *Paying by credit card*, later.

The taxpayer is not required to pay any of the tax due when submitting the form. However, the taxpayer will owe interest on any tax that is owed but not paid by the due date. Interest will be charged from the due date to the date of payment. In addition, the taxpayer may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90% of the actual tax owed.

For more details on penalties, refer to filing information in Publication 17 and lesson 7 in the Volunteer Assistor's Guide.

If Form 4868 is filed late, the request for an extension will be denied. The Internal Revenue Service will inform the taxpayer if the request is denied.

Taxpayers **cannot** use the automatic extension if they:

- Choose to have the IRS figure their tax, or
- Are under a court order to file their returns by the regular due date.

When the tax return is actually filed, any payment made with the application should be entered on line 67, Form 1040; added to the total on line 43, Form 1040A; or added to the total on line 10, Form 1040EZ.

The taxpayer can request an extension beyond this 4-month period by filing Form 2688, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return*, or by letter. Except in undue hardship cases, this additional extension will not be granted unless Form 4868 has been filed first. Form 2688 or the taxpayer's letter will not be considered if filed after the extended due date.

## Outside the United States and Puerto Rico

U.S. citizens and resident aliens who are living outside the United States and Puerto Rico on April 15 and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico are allowed an automatic 2-month extension of time until June 15, 2003, to file a 2002 return. However, interest will be charged from the due date to the date the tax is paid.

**Note:** Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic 2-month extension.

Taxpayers using this automatic extension must attach a statement to their return stating that they were living outside the United States and Puerto Rico on the due date and that their main place of business or their assigned tour of duty is outside the United States and Puerto Rico.

**Joint returns.** For married persons who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

**Separate returns.** For married persons who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

As discussed earlier, taxpayers who live outside the United States and Puerto Rico and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 15 or by paying the tax due by credit card by April 15, 2003. The due date will then be extended to August 15. To obtain the additional extension, the taxpayer must file Form 4868 and write "Taxpayer Abroad" in the top margin of the form. If more time is needed, the taxpayer should file Form 2688.

**Paying by credit card.** Taxpayers generally can get an extension by phone if they pay part or all of their estimate of income tax due by using a credit card (American Express® Card, MasterCard®, or Discover® Card) or by authorizing a direct debit (automatic withdrawal) from the taxpayer's checking or savings account. To pay by credit card, taxpayers may pay by phone or Internet by the regular due date of their income tax return, and follow the instructions. If they pay the tax by credit card, they do not have to file Form 4868. For more information, get Form 4868 instructions.



## Combat Zone Participants

The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended for members of the Armed Forces who served in a combat zone, qualified hazardous duty area, or began performing qualifying service outside of a combat zone or qualified hazardous duty area. The designation of the combat zone and the combat pay exclusion are described in Lesson 1.

The deadline for taking actions with the IRS is extended for at least 180 days after the later of:

1. The last day a member is in a combat zone, qualified hazardous duty area, or has qualifying service outside of the combat zone/qualified hazardous duty area (or the last day the area qualifies as a combat zone/qualified hazardous duty area), or
2. The last day of any continuous qualified hospitalization (defined in Lesson 2) for injury from service in the combat zone, qualified hazardous duty area, or qualified service outside the combat zone/qualified hazardous duty area.

Time in a missing status (missing in action or prisoner of war) counts as time in a combat zone.

In addition to the 180 days, the deadline is extended by the number of days that were left for the member to take the action with the IRS when he/she entered a combat zone, qualified hazardous duty area (or began performing qualifying service outside of the combat zone/qualified hazardous duty area). If the member entered the combat zone/qualified hazardous duty area (or began performing qualifying service outside of the combat zone/qualified hazardous duty area) before the period of time to take the action began, the deadline is extended by the entire time he/she had to take the action. For example, the member has 3½ months (Jan. 1–Apr. 15, 2002) to file his/her 2001 tax return.

Any days of the 3½ month period that are left when he/she entered a combat zone (or the entire 3½ months if the member entered the combat zone before January 1) are added to the 180 days to find the last day allowed for filing the 2001 tax return.

### Example 1

Capt. Margaret Jones entered Saudi Arabia on December 1, 2000. She remained there through March 31, 2002, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Capt. Jones' 2000, 2001, and 2002 tax returns are figured as follows:

**The 2000 tax return deadline** is January 10, 2003. Capt. Jones has 285 days (180 plus 105) after her last day in the combat zone (March 31) to file her 2000 tax return. The 105 additional days are the number of days in the 3<sup>1</sup>/<sub>2</sub>-month filing period that were left when she entered the combat zone (Jan. 1–Apr. 15). There are 105 days in the 2002 filing period.

**The 2001 tax return deadline** is January 10, 2003. Capt. Jones has 285 days (180 plus 105) after her last day in the combat zone to file her 2001 tax return.

**The 2002 tax return deadline** is not extended. The 180-day extension period after March 31, 2002, ends on September 27, 2002, which is before the start of the filing period for her 2002 return.

### **Example 2**

Petty Officer Leonard Brown's ship entered the Persian Gulf on January 5, 2001. On February 15, 2001, Leonard was injured and was flown to a U.S. hospital. He remained in the hospital through April 21, 2002. The deadlines for filing Petty Officer Brown's 2000, 2001, and 2002 returns are figured as follows:

**The 2000 tax return deadline** is January 27, 2003. Petty Officer Brown has 281 days (180 plus 101) after his last day in the hospital (April 21, 2002) to file his 2000 return. The 101 additional days are the number of days in the 3<sup>1</sup>/<sub>2</sub>-month filing period that were left when he entered the combat zone (Jan. 5–Apr. 15).

**The 2001 tax return deadline** is January 31, 2003. Petty Officer Brown has 285 days (180 plus 105) after April 21, 2002, to file his 2001 tax return.

**The 2002 tax return deadline** is April 15, 2003. The 180-day period after April 21, 2002, ends October 18, 2002, which is before the start of the filing period for his 2002 return. The due date for his 2002 return is not extended. He has until April 15, 2003 to file his 2002 tax return.

A detailed explanation of the deadline extension provision for filing returns and taking care of other tax matters is included in Lesson 3, *Tax Benefits for Combat Zone Participants*.

**Interest.** The IRS will pay interest from the regular due date of a return if the return is timely filed (including extensions).

**Identification of combat zone returns.** Taxpayers can choose to file their returns before the end of an extension period. They should file their returns in accordance with procedures provided by the Armed Forces.

**Third-Party Designee.** If the taxpayer wants to allow a friend, family member, or any other person he or she chooses to discuss his or her 2002 tax return with the IRS, the taxpayer should check the “Yes” box in the “Third party designee” area of the return. Also, the taxpayer should enter the designee’s name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN).

If the taxpayer checks the “Yes” box, he or she, and his or her spouse if filing a joint return, is authorizing the IRS to call the designee to answer any questions that may arise during the processing of the return. The taxpayer is also authorizing the designee to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of the taxpayer’s refund or payment(s), and
- Respond to certain IRS notices that the taxpayer has shared with the designee about math errors, offsets, and return preparation. The notices will not be sent to the designee.

The taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS. If the taxpayer wants to expand the designee’s authorization, he or she should see Publication 947, *Practice Before the IRS and Power of Attorney*.

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (without regard to extensions) for filing the taxpayer’s 2003 tax return. This is April 15, 2004, for most people.



**Power of Attorney.** Use Form 2848, *Power of Attorney and Declaration of Representative*, to grant authority to an individual to represent you before the IRS and to receive tax information. If an individual is acting on behalf of a taxpayer serving in the combat zone and does not have a power of attorney specifying that he/she can handle federal tax matters, the IRS will accept a general power of attorney or other statement signed by the person for whom the individual is acting. The general power of attorney or statement must authorize the individual to act on the other person's behalf even though federal tax matters are not specified. A copy must be attached to the tax return.

**Signature.** If it is not possible for the spouse of someone serving in the combat zone to obtain that person's signature on a joint return, power of attorney, or other signed authorization to act on his or her behalf, the IRS will accept a written statement explaining that the husband or wife is serving in the combat zone.

The statement must be signed by the spouse filing the tax return and attached to the return.

### Exercise 1

Pvt. Franklin, a U.S. citizen, is a calendar-year taxpayer. What would be the due date for him to file a return if his assigned tour of duty were in the following places?

**A.** Puerto Rico

Answer \_\_\_\_\_

**B.** Germany

Answer \_\_\_\_\_

**C.** United States

Answer \_\_\_\_\_

## Exercise 2

Capt. Russell is stationed in England on April 15. He is concerned about when he should file his federal tax return. Answer the following questions for Capt. Russell.

- A. What extensions of time are available to him?

Answer \_\_\_\_\_

- B. How can he get those extensions?

Answer \_\_\_\_\_

## Exercise 3

Capt. McNulty entered the Persian Gulf area combat zone on October 9, 2000, and left the combat zone on May 10, 2002. She was not injured and did not return to the combat zone.

- A. When are her 2000 and 2001 returns due after applying the deadline extension provision?

Answer \_\_\_\_\_

- B. How can she get this additional extension?

Answer \_\_\_\_\_

## ▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson you have learned where members of the Armed Forces should file their returns. You learned when the returns are due for taxpayers who live both inside and outside the United States and Puerto Rico and how extensions of time to file can affect the due date. You have also learned that members of the Armed Forces who served in a combat zone are allowed additional time to file their returns.

