

Chapter 1: Individual Taxpayer Problems

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Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

PROBLEM 1: SALES TAX DEDUCTION ELECTION ON SCHEDULE A

BACKGROUND INFORMATION

The American Jobs Creation Act of 2004 provided a Schedule A choice, for tax years 2004 and 2005 **only**, between deducting:

- State and local **income** taxes, or
- State and local **sales** taxes

This temporary option primarily benefits those taxpayers who reside in states which do not impose income taxes:

- Alaska
- Florida
- Nevada
- South Dakota
- Texas
- Washington
- Wyoming

Note. Even though this temporary provision is scheduled to end after 2005, U.S. Congressional Representatives from these seven states are attempting to make it permanent. However, the current large federal budget deficit makes this provision an easy target for elimination in the goal for deficit reduction.

The IRS released IRS **Pub. 600**, *Optional Sales Tax Tables*, in December 2004. The tables were revised in January 2005 for Arkansas, California, and Virginia. In March of 2005, the IRS released **Notice 2005-31** to clarify unresolved aspects of computing the sales tax deduction.

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COMPUTING THE SALES TAX DEDUCTION

Taxpayers may compute their sales tax deduction in one of two ways:

1. **Actual** sales taxes paid during the year on purchases of personal use items, or
2. **Optional State Sales Tax Tables** in conjunction with the State and Local General Sales Tax Deduction Worksheet included in Pub. 600.

Caution. Only the **personal use portion** of sales taxes is deductible on Schedule A. The business use portion is used to calculate business-related expenses.

Computing the Deduction from the Tables¹

Most taxpayers use the Optional State Sales Tax Tables to compute their deduction. The tables provide a deductible amount of sales tax paid based on the taxpayer's state of residence, total available income, and number of exemptions. This is a four step process.

Step 1. Compute the Amount of Available Income. The income levels shown in the sales tax tables consist of the taxpayer's AGI **plus** the following **nontaxable** income items:

- Tax-exempt interest
- Veterans' benefits
- Nontaxable portion of combat pay
- Workers' compensation
- Nontaxable portion of social security and railroad retirement benefits
- Nontaxable portion of IRA, pension, or annuity distributions, excluding any rollovers
- Public assistance payments

Step 2. Find the Table Amount. In the appropriate state table, find the line for the taxpayer's available income and go to the column for the number of exemptions claimed on the return. This figure is the starting amount for calculating total sales taxes paid during the year.

Step 3. Add Local General Sales Taxes. Taxpayers may also deduct sales tax paid to local government agencies (e.g. county or city sales taxes). In the 2004 IRS Pub. 600, the IRS did not include any of these taxes in the tables. Instead, a formula was provided to calculate the amount paid based on the locally imposed rate and the amount found in Step 2. **At the time of this writing, the IRS is planning to include local sales taxes in the 2005 tables when those taxes are applied at a uniform rate throughout the state.**

Step 4. Add Sales Tax Paid on Specified Items. In addition to the table amount, taxpayers may deduct the personal use portion of sales tax paid on the following specified items:

1. Motor Vehicles (purchased or leased):
 - Automobiles
 - Motorcycles
 - Motor homes

¹. IRS Pub. 600, *Optional State Sales Tax Tables*

- Recreational vehicles (RVs)
 - Sport utility vehicles
 - Trucks
 - Vans
 - Off-road vehicles
2. Boats
 3. Aircraft
 4. Homes (including mobile and prefabricated)
 5. Home building materials

Clarification of the Term “Home Building Materials” Used in IRS Pub. 600. In Notice 2005-31, the IRS changed the term “home building materials” to “materials to build a home.” Whichever term is used in the revised Pub. 600 for use in preparing 2005 returns, it appears that the IRS interpretation is that sales tax deductions are allowable **only** for the following:

- Materials purchased by the taxpayer (not the contractor) to build a new home
- Materials purchased by the taxpayer (not the contractor) for a new home improvement

In addition, these taxes must be separately stated on the contract or receipt in order to be deductible.

Situations That Complicate Use of the Tables²

Taxpayers Who Reside in Different States during the Year. The state of residence is the state where the taxpayer physically resides. A taxpayer who resides in more than one state during 2005 must use the sales tax tables as shown in the following example.