1.
  - a. April 15
  - b. June 15 if he attached a statement to his return indicating that he was on an assigned tour of duty in Germany on the due date.
  - c. April 15
2.
  - a. An automatic 2-month extension of time to June 15 and an additional 2-month extension to August 15 (for a total of 4 months).
  - b. Captain Russell can obtain the automatic 2-month extension by attaching a statement to his tax return indicating that he was on an assigned tour of duty outside the United States and Puerto Rico on April 15. If Captain Russell needs an additional extension of time, he should file Form 4868 by the automatic extension date of June 15 and write "Taxpayer Abroad" in the top margin of the form. If he still needs additional time, he should request it before the extended due date of August 15 by filing Form 2688, or by letter.
3.
  - a. Capt. McNulty has 285 days (180 plus 105) after her last day in the combat zone (May 10, 2002) to file her 2000 return. She has 285 days (180 plus 105) after her last day in the combat zone to file her 2001 return. These additional days are the number of days in the 3½ month filing period that were left when she entered the Persian Gulf. Her 2000 return and her 2001 return are both due February 19, 2003.
  - b. Capt. McNulty should follow procedures provided by the Armed Forces when filing her returns.

### OBJECTIVES

After completing this lesson you will be able to:

- Determine which credit is applicable
- Compute each credit by completing the Form 8863
- Determine the amount of tuition and fees deduction
- Determine allowable education expense deduction

### INTRODUCTION

In this lesson, you will learn about the following education credits.

- Hope Credit, and the
- Lifetime Learning Credit

AND education associated adjustments to income:

- Student Loan Interest Deduction
- Tuition and Fees Deduction
- Deduction for Educator's Expenses

### EDUCATION CREDITS

The two education credits are the Hope and the Lifetime Learning Credit. The credits have some of the same criteria, but differ as to when each can be taken.

The Hope Credit can only be taken the first two years of post-secondary education, generally the freshman and sophomore years of college. The Hope Credit is available:

- Only for two years per eligible student.
- The student qualifying for this credit must be enrolled in a degree or other recognized educational credential, and
- The student is enrolled in that program for at least one academic period during the year, and
- The student has no felony drug convictions on the student's record

The Hope Credit can be up to \$1,500 per eligible student.

The Lifetime Learning Credit is available for all years of postsecondary education.

The Lifetime Learning Credit is available:

- For an unlimited number of years.
- Even if the student is not pursuing a degree or other recognized educational credential

The Lifetime Learning Credit can be up to \$1,000 per tax return.

**NOTE:** While the Lifetime Learning Credit can be taken for any postsecondary education, if the student qualifies for either credit, it is more advantageous to advise the taking of the Hope credit when it is available. You **cannot** claim the Hope credit and the lifetime learning credit on the same student in the same tax year.

## **WHAT QUALIFIES FOR THE CREDIT**

The Hope and the Lifetime Learning Credits are based on qualified tuition and related expenses for the taxpayer, their spouse or dependents they claim on their tax return. Generally the credit is allowed for qualified tuition and related expenses paid in 2002 for an academic period beginning in 2002 or for the first three months of 2003.

**Qualified tuition and related expenses.** In general, qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible institution.

Student activity fees and fees for course-related books, supplies, and equipment are included in qualified tuition and related expenses **only** if the fees must be paid to the institution as a condition of enrollment or attendance.

**Academic period.** An academic period includes a semester, trimester, quarter, or other period of study (such as summer school session) as reasonably determined by the educational institution.

**Prepaid expenses.** If you paid qualified tuition and related expenses in 2002 for an academic period that begins in the first three months of 2003, you can use the prepaid amount in figuring your 2002 credit. As an example, if the taxpayer paid \$1,500 in December 2002 for qualified tuition for the winter 2003 semester, which begins in January 2003, the taxpayer can use the prepaid amount to figure their credit for 2002.

**Payment with borrowed funds.** You can claim an education credit for qualified tuition and related expenses paid with the proceeds of a loan. You use the expenses to figure the credit of

the year in which the expenses are paid, not the year in which the loan is repaid. However, you can still claim an adjustment to income for the interest you pay when you are repaying the loan.

**Expenses that do not qualify.** Qualified tuition and related expenses do not include the cost of :

- Insurance
- Medical expenses (including student health fees)
- Room and board
- Transportation or
- Similar personal, living, or family expenses.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any non credit course. However, if the course of instruction or other education is part of student's degree program or, in the case of the Lifetime Learning Credit, is taken by the student to acquire or improve job skills, these expenses can qualify.

**No double benefit allowed.** You cannot:

- Deduct higher education expenses on your income tax return and also claim an education credit base on the same expenses.
- Claim a Hope Credit and a Lifetime Learning Credit based on the same qualified education expense or student (in the same tax year).
- Claim a credit based on expenses paid with tax-free scholarship, grant, or employment-provided education assistance.

**Adjustments to Qualified Expenses.** If you pay higher education expenses with certain tax-free funds, you cannot claim a credit for those amounts. You must reduce the qualified expenses by the amount of any tax-free education assistance you receive. Tax-free education assistance could include:

- Scholarships
- Pell grants
- Employer-provided education assistance
- Veteran's education assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses

Do not reduce the qualified expenses by amounts paid with the student's:

- Earnings
- Loans
- Gifts
- Inheritances, and
- Personal savings

Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses.

**Example 1**

PV2 Charlie Delta is single, his SSN is 000-00-0004. Charlie entered college for the first time as a freshman in 2002. He paid qualified tuition and fees to school, which totaled \$2,100. In 2002, he received tuition assistance of \$750. Compute Hope credit on the Form 8863.

Form <b>8863</b> Department of the Treasury Internal Revenue Service	<b>Education Credits</b> <b>(Hope and Lifetime Learning Credits)</b> ▶ See instructions.      ▶ Attach to Form 1040 or Form 1040A.	OMB No. 1545-1618 <b>2002</b> Attachment Sequence No. <b>50</b>					
Name(s) shown on return Charlie Delta		Your social security number 000 : 00 : 0004					
<b>Part I Hope Credit. Caution: The Hope credit may be claimed for no more than 2 tax years for the same student.</b>							
<b>1</b>	<b>(a) Student's name</b> (as shown on page 1 of your tax return) First name Last name	<b>(b) Student's social security number</b> (as shown on page 1 of your tax return)	<b>(c) Qualified expenses</b> (but <b>do not</b> enter more than \$2,000 for each student). See instructions	<b>(d) Enter the smaller</b> of the amount in column (c) or \$1,000	<b>(e) Subtract</b> column (d) from column (c)	<b>(f) Enter one-half</b> of the amount in column (e)	
	Charlie Delta	000 : 00 : 0004	1350 00	1000 00	350 00	175 00	
<b>2</b>	Add the amounts in columns (d) and (f)		<b>2</b>	1000 00		175 00	
<b>3</b>	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III					<b>3</b>	1175 00



## Refunds of Education Expenses

Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2002 and you received a refund before you file your tax return for 2002, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2002 tax return, you will need to file an amended return (1040X) to recalculate the credit and repay the excess credit claimed.

## Student Loan Repayment Program

When some service members enlist, they get their student loans repaid as an enlistment incentive. The amount of the student loan repayment will show on their W-2 statement as other wages (in Box 14) and this amount must be included with amount in Box 1 income on their W-2 before entering on the "Wages, salaries, tips, etc.) line of the appropriate tax return.

## ***STUDENT LOAN INTEREST DEDUCTION***

You may be able to deduct up to \$2,500 of the interest you pay in 2002 on a qualified student loan.

**Note:** Effective for 2002, student loan interest qualifies as an adjustment, even if the required payment began more than 60 months ago.

You cannot claim the deduction if:

- Another taxpayer claims an exemption for you as a dependent
- Your filing status is married filing separately, or
- You are not legally obligated to make payments on the loan.

A qualified student loan is a loan you took out to pay qualified expenses. The expenses must have been:

- For you, your spouse, or a person who was your dependent when you took out the loan.
- Paid or incurred within a reasonable time before or after you took out the loan, and
- For education furnished during a period when the recipient was an eligible student.

The student must have been enrolled in a degree, certificate, or other program leading to a recognized educational credential at an eligible institution and must have carried at least on half of a normal full-time workload for the course of study being pursued.

The deduction is phased out ratably over a range that:

- Begins when modified AGI exceeds \$50,000 (\$100,000 if married filing jointly or qualified widow(er), and
- Ends at \$65,000 (\$130,000 if married filing jointly or qualifying widow(er))

If the student paid \$600 or more of interest on a qualifying student loan during the year, the student should receive a Form 1098-E – Student Loan Interest Statement from the financial institution, governmental unit (or any of its subsidiary agencies), educational institutions, or any person to whom you had paid student loan interest of \$600 or more in the course of their trade or business. Interest on a loan from a related party, including the taxpayer's spouse, brothers or sisters, half-brother or sister, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren) **may not** be deducted.

## ***TUITION AND FEES DEDUCTION***

Taxpayers can claim an itemized deduction for education expenses of Form 1040, Schedule A as a miscellaneous expense limited to 2% of AGI.

Beginning in 2002, taxpayers can deduct an amount equal to the qualified tuition and related expenses paid during the tax year as an adjustment to income. The adjustment is reported on Form 1040, line 26, or Form 1040A line 19.

To claim the deduction the taxpayer must have incurred qualified expenses for an eligible student to attend an eligible educational institution during the tax year.

For more information, refer to lesson 4 in Publication 678.

## ***DEDUCTION FOR EDUCATOR EXPENSES***

If the taxpayer or the spouse is an eligible educator, he or she can deduct as an adjustment to income up to \$250 in qualified expenses. The taxpayer can deduct these expenses even if he or she does not itemize deductions on Schedule A. This adjustment to income is for expenses paid or incurred in 2002. Previously, these expenses (without the \$250 limit) were deductible only as a miscellaneous itemized deduction subject to the 2% of AGI limitation.

The taxpayer will be considered an eligible educator if he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide and he or she works at least 900 hours during a school year at a school that provides elementary or secondary education.

Qualified expenses are limited to the non-reimbursed expenses paid or incurred for books, supplies, computer equipment or other related supplementary materials that the taxpayer uses in his or her classroom. For courses in health and physical education, expenses for supplies are qualified expenses only if they relate to athletics.

The educator expense can be claimed on Form 1040, line 23 or Form 1040A, line 18.

### ▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ There are two credits available for qualified educational expenses. The Hope Credit and the Lifetime Learning Credit are non-refundable, educational credits.
- ▶ You cannot claim the Hope Credit and the Lifetime Learning Credit for the same student for the same year.
- ▶ The educational credits are calculated on Form 8863.
- ▶ A new adjustment to income is available for tuition and fees paid by the taxpayer.
- ▶ A new adjustment to income is available for qualified educator's expenses.



# **INDIVIDUAL RETIREMENT ARRANGEMENTS (IRA) AND THRIFT SAVINGS PLAN (TSP)**

LESSON 17

## **OBJECTIVES**

At the end of this lesson you will be able to:

1. Describe what an Individual Retirement Arrangements (IRA) is.
2. List when contributions are tax deductible.
3. Explain the difference between a Traditional IRA and a Roth IRA.
4. List who qualifies to participate in the Thrift Savings Plan (TSP) and the tax benefits for participation.

## **INTRODUCTION**

This lesson describes Individual Retirement Arrangements (IRA), the different types, when contributions to them can be made, how much can be contributed to an IRA and the deadline for making contributions for those serving in a combat zone. This lesson also includes information on the Thrift Savings Plan (TSP). It tells what it is, who is eligible to make contributions and the rules associated when a service member serves in a combat zone.

## **INDIVIDUAL RETIREMENT ARRANGEMENTS (IRA)**

An individual retirement arrangement, or IRA, is a personal savings plan, which allows individuals to set aside money for retirement, while offering tax advantages. Taxpayers may be able to deduct some or all of their contributions to a traditional IRA. Amounts in a traditional IRA, including earnings, generally are not taxed until distributed. IRA's cannot be owned jointly. However, any amounts remaining in an IRA upon a taxpayer's death can be paid to his or her beneficiary or beneficiaries.

The two types of IRA's discussed in this lesson are:

1. Traditional IRA (those that are not Roth or SIMPLE IRA's)
2. Roth IRA, which features nondeductible contributions and tax free distributions.

## Contributions

To contribute to a Traditional IRA, individuals must be under age 70½ at the end of the tax year and they, or their spouse if filing a joint return, must have taxable compensation, such as wages, salaries, commissions, tips, bonuses, or net income from self-employment. In addition, taxable alimony and separate maintenance payments received by an individual are treated as compensation for IRA purposes.

Compensation does not include earnings and profits from property, such as rental income, interest and dividend income or any amount received as pension or annuity income, or as deferred compensation.

Contributions to the Roth IRA are not deductible. The amount that can be contributed is reduced by any amounts contributed to a Traditional IRA. Contributions are first applied to a Traditional IRA, then to a Roth IRA. Contributions to a Roth IRA are permitted after 70½.

For 2002, taxpayers may contribute up to \$3,000 for the year to a Traditional IRA or a Roth IRA. Contributions up to \$3,000 in total may be allocated between the two types of IRAs.

Under a special catch-up provision, individuals who are age 50 or older before the close of the taxable year may make additional contributions. The catch-up provision increases the maximum annual contribution amount for future taxable years by \$500.

## Deductibility of Contributions to Traditional IRAs

The contributions made to a Traditional IRA may be deductible for income tax purposes. As military members are deemed "active participants" in a qualified retirement plan, the portion of the contribution to a Traditional IRA they may deduct can decline or be eliminated altogether. **IMPORTANT** — all non-deductible contributions to Traditional IRAs are not taxed when the funds are withdrawn. They were already taxed because they could not be deducted when made. If either the Traditional IRA account holder or their spouse is an active participant in a qualified retirement plan, then the amount deductible is reduced or eliminated once the adjusted gross income exceeds a certain amount (see Publication 590 for more information).

## Premature Withdrawals — Traditional IRA's

Taxpayers are subject to an additional ten-percent income tax, which will be imposed on the taxable portion of a distribution from an IRA if the early withdrawal is taken before the account holder reaches age 59½, unless an exception applies.

## Conversions From Traditional IRAs

Traditional IRA can be converted or rolled into a Roth IRA as long as the taxpayer is either a single filer or a married person filing jointly whose modified adjusted gross income does not exceed \$100,000.

Traditional IRA to Roth IRA conversions are not allowed for married persons filing separate returns. A married person filing separately, who has lived apart from his or her spouse for the entire year is treated as single for this purpose.

The regulations specify three methods by which such a conversion can occur.

- a. A distribution from a Traditional IRA that is rolled over to a Roth IRA within 60 days;
- b. A financial institution to transfer from a Traditional IRA to a Roth IRA; or
- c. A transfer from a Traditional IRA to a Roth maintained by the same trustee.

The taxable portion of the IRA will be subject to income tax, but not to the ten percent additional income tax for premature withdrawals or the six percent excess contribution excise tax.

The ten percent early withdrawal penalty tax applies to a Traditional IRA rollover conversion that is distributed to the account holder within the five-taxable-year period beginning in the year in which it was made as if that amount is included in gross income, unless an exception applies.

## Military Taxpayers

The deadline for making a contribution to a Traditional IRA for the year is the due date of your return, not including any extensions of time to file. Military members deployed to a certified combat zone have additional time to make a qualified retirement contribution to an IRA until 180 days after the late of:

- The last day you are in a combat zone/qualified hazardous duty area or have qualifying service outside of the combat zone/qualified hazardous duty area (or the last day the area qualifies as a combat zone or qualified hazardous duty area), or

- The last day of any continuous qualified hospitalization (defined later) for injury from service in the combat zone/qualified hazardous duty area or while performing qualifying service outside of the combat zone/qualified hazardous duty area.

## ***THRIFT SAVINGS PLAN (TSP)***

The Thrift Savings Plan (TSP) is a retirement savings and investment plan that has been available to civilian employees of the Federal Government since 1987 and was made available to members of the Armed Forces members in 2002. The purpose of the TSP is to provide retirement income. It offers participants the same type of savings and tax benefits that many private corporations offer their employees. The TSP allows participants to save a portion of their pay in a special retirement account administered by the Federal Retirement Thrift Investment Board. The money that participants invest in the TSP comes from pre-tax dollars and reduces their current taxable income; investments and earnings are not taxed until they are withdrawn.

### **Participation.**

The TSP differs from the Military Retirement System in that participation in the TSP is optional and not automatic. Armed Forces members must sign up with their service to participate in the TSP. They contribute to the TSP from their own pay on a pre-tax basis, and the amount they contribute and the earnings attributable to their contributions belong to the service member. They are the service member's to keep even if they do not serve the 20 years ordinarily necessary to receive military retired pay.

Uniformed members of the Army, Navy, Air Force, Marine Corps, Coast Guard, Public Health Service, and the National Oceanic and Atmospheric Administration serving on active duty and members of the Ready Reserve or National Guard of those services (as applicable) in any pay status can contribute to the TSP.

### **Contributions**

In 2002, service members could contribute up to 7% of their basic pay earned each month. Service members were also able to contribute all or any whole percentage of any special or incentive pay (including reenlistment or other bonuses) they receive. However, the total amount they can contribute each year cannot exceed the Internal Revenue Code's elective deferral limit of \$11,000 for 2002.

A service members' payroll office will deduct contributions from military pay each month based on the election and will remit these contributions to the TSP. Service members cannot send a check to the TSP; once the service member receives his pay, he or she cannot contribute any of it to the TSP.

### **Combat Zone rules.**

If the service member served in a combat zone, special rules apply. Because all or part of pay earned during a month a combat zone is tax exempt, they do not receive the benefit of tax deferral when they contribute it to the TSP. As a consequence, contributions from tax-exempt pay are not subject to the elective deferral limit.

### **Tax Saver's Credit**

Members, who participate in the TSP during tax years 2002 through 2006, may be eligible for a tax credit on their federal income tax return for each year they contribute to the plan. For married members who file a joint return, the maximum credit is \$2,000.

For single members, the maximum credit is \$1,000. However, the amount of the tax credit may be offset by any taxable distribution paid directly to them by the TSP. This benefit, called the saver's tax credit, is available to participants with an adjusted gross income of no more than \$50,000 if married filing jointly, \$37,500 if head of household, or \$25,000 if single or married filing separately.

## **▶▶ SUMMING UP THIS LESSON ◀◀**

In this lesson you have learned that:

- ▶ Taxpayers can contribute up to \$3,000 \$6,000 if married, to a Traditional IRA or Roth IRA in 2002. Only contributions to a Traditional IRA are tax deductible.
- ▶ Military members deployed to a combat zone have 180 days of additional time, to make qualified retirement contribution to an IRA, after they leave the combat zone.
- ▶ The Thrift Savings Plan is a retirement savings and investment plan that is now available to members of the Armed Forces. Service members could contribute up to 7 percent of their basic pay earned each month in 2002. Service members were also able to contribute all or any whole percentage of special, incentive, or bonus pay they received. The maximum amount they could contribute in 2002 was \$11,000.

**STUDENT NOTES**



### OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine when business income must be reported using the schedule C or C-EZ.
2. Determine when a Schedule SE must be filed.
3. Properly complete the Schedule E.

### INTRODUCTION

In lesson 1 we discussed what the definition of Gross Income is. Included in that definition was self employment income. In this lesson we will discuss how to handle self-employment income and what is required in order to prepare a tax return with a schedule C or C-EZ. Many military members and their spouses may earn additional income as sole proprietors and not be aware of their responsibility to report it. In some cases, income received is reported to those individuals by means of Form 1099-MISC. In other cases just cash or checks are received through the mail or personally handed to the taxpayer.

### DETERMINING WHICH TAX YEAR TO REPORT THE BUSINESS INCOME

Under the cash method, a self-employed taxpayer includes in his or her business gross income all items of income actually or constructively received during the tax year. If a taxpayer received property or services, he or she must include the fair market value of those items received in income.