Example 1. Jack owns homes in Georgia and Iowa. He lived in his Georgia home for the first eight months of 2005, or **243 days**. He lived in his Iowa home for the last four months of 2005, or **122 days**. His sales tax deduction using the 2005 optional sales tax tables is:

- \$600 if he had lived in Georgia the entire year, or
- \$700 if he had lived in Iowa the entire year

Tax Solution for Example 1. Jack’s 2005 sales tax deduction using the tables is \$633, computed as shown.

| | | |
|-------------------------------|---------------------------------|--------------|
| For Georgia: | $\$600 \times (243 \div 365) =$ | \$399 |
| For Iowa: | $\$700 \times (122 \div 365) =$ | 234 |
| Total allowed for 2005 | | \$633 |

Joint Return Filers Who Live in Different States. Sometimes a husband and wife who file jointly reside in different states. These taxpayers apply their **separate incomes to each state** of residence, using their own exemptions, plus the exemptions for dependents who resided with each taxpayer. However, **either spouse (but not both)** may take into account dependents who did **not** reside with **either** taxpayer.

² IRS Notice 2005-31, March 11, 2005

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Married Taxpayers Filing Separately. If one spouse uses the sales tax tables, and the other spouse is also electing to use the sales tax option, the other spouse must also use the tables. Each taxpayer uses his or her separate incomes and the **actual** exemptions claimed on their separate returns to find the sales tax table amount.

Note. The number of exemptions claimed by the taxpayer on the separate return may be different from the number of dependents living with the taxpayer. The IRS guidance is specific that the taxpayer should use only the number of exemptions claimed.

Example 2. Bonnie and Clyde are married, have three children, and file separate 2005 tax returns. All three children live with Bonnie. The chart shows each spouse's facts for 2005.

| Spouse | Available Income | Number of Exemptions Claimed |
|--------|------------------|------------------------------|
| Bonnie | \$40,000 | 2 (herself and one child) |
| Clyde | 60,000 | 3 (himself and two children) |

Tax Solution for Example 2. Bonnie determines her sales tax deduction from the tables based on \$40,000 income and two exemptions. Therefore, Clyde must determine his deduction based on \$60,000 income and three exemptions using the sales tax tables. He cannot elect to deduct his actual 2005 sales taxes paid based on his receipts. However, he could elect to deduct his state income taxes paid in lieu of state sales taxes.

Observation. Even though many couples who file separately do not communicate, rules and regulations require that the first taxpayer who files must inform the later-filing spouse of elections made on the first return.

TAX PLANNING SUGGESTIONS

1. Many retirees, including those who reside in Illinois, are entitled to exclude their federally taxed pensions and social security benefits on their state income tax returns. If they have little other income, they would likely benefit from electing the sales tax deduction as opposed to deducting their state income tax. This assumes, of course, that the retiree itemizes deductions for 2005.
2. Taxpayers who deducted state income tax on their 2004 Schedule A may choose to deduct state sales taxes on their 2005 Schedule A.
3. High-income taxpayers will probably find that the use of the sales tax tables understates their actual sales tax paid. They may want to keep accurate records of actual sales tax paid in 2005, especially if they live in a state with low state income tax rates.
4. Taxpayers who plan to buy a personal use automobile in either 2005 or 2006 may be wise to buy it in 2005.
5. Deducting state and local income taxes in one year may create taxable income in the next year if any of those taxes are refunded. If the refund is large, and if the taxpayer will be in a higher tax bracket next year, it may be better for the taxpayer to deduct state sales taxes even though the state income taxes produce a higher current year deduction.

PROBLEM 2: HSA UPDATE**BACKGROUND INFORMATION**

Health savings accounts (HSAs) are becoming more popular. The principle of HSAs is to make consumers interested in controlling their health care costs. To entice taxpayers to participate, the accounts offer significant tax benefits to individuals and to employers who offer high deductible health plans (HDHPs).

In 2004, it was difficult to find a companion health care plan that qualified under the HSA rules. The plan must have been an HDHP and must have conformed to specific out-of-pocket limitations. However, by March of 2005, the number of health insurers offering HDHPs was nearly five times the number six months earlier.³ It is projected that almost all insurers will be offering some type of HDHPs in the near future.

Enrollment in HSAs doubled in the six months from September 2004 to March 2005 with the total number of HSAs surpassing one million at the end of that period.⁴ Many small employers are switching their employee group coverage to HDHPs for cost control purposes. In addition, many individuals who are not already enrolled in Medicare, particularly those who are relatively wealthy and healthy, are switching their traditional health insurance coverage to a HDHP/HSA combination.