#### Example

On December 30, 2001, a customer mailed a check for interior decorating services provided by Kathy (your taxpayer). Kathy received the check on January 2, 2002. Kathy must include the amount of the check in income for 2002.

**Constructive receipt.** You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent received it.

**Example**

Interest is credited to your bank account in December 2002. You do not withdraw it or enter it into your passbook until 2003. You must include it in your gross income for 2002.

**Delaying receipt of income.** You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

**Example**

Frances Jones, a service contractor, was entitled to receive a \$10,000 payment on a contract in December 2002. She was told in December that her payment was available. At her request, she was not paid until January 2003. She must include this payment in her 2002 income because it was constructively received in 2002.

**Checks.** Receipt of a valid check by the end of the tax year is constructive receipt of income in that year, even if you cannot cash or deposit the check until the following year.

**Example**

Mrs. Redd received a check for \$500 on December 31, 2002, from a parent in her day care business. She could not deposit the check in her business account until January 2, 2003. She must include this fee in her income for 2002.

## **INCOME**

Business income may be reported to taxpayers in various ways or even not at all. Some taxpayers receive informational returns such as the 1099 MISC other times it may be just a check or cash for services performed. Regardless of how income is received, self-employed taxpayers are responsible for recording the amount of income received, and related expenses, in their permanent books of record. Normally, the easiest record keeping is maintaining a separate business checking account.

From these records the taxpayer should be able to state to you the total gross receipts or sales for the year, any returns and allowances (although normally a cash based taxpayer should not have any of these since income is reported at the end of the year) and the Cost of Goods Sold. We will discuss deductions for expenses later in the lesson.

# DEDUCTIONS FOR EXPENSES

In earlier chapters you learned about deductions from gross income. The same concept applies to business gross income. Self-employed taxpayers are allowed to deduct from income those “ordinary and necessary” expenses paid or incurred during the taxable year in carrying out a trade or business.

## Auto Expenses

Business auto expenses can be calculated by either the actual cost method or the standard mileage method. The taxpayer usually makes the choice of which method to use the first year that the vehicle is used for the business. It is permissible to switch from the standard mileage method to the actual expense method; however, taxpayers generally are not permitted to switch from actual method to the standard mileage method.

**The Standard Mileage Method** is available for both owned and leased autos. However, the vehicle must not be used for hire (such as a taxi or shuttle van). The election to use the standard mileage method must generally be made in the year the auto is first used in business. In a later year the taxpayer may switch to the actual expense method but cannot claim any depreciation, if the vehicle is considered fully depreciated. In leased cars the standard mileage method must be for the entire lease period of the auto.

In 2002 the standard mileage rate is 36.5¢.

Expenses not included in the standard mileage allowance and deductible in addition to the standard mileage allowance are business parking fees and tolls, and interest on auto loan (business portion).

A taxpayer is limited to the actual expense method if any of the following are true:

1. ACRS or MACRS Depreciation has previously been claimed on the auto.
2. A section 179 expense has been claimed on the auto.
3. Any method of depreciation on the auto other than straight line over the estimated useful life of the auto.

Under this method the taxpayer determines the actual cost of those items listed under the standard mileage rate and deducts that amount. Both methods should be considered to determine which gives the most beneficial deduction to the taxpayer.

## **CRITERIA FOR FILING SCHEDULE C-EZ AND SCHEDULE C**

In order to file the EZ version of the Schedule C the taxpayer must meet the criteria listed below:

1. Have less than \$2,500 in business expenses
2. Use the Cash method of accounting
3. Have no inventory at any time during the year
4. Have positive net income (not have a net loss)
5. Operate only one business as a sole proprietor during the tax year
6. Have no employees during the year.

### **Example**

Jerry owns and operates a one-person tax preparation business during the filing season. His income is \$1,500 accounted for via the cash method; this is the only business he operated during the year. He has the following expenses, paper \$400, and ink \$200. Since Jerry's expenses total \$600 Jerry has met all the requirements and therefore can use the Schedule CEZ for reporting his business income.

### **Exercise 1**

Jim is the civilian spouse of Lt. Carry Ann. He operates a business (sole proprietorship) as a lawyer. His gross income from business is \$70,000. His total business expenses amount to \$1,800. He can use the Schedule C-EZ yes or no?

Answer \_\_\_\_\_

## Exercise 2

Martha is the wife of Stuart, a Marine stationed in California. During the year Martha operates a sole proprietorship called Squared Away Child Care services. She comes to you for help with her return. A review of her records reflect the following:

Income: \$6,700

Expenses:

Advertising	\$600
Car & Truck	\$150
Office Expense	\$500
Toys and Games	\$200
Telephone	\$800
Utilities	<u>\$300</u>
Total Expenses	\$2,550
Net Income	\$4,150

Should Martha file a Schedule C or Schedule C-EZ?

Answer \_\_\_\_\_

## SCHEDULE SE

If the net income on the Schedule C or Schedule C-EZ is \$400 or more, you will need to file a Schedule SE. The Schedule SE calculates the self-employment tax, which is comprised of the Social Security and Medicare taxes.

## SCHEDULE E

For the military, rental income and expenses is a frequent occurrence since many military members are not able to sell their homes when they get orders to relocate. Many homeowners rent out their old home. The income and the expenses from the rental of the property are recorded on Schedule E. This section will provide basic guidance on how to complete the Schedule E.

We will not discuss the calculation of depreciation. Depreciation is a complex subject. If the taxpayer provides you with the depreciation amount, you can enter it on the tax return. If the taxpayer does not know the depreciation amount, you may need to refer them to a paid tax professional.

In the first year of the rental, you might have to divide the mortgage interest and real estate taxes between Schedule A and Schedule E. You simply divide the total mortgage interest

and property taxes by twelve and multiply by the number of months the home was used for each purpose.

**Example**

Sgt Jones lived in his home through September 2002. He got orders and rented his home out in October. Nine months of the mortgage interest and property taxes would go on his Schedule A and the other three months would go on the Schedule E. Remember, also, that three months of his property insurance is also a deductible item on Schedule E, even though this expense is not deductible when the home is his residence.

Other expenses that are deductible for rental property are: cleaning and maintenance, repairs, utilities that are paid for the tenant, legal and professional fees, management fees you pay a real estate company or individual to care for your property in your absence, auto and travel expense to check on the property, long distance phone calls, etc.

Once you deduct all of the expenses and the depreciation from the rent received, you may come up with a loss. The net income or loss from rental property is usually considered passive. If the taxpayer actively participates in the renting of the property (such as making decisions, determining who can rent the property), the loss is fully deductible.

**▶▶ SUMMING UP THIS LESSON ◀◀**

- ▶ Business income is reported on either a Schedule C or C-EZ.
- ▶ The Schedule C-EZ has limited use.
- ▶ Schedule SE is used to calculate the self-employment tax when the net business income exceeds \$400.
- ▶ Schedule E is used to report rent and royalty income.

**ANSWERS TO EXERCISES**

1. Yes
2. Schedule C



# ***SUMMARY PROBLEMS***

## ***PROBLEM 1***

Sgt. Michael A. Adams, SSN 271-00-3456, is stationed in Heidelberg, Germany, on April 15, 2003. He and his wife, Frieda F., a citizen of Germany, SSN 654-00-3217, want to make the special choice to file a joint return. They have one son, John, age 4, SSN 231-00-6457, who qualifies as their dependent. Their address in Heidelberg is 3/45 Aviation Bn, APO New York 09036.

Sgt. Adams had the following sources of income: wages of \$33,520; interest of \$40; uniform allowance of \$150; and basic allowance for housing (BAH) of \$7,480. Sgt. Adams had \$2,500 of federal income tax withheld from his wages. His wife had no income. Both spouses want to contribute \$3 to the Presidential Election Campaign Fund.

- a.** When should the Adamses file their return?

Answer \_\_\_\_\_

- b.** Complete Form 1040A for Sgt. Adams and his wife.

Form 1040A U.S. Individual Income Tax Return (99) 2002 Department of the Treasury—Internal Revenue Service IRS Use Only—Do not write or staple in this space.

Label (See page 19.)

Use the IRS label. Otherwise, please print or type.

Form fields for name, address, and social security numbers.

Fields for OMB No. 1545-0085 and social security numbers.

Important! You must enter your SSN(s) above.

Presidential Election Campaign (See page 20.)

Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund?

Filing status

- 1 Single, 2 Married filing jointly, 3 Married filing separately, 4 Head of household, 5 Qualifying widow(er) with dependent child.

Check only one box.

Exemptions

Exemption section including 6a Yourself, 6b Spouse, 6c Dependents, and 6d Total number of exemptions claimed.

Income

Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 25.

Enclose, but do not attach, any payment.

Main income section with lines 7 through 21 for wages, interest, dividends, and adjustments.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 53.