Due to this trend, practitioners will more likely encounter clients with HSAs when they prepare **2005** tax returns. **The following 2005 forms relate to HSAs:**

- Form 1099-SA, *Distributions From an HSA, Archer MSA or Medicare Advantage MSA*
- Form 5498-SA, *HSA, Archer MSA or Medicare Advantage MSA Information*, similar to a Form 5498 for IRAs-Copy B to be furnished to the HSA owner by May 31, 2006
- Form 8889, *Health Savings Accounts*, used to compute the HSA deduction on line 25 of the 2005 Form 1040

Two examples with completed 2005 forms are included later in Problem 2.

Note. For a thorough discussion of most of the complex HSA issues, see pages 561–588 and 490–491 in the *2004 University of Illinois Federal Tax Workbook*.

INFORMATION PROVIDED IN PUB. 969 FOR HSAs

The IRS released a new publication to assist taxpayers and practitioners in dealing with HSA tax issues. Some information from Pub. 969 is shown below.

An HSA is a tax-exempt account that a taxpayer establishes with a qualified trustee to pay or reimburse medical expenses incurred by the HSA owner.

³. www.ahip.net/content/pressrelease.aspx?docid=9771

⁴. Ibid

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HSA BENEFITS

A taxpayer may enjoy several benefits from owning an HSA:

- HSA owners can claim a tax deduction for contributions they, or someone other than their employer, make to their individually owned HSA even if they do not itemize deductions.
- Employer contributions to an employee-owned HSA, including contributions made through a cafeteria plan, may be excluded from the employee's gross income. The result is income, social security, and Medicare tax savings for both the employee and employer.
- The interest or other earnings on the account assets are tax free.
- Distributions are tax free if used to pay qualified medical expenses of the taxpayer and the taxpayer's spouse and dependents. Qualified medical expenses include most normally deductible medical expenses as well as nonprescription medicines. See IRS Pub. 502, *Medical and Dental Expenses*, for more information about qualified expenses.
- An HSA is "portable" so it remains with taxpayers when they change employment or retire.

CONTRIBUTIONS TO AN HSA

There are two types of HDHPs: those covering only the individual and those covering the individual and his family. **The maximum contribution for 2005 is \$2,650 for an individual plan and \$5,250 for a family plan.**⁵ In addition, the contribution cannot exceed the plan's deductible. Two examples from IRS Pub. 969 are included below.

Note. For 2005, eligible individuals who are 55 or older are entitled to an additional \$600 HSA contribution. However, the additional \$600 amount must be prorated if the owner was not covered by the HDHP for all twelve months of 2005.

Example 3. On July 1, 2005, Ben and Jennifer, a married couple, switched their traditional HMO health plan to a family coverage high deductible health plan (HDHP). The family was covered under the HDHP for the entire months of July through December (six months). The annual deductible under their HDHP is \$4,000. **Both are under age 55.**

Ben established his HSA in **January 2006**. Jennifer did not establish her own HSA.

Because they were not covered by the HDHP for the entire year, they must prorate the deductible over the number of months they were covered. The **worksheet for line 3 of Form 8889** (shown in the Form 8889 instructions) helps Ben with this proration.

Ben enters \$4,000 for each month (July through December) that he was an eligible individual.

$$6 \text{ months} \times \$4,000 = \$24,000$$

Ben divides \$24,000 by 12 to determine his 2005 HSA contribution limit of \$2,000, as shown in the following worksheet.

⁵. Rev. Proc. 2004-71, December 13, 2004

For Example 3

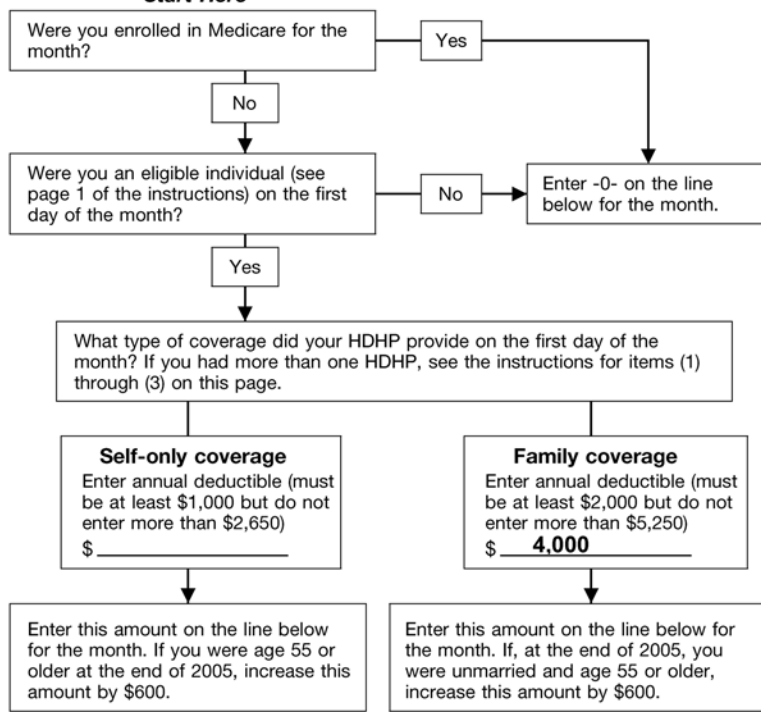
Line 3 Limitation Chart and Worksheet

Go through this chart for each month of 2005.