Cat. No. 11327A

Form 1040A (2002)

Form 1040A (2002)

Page 2

<b>Tax, credits, and payments</b>	<b>22</b>	Enter the amount from line 21 (adjusted gross income).	22	
	<b>23a</b>	Check <input type="checkbox"/> You were 65 or older <input type="checkbox"/> Blind	Enter number of boxes checked ▶ 23a <input type="checkbox"/>	
		if: <input type="checkbox"/> Spouse was 65 or older <input type="checkbox"/> Blind		
	<b>b</b>	If you are married filing separately and your spouse itemizes deductions, see page 32 and check here . . . . . ▶ 23b <input type="checkbox"/>		
	<b>24</b>	Enter your <b>standard deduction</b> (see left margin).	24	
	<b>25</b>	Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25	
	<b>26</b>	Multiply \$3,000 by the total number of exemptions claimed on line 6d.	26	
	<b>27</b>	Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your <b>taxable income</b> .	▶ 27	
	<b>28</b>	<b>Tax, including any alternative minimum tax</b> (see page 33).	28	
	<b>29</b>	Credit for child and dependent care expenses. Attach Schedule 2.	29	
<b>30</b>	Credit for the elderly or the disabled. Attach Schedule 3.	30		
<b>31</b>	Education credits. Attach Form 8863.	31		
<b>32</b>	Retirement savings contributions credit. Attach Form 8880.	32		
<b>33</b>	Child tax credit (see page 36).	33		
<b>34</b>	Adoption credit. Attach Form 8839.	34		
<b>35</b>	Add lines 29 through 34. These are your <b>total credits</b> .	35		
<b>36</b>	Subtract line 35 from line 28. If line 35 is more than line 28, enter -0-.	36		
<b>37</b>	Advance earned income credit payments from Form(s) W-2.	37		
<b>38</b>	Add lines 36 and 37. This is your <b>total tax</b> .	▶ 38		
<b>39</b>	Federal income tax withheld from Forms W-2 and 1099.	39		
<b>40</b>	2002 estimated tax payments and amount applied from 2001 return.	40		
<b>41</b>	<b>Earned income credit (EIC).</b>	41		
<b>42</b>	Additional child tax credit. Attach Form 8812.	42		
<b>43</b>	Add lines 39 through 42. These are your <b>total payments</b> .	▶ 43		
<b>Refund</b>	<b>44</b>	If line 43 is more than line 38, subtract line 38 from line 43. This is the amount you <b>overpaid</b> .	44	
	<b>45a</b>	Amount of line 44 you want <b>refunded to you</b> .	▶ 45a	
	<b>b</b>	Routing number <input type="text"/> ▶ <b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
<b>d</b>	Account number <input type="text"/>			
<b>46</b>	Amount of line 44 you want <b>applied to your 2003 estimated tax</b> .	46		
<b>Amount you owe</b>	<b>47</b>	<b>Amount you owe.</b> Subtract line 43 from line 38. For details on how to pay, see page 48.	▶ 47	
	<b>48</b>	Estimated tax penalty (see page 48).	48	
<b>Third party designee</b>	Do you want to allow another person to discuss this return with the IRS (see page 49)? <input type="checkbox"/> <b>Yes.</b> Complete the following. <input type="checkbox"/> <b>No</b>			
	Designee's name ▶	Phone no. ▶ ( )	Personal identification number (PIN) ▶	<input type="text"/>
<b>Sign here</b>	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.			
	Your signature	Date	Your occupation	Daytime phone number ( )
	Spouse's signature. If a joint return, <b>both</b> must sign.	Date	Spouse's occupation	
	Preparer's signature ▶	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
<b>Paid preparer's use only</b>	Firm's name (or yours if self-employed), address, and ZIP code ▶	EIN	Phone no. ( )	



## PROBLEM 2

Capt. Margaret A. Williams, SSN 271-00-6543, a legal assistance officer, is single. She was transferred from Scott Air Force Base in Illinois to Andrews Air Force Base in Maryland. On February 8, 2002, she sold her home in Illinois for \$132,000. She had originally bought this home for \$76,000 in December 1998. She had lived in it since January 3, 1999. On March 12, 2002, she bought a new home at 3219 33rd Ave., Hyattsville, MD 20782, for \$110,000.

She also incurred the following moving expenses:

Transportation of household goods (provided in kind by the Air Force)	\$2,800
Travel and lodging en route	\$ 225
Meals en route	\$ 125

The Air Force did not reimburse Captain Williams for the travel expense and she was not eligible to receive a dislocation allowance.

Captain Williams' Form W-2 shows wages of \$36,800. She had interest income of \$175. She knows her BAH is not taxable. She also had a uniform allowance of \$200. She had no other sources of income. Her federal income tax withheld was \$4,200. She has no dependents. Captain Williams would like to contribute \$3 to the Presidential Election Campaign Fund.

Captain Williams had the following itemized deductions for the year:

Contributions to church	\$ 700
Real estate taxes	\$1,300
Deductible home mortgage interest	\$6,600

Prepare Captain Williams' Form 1040, Schedule A, and Form 3903, *Moving Expenses*.



Form 1040

Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return 2002

(99) IRS Use Only—Do not write or staple in this space.

Label

(See instructions on page 19.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE

For the year Jan. 1–Dec. 31, 2002, or other tax year beginning , 2002, ending , 20
Your first name and initial Last name
If a joint return, spouse's first name and initial Last name
Home address (number and street). If you have a P.O. box, see page 19. Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.

OMB No. 1545-0074

Your social security number
Spouse's social security number

Important! You must enter your SSN(s) above.

Presidential Election Campaign (See page 19.)

Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund? Yes No

You Spouse Yes No Yes No

Filing Status

Check only one box.

- 1 Single
2 Married filing jointly (even if only one had income)
3 Married filing separately. Enter spouse's SSN above and full name here.
4 Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 Qualifying widow(er) with dependent child (year spouse died ). (See page 19.)

Exemptions

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.
b Spouse
c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 20)
d Total number of exemptions claimed

No. of boxes checked on 6a and 6b
No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see page 20)
Dependents on 6c not entered above
Add numbers on lines above

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Table with 2 columns: Description (7 Wages, salaries, tips, etc. Attach Form(s) W-2; 8a Taxable interest; 9 Ordinary dividends; 10 Taxable refunds, credits, or offsets; 11 Alimony received; 12 Business income; 13 Capital gain; 14 Other gains; 15a IRA distributions; 16a Pensions and annuities; 17 Rental real estate; 18 Farm income; 19 Unemployment compensation; 20a Social security benefits; 21 Other income; 22 Total income) and Line Number (7-22).

Adjusted Gross Income

Table with 2 columns: Description (23 Educator expenses; 24 IRA deduction; 25 Student loan interest; 26 Tuition and fees; 27 Archer MSA; 28 Moving expenses; 29 Self-employment tax; 30 Self-employed health insurance; 31 Self-employed SEP, SIMPLE, and qualified plans; 32 Penalty on early withdrawal; 33a Alimony paid; 34 Total adjustments; 35 Adjusted gross income) and Line Number (23-35).

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72.

Cat. No. 11320B

Form 1040 (2002)

Summary Problems

SP-5



**SCHEDULES A&B**  
**(Form 1040)**

**Schedule A-Itemized Deductions**

OMB No. 1545-0074

**2002**

Attachment  
Sequence No. **07**

Department of the Treasury  
Internal Revenue Service (99)

(Schedule B is on back)

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedules A and B (Form 1040).**

Name(s) shown on Form 1040

Your social security number

<b>Medical and Dental Expenses</b>	<b>1</b>	Medical and dental expenses (see page A-2)	<b>1</b>				
	<b>2</b>	Enter amount from Form 1040, line 36 <b>2</b>	<b>3</b>				
	<b>3</b>	Multiply line 2 above by 7.5% (.075)	<b>3</b>				
	<b>4</b>	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	<b>4</b>				
<b>Taxes You Paid</b> (See page A-2.)	<b>5</b>	State and local income taxes	<b>5</b>				
	<b>6</b>	Real estate taxes (see page A-2)	<b>6</b>				
	<b>7</b>	Personal property taxes	<b>7</b>				
	<b>8</b>	Other taxes. List type and amount ▶	<b>8</b>				
	<b>9</b>	Add lines 5 through 8	<b>9</b>				
<b>Interest You Paid</b> (See page A-3.)	<b>10</b>	Home mortgage interest and points reported to you on Form 1098	<b>10</b>				
	<b>11</b>	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	<b>11</b>				
	<b>12</b>	Points not reported to you on Form 1098. See page A-3 for special rules	<b>12</b>				
	<b>13</b>	Investment interest. Attach Form 4952 if required. (See page A-3.)	<b>13</b>				
<b>Gifts to Charity</b> If you made a gift and got a benefit for it, see page A-4.	<b>14</b>	Add lines 10 through 13	<b>14</b>				
	<b>15</b>	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	<b>15</b>				
	<b>16</b>	Other than by cash or check. If any gift of \$250 or more, see page A-4. You <b>must</b> attach Form 8283 if over \$500	<b>16</b>				
	<b>17</b>	Carryover from prior year	<b>17</b>				
<b>18</b>	Add lines 15 through 17	<b>18</b>					
<b>Casualty and Theft Losses</b>	<b>19</b>	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)	<b>19</b>				
<b>Job Expenses and Most Other Miscellaneous Deductions</b> (See page A-5 for expenses to deduct here.)	<b>20</b>	Unreimbursed employee expenses—job travel, union dues, job education, etc. You <b>must</b> attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶	<b>20</b>				
	<b>21</b>	Tax preparation fees	<b>21</b>				
	<b>22</b>	Other expenses—investment, safe deposit box, etc. List type and amount ▶	<b>22</b>				
	<b>23</b>	Add lines 20 through 22	<b>23</b>				
	<b>24</b>	Enter amount from Form 1040, line 36 <b>24</b>	<b>24</b>				
	<b>25</b>	Multiply line 24 above by 2% (.02)	<b>25</b>				
<b>26</b>	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	<b>26</b>					
<b>Other Miscellaneous Deductions</b>	<b>27</b>	Other—from list on page A-6. List type and amount ▶	<b>27</b>				
<b>Total Itemized Deductions</b>	<b>28</b>	Is Form 1040, line 36, over \$137,300 (over \$68,650 if married filing separately)? <input type="checkbox"/> <b>No.</b> Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 38. <input type="checkbox"/> <b>Yes.</b> Your deduction may be limited. See page A-6 for the amount to enter.	<b>28</b>				

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11330X

Schedule A (Form 1040) 2002

Form **3903**

(Rev. October 2002)  
Department of the Treasury  
Internal Revenue Service

**Moving Expenses**

▶ Attach to Form 1040.

OMB No. 1545-0062

Attachment  
Sequence No. **62**

Name(s) shown on Form 1040

Your social security number

**Before you begin:** ✓ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.  
✓ If you are a member of the armed forces, see the instructions to find out how to complete this form.

1	Enter the amount you paid for transportation and storage of household goods and personal effects (see instructions)	1	
2	Enter the amount you paid for travel and lodging expenses in moving from your old home to your new home. <b>Do not</b> include the cost of meals (see instructions)	2	
3	Add lines 1 and 2	3	
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is <b>not</b> included in the wages box (box 1) of your W-2 form. This amount should be identified with code <b>P</b> in box 12 of your W-2 form	4	
5	Is line 3 <b>more than</b> line 4?  <input type="checkbox"/> <b>No.</b> You <b>cannot</b> deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on the "Wages, salaries, tips, etc." line of Form 1040.  <input type="checkbox"/> <b>Yes.</b> Subtract line 4 from line 3. Enter the result here and on the "Moving expenses" line of Form 1040. This is your <b>moving expense deduction</b>	5	

**General Instructions**

**A Change To Note**

Beginning in 2002, the standard mileage rate for using your vehicle to move to a new home is 13 cents a mile.

**Purpose of Form**

Use Form 3903 to figure your moving expense deduction for a move related to the start of work at a new principal place of work (workplace). If the new workplace is outside the United States or its possessions, you must be a U.S. citizen or resident alien to deduct your expenses.

If you qualify to deduct expenses for more than one move, use a separate Form 3903 for each move.

For more details, see **Pub. 521**, Moving Expenses.

**Who May Deduct Moving Expenses**

If you move to a new home because of a new principal workplace, you may be able to deduct your moving expenses whether you are self-employed or an employee. But you must meet both of the tests explained next.

**Distance Test**

Your new principal workplace must be at least 50 miles farther from your old home than your old workplace was. For example, if your old workplace was 3 miles from your old home, your new workplace must be at least 53 miles from that home. If you did not have an old workplace, your new workplace must be at least 50 miles from your old home. The distance between the two points is the shortest of the more commonly traveled routes between them.



To see if you meet the distance test, you can use the worksheet below.

**Distance Test Worksheet**

Keep a Copy for Your Records



Members of the armed forces may not have to meet this test. For details, see the instructions on the back of this form.

1. Enter the number of miles from your **old home** to your **new workplace** . . . . . 1. \_\_\_\_\_ miles
2. Enter the number of miles from your **old home** to your **old workplace** . . . . . 2. \_\_\_\_\_ miles
3. Subtract line 2 from line 1. If zero or less, enter -0- . . . . . 3. \_\_\_\_\_ miles

**Is line 3 at least 50 miles?**

- Yes.** You meet this test.
- No.** You do not meet this test. You **cannot** deduct your moving expenses. **Do not** complete Form 3903.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 12490K

Form **3903** (Rev. 10-2002)



# ANSWERS TO SUMMARY PROBLEMS

## PROBLEM 1

- a. Michael and Frieda Adams are allowed an automatic extension until June 15 because they are outside the United States on April 15.
- b. See Exhibits P-1 and P-2. (Filled-in Form 1040A)

### Note:

- Sgt. Adams and his wife do not qualify for the earned income tax credit (EIC) because their taxable earned income and AGI are each more than \$30,201, the 2002 earned income threshold for married taxpayers filing a joint return, and their son is a qualifying child.
- Sgt. Adams and his wife are entitled to the maximum *child tax credit* allowed for 2002 (\$600) because their AGI for this purpose is under \$110,000. This credit is covered in the Volunteer Assistor's Guide.

### IMPORTANT REMINDER:

Since Michael and his wife, Frieda, are filing a 2002 joint income tax return for the first time, they did not receive an IRS peel-off label generally mailed to filers. They must write their names and social security numbers (SSNs) in the label section of the return.

Because the IRS uses the first name and SSN on a joint return as a **primary account number**, it is important that Michael's name and social security number always be listed first for consistency in the processing of joint returns.

**Social Security numbers** must be entered on the Forms 1040, 1040A, and 1040EZ because they are not shown on the preprinted label.

## ***PROBLEM 2***

See Exhibits P-3 through P-6. (Filled-in Form 1040)

**Note:**

- Most taxpayers will not have a gain on the sale of their principal residence over the \$250,000 (\$500,000 for a married couple filing jointly) exclusion amount. Captain Williams does not have a taxable gain. Sale of home is discussed in lesson 13 of the Volunteer Assistor's Guide and in Publication 523, *Selling Your Home*.
- Captain Williams' meal expenses are not deductible moving expenses.



Form **1040A** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** (99) **2002** IRS Use Only—Do not write or staple in this space.

**Label**  
(See page 19.)

LABEL HERE	Your first name and initial <b>Michael A.</b>	Last name <b>Adams</b>
	If a joint return, spouse's first name and initial <b>Frieda F.</b>	Last name <b>Adams</b>
	Home address (number and street). If you have a P.O. box, see page 20. <b>3145 Aviation Bn</b>	
	City, town or post office, state, and ZIP code. If you have a foreign address, see page 20. <b>APO New York 09036</b>	
	Apt. no.	

OMB No. 1545-0085  
**Your social security number**  
**271 : 00 : 3456**  
**Spouse's social security number**  
**654 : 00 : 3217**

**Presidential Election Campaign**  
(See page 20.)

**Note.** Checking "Yes" will not change your tax or reduce your refund.  
 Do you, or your spouse if filing a joint return, want \$3 to go to this fund? 
 **You Yes**  **No**  **Spouse Yes**  **No**

**Filing status**

- 1  Single
- 2  Married filing jointly (even if only one had income)
- 3  Married filing separately. Enter spouse's SSN above and full name here.
- 4  Head of household (with qualifying person). (See page 21.) If the qualifying person is a child but not your dependent, enter this child's name here.
- 5  Qualifying widow(er) with dependent child (year spouse died ▶ ). (See page 22.)

**Exemptions**

6a  **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a. No. of boxes checked on 6a and 6b **2**

b  **Spouse**

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 23)	No. of children on 6c who: • lived with you <b>1</b> • did not live with you due to divorce or separation (see page 24)
John	Adams	231 : 00 : 6457	son	<input checked="" type="checkbox"/>	
				<input type="checkbox"/>	
				<input type="checkbox"/>	
				<input type="checkbox"/>	

d Total number of exemptions claimed. Add numbers on lines above **3**

**Income**

**Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld.**

<b>7</b> Wages, salaries, tips, etc. Attach Form(s) W-2.	7	33,520	00
<b>8a</b> Taxable interest. Attach Schedule 1 if required.	8a	40	00
<b>b</b> Tax-exempt interest. Do not include on line 8a.	8b		
<b>9</b> Ordinary dividends. Attach Schedule 1 if required.	9		
<b>10</b> Capital gain distributions (see page 25).	10		
<b>11a</b> IRA distributions.	11a		
<b>11b</b> Taxable amount (see page 25).	11b		
<b>12a</b> Pensions and annuities.	12a		
<b>12b</b> Taxable amount (see page 26).	12b		
<b>13</b> Unemployment compensation and Alaska Permanent Fund dividends.	13		
<b>14a</b> Social security benefits.	14a		
<b>14b</b> Taxable amount (see page 28).	14b		
<b>15</b> Add lines 7 through 14b (far right column). This is your <b>total income</b> .	15	33,560	00
<b>16</b> Educator expenses (see page XX).	16		
<b>17</b> IRA deduction (see page 28).	17		
<b>18</b> Student loan interest deduction (see page 31).	18		
<b>19</b> Tuition and fees deduction (see page XX).	19		
<b>20</b> Add lines 16 through 19. These are your <b>total adjustments</b> .	20		
<b>21</b> Subtract line 20 from line 15. This is your <b>adjusted gross income</b> .	21	33,560	00

**Adjusted gross income**

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 53.

Cat. No. 11327A

Form **1040A** (2002)

Form 1040A (2002)

Page 2

**Tax, credits, and payments**

**22** Enter the amount from line 21 (adjusted gross income). 22 33,560 00

**23a** Check  You were 65 or older  Blind  Spouse was 65 or older  Blind Enter number of boxes checked ▶ 23a

**b** If you are married filing separately and your spouse itemizes deductions, see page 32 and check here ▶ 23b

**Standard Deduction for—**

- People who checked any box on line 23a or 23b or who can be claimed as a dependent, see page 33.
- All others:
  - Single, \$4,700
  - Head of household, \$6,900
  - Married filing jointly or Qualifying widow(er), \$7,850
  - Married filing separately, \$3,925

**24** Enter your **standard deduction** (see left margin). 24 7,850 00

**25** Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-. 25 25,710 00

**26** Multiply \$3,000 by the total number of exemptions claimed on line 6d. 26 9,000 00

**27** Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your **taxable income**. ▶ 27 16,710 00

**28 Tax**, including any alternative minimum tax (see page 33). 28 1,909 00

**29** Credit for child and dependent care expenses. Attach Schedule 2. 29

**30** Credit for the elderly or the disabled. Attach Schedule 3. 30

**31** Education credits. Attach Form 8863. 31

**32** Retirement savings contributions credit. Attach Form 8880. 32

**33** Child tax credit (see page 36). 33 600 00

**34** Adoption credit. Attach Form 8839. 34

**35** Add lines 29 through 34. These are your **total credits**. 35 600 00

**36** Subtract line 35 from line 28. If line 35 is more than line 28, enter -0-. 36 1,309 00

**37** Advance earned income credit payments from Form(s) W-2. 37

**38** Add lines 36 and 37. This is your **total tax**. ▶ 38 1,309 00

**39** Federal income tax withheld from Forms W-2 and 1099. 39 2,500 00

**40** 2002 estimated tax payments and amount applied from 2001 return. 40

**41 Earned income credit (EIC)**. 41

**42** Additional child tax credit. Attach Form 8812. 42

**43** Add lines 39 through 42. These are your **total payments**. ▶ 43 2,500 00

If you have a qualifying child, attach Schedule EIC.

**Refund**

**44** If line 43 is more than line 38, subtract line 38 from line 43. This is the amount you **overpaid**. 44 1,191 00

**45a** Amount of line 44 you want **refunded to you**. ▶ 45a 1,191 00

▶ **b** Routing number  ▶ **c** Type:  Checking  Savings

▶ **d** Account number

**46** Amount of line 44 you want **applied to your 2003 estimated tax**. 46

**Amount you owe**

**47 Amount you owe**. Subtract line 43 from line 38. For details on how to pay, see page 48. ▶ 47

**48** Estimated tax penalty (see page 48). 48

**Third party designee** Do you want to allow another person to discuss this return with the IRS (see page 49)?  Yes. Complete the following.  No

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

**Sign here** Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Michael A. Adams	4-15-03	US Army, Active	( )
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	
Frieda F. Adams	4-15-03	Homemaker	

**Paid preparer's use only**

Preparer's signature ▶ Date ▶ Check if self-employed  Preparer's SSN or PTIN ▶

Firm's name (or yours if self-employed), address, and ZIP code ▶ EIN ▶ Phone no. ( ) ▶



Form 1040

Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return 2002

(99) IRS Use Only—Do not write or staple in this space.

Label

(See instructions on page 19.)

Use the IRS label.

Otherwise, please print or type.

LABEL HERE

For the year Jan. 1-Dec. 31, 2002, or other tax year beginning , 2002, ending , 20

OMB No. 1545-0074

Your first name and initial Margaret A.

Last name Williams

Your social security number 271 00 6543

If a joint return, spouse's first name and initial

Last name

Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 19.

Apt. no.

3219 33rd Avenue

City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.

Hyattsville, MD 20782

Important!

You must enter your SSN(s) above.

Presidential Election Campaign (See page 19.)

Note. Checking "Yes" will not change your tax or reduce your refund.

Do you, or your spouse if filing a joint return, want \$3 to go to this fund?

You Spouse Yes No Yes No

Filing Status

Check only one box.

- 1 Single, 2 Married filing jointly, 3 Married filing separately, 4 Head of household, 5 Qualifying widow(er)

Exemptions

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a

b Spouse

c Dependents: (1) First name, Last name, (2) Dependent's social security number, (3) Dependent's relationship to you, (4) if qualifying child for child tax credit

If more than five dependents, see page 20.

No. of boxes checked on 6a and 6b: 1. No. of children on 6c who: lived with you, did not live with you due to divorce or separation

d Total number of exemptions claimed: 1

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Table with 2 columns: Description (7 Wages, salaries, tips, etc.; 8a Taxable interest; 9 Ordinary dividends; 10 Taxable refunds, credits, or offsets of state and local income taxes; 11 Alimony received; 12 Business income or (loss); 13 Capital gain or (loss); 14 Other gains or (losses); 15a IRA distributions; 16a Pensions and annuities; 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc.; 18 Farm income or (loss); 19 Unemployment compensation; 20a Social security benefits; 21 Other income; 22 Add the amounts in the far right column for lines 7 through 21. This is your total income) and Amount (36,800.00; 175.00; 36,975.00)

Adjusted Gross Income

Table with 2 columns: Description (23 Educator expenses; 24 IRA deduction; 25 Student loan interest deduction; 26 Tuition and fees deduction; 27 Archer MSA deduction; 28 Moving expenses; 29 One-half of self-employment tax; 30 Self-employed health insurance deduction; 31 Self-employed SEP, SIMPLE, and qualified plans; 32 Penalty on early withdrawal of savings; 33a Alimony paid; 34 Add lines 23 through 33a; 35 Subtract line 34 from line 22. This is your adjusted gross income) and Amount (225.00; 36,750.00)

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72.

Cat. No. 11320B

Form 1040 (2002)

Tax and Credits

Standard Deduction for- People who checked any box on line 37a or 37b or who can be claimed as a dependent, see page 31. All others: Single, \$4,700 Head of household, \$6,900 Married filing jointly or Qualifying widow(er), \$7,850 Married filing separately, \$3,925

Table with 3 columns: Line number, Description, and Amount. Rows include 36 (Amount from line 35), 37a (Check if 65 or older, Blind, Spouse was 65 or older, Blind), 38 (Itemized deductions), 39 (Subtract line 38 from line 36), 40 (If line 36 is \$103,000 or less, multiply \$3,000 by the total number of exemptions), 41 (Taxable income), 42 (Tax), 43 (Alternative minimum tax), 44 (Add lines 42 and 43), 45-53 (Credits), 54 (Add lines 45 through 53), 55 (Subtract line 54 from line 44).

Other Taxes

Table with 3 columns: Line number, Description, and Amount. Rows include 56 (Self-employment tax), 57 (Social security and Medicare tax on tip income), 58 (Tax on qualified plans), 59 (Advance earned income credit payments), 60 (Household employment taxes), 61 (Add lines 55 through 60).

Payments

If you have a qualifying child, attach Schedule EIC.

Table with 3 columns: Line number, Description, and Amount. Rows include 62 (Federal income tax withheld), 63 (2002 estimated tax payments), 64 (Earned income credit), 65 (Excess social security and tier 1 RRTA tax withheld), 66 (Additional child tax credit), 67 (Amount paid with request for extension), 68 (Other payments from Form 2439 or Form 4136), 69 (Add lines 62 through 68).

Refund

Direct deposit? See page 51 and fill in 71b, 71c, and 71d.

Table with 3 columns: Line number, Description, and Amount. Rows include 70 (If line 69 is more than line 61, subtract line 61 from line 69), 71a (Amount of line 70 you want refunded to you), 71b (Routing number), 71c (Type: Checking or Savings), 71d (Account number), 72 (Amount of line 70 you want applied to your 2003 estimated tax), 73 (Amount you owe), 74 (Estimated tax penalty).

Amount You Owe

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? Yes. Complete the following. No

Sign Here

Joint return? See page 19. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. Your signature: Margaret A. Williams, Date: 3/20/03, Your occupation: U.S. Air Force, Daytime phone number: ( )

Paid Preparer's Use Only

Preparer's signature, Date, Check if self-employed, Preparer's SSN or PTIN, Firm's name (or yours if self-employed), address, and ZIP code, EIN, Phone no.

<p><b>SCHEDULES A&amp;B</b> <b>(Form 1040)</b></p> <p>Department of the Treasury Internal Revenue Service (99)</p> <p>Name(s) shown on Form 1040 <b>Margaret A. Williams</b></p>	<p><b>Schedule A—Itemized Deductions</b> (Schedule B is on back)</p> <p>▶ <b>Attach to Form 1040.</b> ▶ See Instructions for Schedules A and B (Form 1040).</p>	<p>OMB No. 1545-0074</p> <p><b>2002</b> Attachment Sequence No. <b>07</b></p> <p>Your social security number <b>271 00 6543</b></p>																																																						
<p><b>Medical and Dental Expenses</b></p> <p><b>Caution.</b> Do not include expenses reimbursed or paid by others.</p> <p><b>1</b> Medical and dental expenses (see page A-2) . . . . .</p> <p><b>2</b> Enter amount from Form 1040, line 36</p> <p><b>3</b> Multiply line 2 above by 7.5% (.075) . . . . .</p> <p><b>4</b> Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">1</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">2</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">3</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">4</td><td></td><td></td><td></td><td></td><td></td></tr> </table>	1						2						3						4						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">4</td><td></td><td></td><td></td><td></td><td></td></tr> </table>							4																							
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<p><b>Taxes You Paid</b></p> <p>(See page A-2.)</p> <p><b>5</b> State and local income taxes . . . . .</p> <p><b>6</b> Real estate taxes (see page A-2) . . . . .</p> <p><b>7</b> Personal property taxes . . . . .</p> <p><b>8</b> Other taxes. List type and amount ▶</p> <p><b>9</b> Add lines 5 through 8 . . . . .</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">5</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">6</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">7</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">8</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">9</td><td></td><td></td><td></td><td></td><td></td></tr> </table>	5						6						7						8						9						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">9</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td></td><td></td><td></td><td></td><td></td><td style="text-align: right;">1,300 00</td></tr> </table>							9											1,300 00						
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<p><b>Interest You Paid</b></p> <p>(See page A-3.)</p> <p><b>10</b> Home mortgage interest and points reported to you on Form 1098 . . . . .</p> <p><b>11</b> Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶</p> <p><b>Note.</b> Personal interest is not deductible.</p> <p><b>12</b> Points not reported to you on Form 1098. See page A-3 for special rules . . . . .</p> <p><b>13</b> Investment interest. Attach Form 4952 if required. (See page A-3.) . . . . .</p> <p><b>14</b> Add lines 10 through 13 . . . . .</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">10</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">11</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">12</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">13</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">14</td><td></td><td></td><td></td><td></td><td></td></tr> </table>	10						11						12						13						14						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">10</td><td></td><td></td><td></td><td></td><td style="text-align: right;">6,600 00</td></tr> <tr><td style="text-align: center;">14</td><td></td><td></td><td></td><td></td><td style="text-align: right;">6,600 00</td></tr> </table>							10					6,600 00	14					6,600 00						
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<p><b>Gifts to Charity</b></p> <p>If you made a gift and got a benefit for it, see page A-4.</p> <p><b>15</b> Gifts by cash or check. If you made any gift of \$250 or more, see page A-4 . . . . .</p> <p><b>16</b> Other than by cash or check. If any gift of \$250 or more, see page A-4. You <b>must</b> attach Form 8283 if over \$500 . . . . .</p> <p><b>17</b> Carryover from prior year . . . . .</p> <p><b>18</b> Add lines 15 through 17 . . . . .</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">15</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">16</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">17</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">18</td><td></td><td></td><td></td><td></td><td></td></tr> </table>	15						16						17						18						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">15</td><td></td><td></td><td></td><td></td><td style="text-align: right;">700 00</td></tr> <tr><td style="text-align: center;">18</td><td></td><td></td><td></td><td></td><td style="text-align: right;">700 00</td></tr> </table>							15					700 00	18					700 00												
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<p><b>Casualty and Theft Losses</b></p> <p><b>19</b> Casualty or theft loss(es). Attach Form 4684. (See page A-5.) . . . . .</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">19</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> </table>	19						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">19</td><td></td><td></td><td></td><td></td><td></td></tr> </table>							19																																									
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<p><b>Job Expenses and Other Miscellaneous Deductions</b></p> <p>(See page A-5 for expenses to deduct here.)</p> <p><b>20</b> Unreimbursed employee expenses—job travel, union dues, job education, etc. You <b>must</b> attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶</p> <p><b>21</b> Tax preparation fees . . . . .</p> <p><b>22</b> Other expenses—investment, safe deposit box, etc. List type and amount ▶</p> <p><b>23</b> Add lines 20 through 22 . . . . .</p> <p><b>24</b> Enter amount from Form 1040, line 36</p> <p><b>25</b> Multiply line 24 above by 2% (.02) . . . . .</p> <p><b>26</b> Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">20</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">21</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">22</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">23</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">24</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">25</td><td></td><td></td><td></td><td></td><td></td></tr> <tr><td style="text-align: center;">26</td><td></td><td></td><td></td><td></td><td></td></tr> </table>	20						21						22						23						24						25						26						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">26</td><td></td><td></td><td></td><td></td><td></td></tr> </table>							26					
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<p><b>Other Miscellaneous Deductions</b></p> <p><b>27</b> Other—from list on page A-6. List type and amount ▶</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">27</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> </table>	27						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">27</td><td></td><td></td><td></td><td></td><td></td></tr> </table>							27																																									
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<p><b>Total Itemized Deductions</b></p> <p><b>28</b> Is Form 1040, line 36, over \$137,300 (over \$68,650 if married filing separately)?</p> <p><input type="checkbox"/> <b>No.</b> Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 38.</p> <p><input type="checkbox"/> <b>Yes.</b> Your deduction may be limited. See page A-6 for the amount to enter.</p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%; text-align: center;">28</td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> </table>	28						<table border="1" style="width:100%; border-collapse: collapse;"> <tr><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td><td style="width:10%;"></td></tr> <tr><td style="text-align: center;">28</td><td></td><td></td><td></td><td></td><td style="text-align: right;">8,600 00</td></tr> </table>							28					8,600 00																																				
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Form **3903**  
(Rev. October 2002)  
Department of the Treasury  
Internal Revenue Service

### Moving Expenses

▶ Attach to Form 1040.

OMB No. 1545-0062

Attachment  
Sequence No. **62**

Name(s) shown on Form 1040

Margaret A. Williams

Your social security number

271 00 6543

**Before you begin:** ✓ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.  
✓ If you are a member of the armed forces, see the instructions to find out how to complete this form.

1	Enter the amount you paid for transportation and storage of household goods and personal effects (see instructions)	1	0	00
2	Enter the amount you paid for travel and lodging expenses in moving from your old home to your new home. <b>Do not</b> include the cost of meals (see instructions)	2	225	00
3	Add lines 1 and 2	3	225	00
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is <b>not</b> included in the wages box (box 1) of your W-2 form. This amount should be identified with code <b>P</b> in box 12 of your W-2 form	4		
5	Is line 3 <b>more than</b> line 4?  <input type="checkbox"/> <b>No.</b> You <b>cannot</b> deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on the "Wages, salaries, tips, etc." line of Form 1040.  <input checked="" type="checkbox"/> <b>Yes.</b> Subtract line 4 from line 3. Enter the result here and on the "Moving expenses" line of Form 1040. This is your <b>moving expense deduction</b>	5	225	00

#### General Instructions

##### A Change To Note

Beginning in 2002, the standard mileage rate for using your vehicle to move to a new home is 13 cents a mile.

##### Purpose of Form

Use Form 3903 to figure your moving expense deduction for a move related to the start of work at a new principal place of work (workplace). If the new workplace is outside the United States or its possessions, you must be a U.S. citizen or resident alien to deduct your expenses.

If you qualify to deduct expenses for more than one move, use a separate Form 3903 for each move.

For more details, see **Pub. 521**, Moving Expenses.

##### Who May Deduct Moving Expenses

If you move to a new home because of a new principal workplace, you may be able to deduct your moving expenses whether you are self-employed or an employee. But you must meet both of the tests explained next.

##### Distance Test

Your new principal workplace must be at least 50 miles farther from your old home than your old workplace was. For example, if your old workplace was 3 miles from your old home, your new workplace must be at least 53 miles from that home. If you did not have an old workplace, your new workplace must be at least 50 miles from your old home. The distance between the two points is the shortest of the more commonly traveled routes between them.



To see if you meet the distance test, you can use the worksheet below.

#### Distance Test Worksheet

Keep a Copy for Your Records



Members of the armed forces may not have to meet this test. For details, see the instructions on the back of this form.

1. Enter the number of miles from your **old home** to your **new workplace** . . . . . 1. \_\_\_\_\_ miles
2. Enter the number of miles from your **old home** to your **old workplace** . . . . . 2. \_\_\_\_\_ miles
3. Subtract line 2 from line 1. If zero or less, enter -0- . . . . . 3. \_\_\_\_\_ miles

##### Is line 3 at least 50 miles?

- Yes.** You meet this test.  
 **No.** You do not meet this test. You **cannot** deduct your moving expenses. **Do not** complete Form 3903.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 12490K

Form **3903** (Rev. 10-2002)

# **COMPREHENSIVE TEST QUESTIONS FOR MILITARY ISSUES**

**Answer Yes or No to the following questions.**

1. Is Imminent Danger Pay taxable?
2. Charlie Becker was separated from service due to a medical condition. He was given \$32,000 of medical separation pay in 2001. He included this amount on his 2001 tax return. The VA determines in 2002, that due to his medical condition he is entitled to a VA disability pension. Should he amend his 2001 return?
3. Is Yemen considered a “designated combat zone”?
4. Are student loan repayments that are attributable to the period of service in the combat zone excludible from income?
5. Harry is in the air force and is stationed in Germany. His only income is his military pay. Does he qualify for the foreign earned income exclusion?
6. Julie has been serving in a combat zone since October 2002. Does her 2002 federal income tax return have to be filed by 4-15-03?
7. David died while serving in a combat zone. Can his federal income tax liability be forgiven?
8. Maria is married to Bob Smith who is an airman in the U.S. Air Force. They live in Germany where Maria holds her citizenship. Can she file a joint return with Bob?
9. If Maria files a joint return with Bob, can she list only her U.S. sourced income on the joint tax return?
10. For Head of Household purposes are you considered unmarried if your spouse was a nonresident alien at any time during the year (and you do not choose to treat your spouse as a resident alien)?
11. Sally, who is 18, has been in the military all year. Can her mom claim her as a dependent?
12. Can Herman claim his mother (who is a citizen and resident of Austria) on his return?
13. Charlotte is not eligible for a Social Security number. She is filing a joint return with a U.S. citizen. Does she need to apply for an ITIN?

- 14.** Does personal property tax paid to a foreign government qualify for the Foreign Tax Credit?
- 15.** Do you include BAS and BAH in the calculation of earned income for purposes of the earned income credit?
- 16.** Madison sold her house and made \$46,000. She had lived in the house as her main home for the last 3 years. Does she have to pay tax on this gain?
- 17.** Brent had moving costs associated with a permanent change of station. Can he deduct the moving costs (that are not reimbursed)?
- 18.** Lori is in the reserves and she attends training and drills every month that require her to incur travel costs. Can Lori deduct the unreimbursed travel expenses on her tax return?
- 19.** Is the cost of maintaining uniforms that can be worn off-duty eligible for a tax deduction?
- 20.** Gloria paid \$200 to attend an accounting class at a qualified institution. Can she take this amount as an adjustment to income?
- 21.** Is a coach (who does not teach) considered an eligible educator?
- 22.** Richard is in the military. His wife works for a local manufacturer. They are both considered to be covered by a pension plan. Their AGI is \$66,000 and they each contributed \$2,000 to a traditional IRA. Can they deduct their IRA contributions on their tax return?
- 23.** Airman Jones had business income of \$50,000 and business expenses of \$3,500. Can he file Schedule C-EZ?
- 24.** Pvt. Dodd has net income of \$394 on his Schedule C-EZ. Does he need to file a Schedule SE?
- 25.** Larry rents out his former home. Should he report the income and expenses on Schedule E?

# **COMPREHENSIVE TEST ANSWER SHEET FOR MILITARY ISSUES**

1. \_\_\_\_\_
2. \_\_\_\_\_
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# **COMPREHENSIVE TEST ANSWER SHEET FOR MILITARY ISSUES**

- |                |                |
|----------------|----------------|
| 1. <u>Yes</u>  | 14. <u>No</u>  |
| 2. <u>Yes</u>  | 15. <u>No</u>  |
| 3. <u>Yes</u>  | 16. <u>No</u>  |
| 4. <u>Yes</u>  | 17. <u>Yes</u> |
| 5. <u>No</u>   | 18. <u>Yes</u> |
| 6. <u>No</u>   | 19. <u>No</u>  |
| 7. <u>Yes</u>  | 20. <u>Yes</u> |
| 8. <u>Yes</u>  | 21. <u>No</u>  |
| 9. <u>No</u>   | 22. <u>No</u>  |
| 10. <u>Yes</u> | 23. <u>No</u>  |
| 11. <u>No</u>  | 24. <u>No</u>  |
| 12. <u>No</u>  | 25. <u>Yes</u> |
| 13. <u>Yes</u> |                |