See the instructions for line 3 on this page.

(Keep for your records)

Start Here



| Month in 2004 | Amount from chart above |
|--|-------------------------|
| January | _____ |
| February | _____ |
| March | _____ |
| April | _____ |
| May | _____ |
| June | _____ |
| July | <u>4,000</u> |
| August | <u>4,000</u> |
| September | <u>4,000</u> |
| October | <u>4,000</u> |
| November | <u>4,000</u> |
| December | <u>4,000</u> |
| Total for all months | <u>24,000</u> |
| Limitation. Divide the total by 12. Enter here and on line 3. | <u>2,000</u> |

Note. They enter \$2,000 on line 3 of their 2005 Form 8889. Both of their names are entered on Form 8889 since they file a joint 2005 return. Ben enters his SSN on Form 8889 since he is the HSA owner.

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Note. The 2005 Form 8889 for Ben and Jennifer is not shown. If Ben contributes the maximum \$2,000 to his HSA by April 17, 2006, he can deduct the \$2,000 on the joint 2005 return.

Example 4. On April 1, 2005, George and Hillary, a married couple, switched their traditional PPO health plan to a family coverage high deductible health plan (HDHP). The family was covered under the HDHP for the entire nine months of April through December. The annual deductible under their HDHP is \$5,000.

Hillary reached age 55 during 2005. George was 52 at the end of 2005. Hillary established her HSA in October 2005. George did not establish his own HSA.

Hillary's maximum 2005 HSA contribution is \$4,200 as shown below:

| | Before Proration | Prorated Worksheet Amounts |
|--|---------------------|-------------------------------|
| Amount of the deductible for their family coverage HDHP (limited to \$5,250) | \$5,000 | \$3,750 (line 3, Form 8889) |
| Additional contribution allowed to Hillary (she was 55 or older in 2005) | 600 | 450 (line 7, Form 8889) |
| Total before the monthly proration | \$5,600 | |
| Monthly proration (HDHP established on April 1, 2005): $(\$5,600 \div 12) \times 9 =$ | \$4,200 | |

Hillary made her maximum 2005 HSA contribution of \$4,200 in March 2006. It is entered on line 2 on Form 8889, which follows.

For Example 4

| | | |
|--|---|---|
| Form 8889 Department of the Treasury Internal Revenue Service | Health Savings Accounts (HSAs) ▶ Attach to Form 1040. ▶ See separate instructions. | OMB No. 1545-1911 2005 Attachment Sequence No. 138 |
| Name(s) shown on Form 1040 George and Hillary | | Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶ 333 : 33 : 3333 |

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I HSA Contributions and Deduction. See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions).

| | | |
|---|---|--------------|
| 1 Check the box to indicate your coverage under a high-deductible health (HDHP) plan during 2005 (see page 2 of the instructions) ▶ | <input type="checkbox"/> Self-only <input checked="" type="checkbox"/> Family | |
| 2 HSA contributions you made for 2005 (or those made on your behalf), including those made from January 1, 2006, through April 17, 2006, that were for 2005. Do not include employer contributions or rollovers (see page 2 of the instructions) | 2 | 4,200 |
| 3 If you were under age 55 at the end of 2005, and on the first day of every month during 2005, you were an eligible individual with the same annual deductible and coverage, enter the smaller of: • Your annual deductible (see page 3 of the instructions), or • \$2,650 (\$5,250 for family coverage). All others, enter the limit from the worksheet on page 3 of the instructions | 3 | 3,750 |
| 4 Enter the amount you and your employer contributed to your Archer MSAs for 2005 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2005, also include any amount contributed to your spouse's Archer MSAs | 4 | 0 |
| 5 Subtract line 4 from line 3. If zero or less, enter -0- | 5 | 3,750 |
| 6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2005, see the instructions on page 4 for the amount to enter. | 6 | 3,750 |
| 7 If you were age 55 or older at the end of 2005, married, and you or your spouse had family coverage under an HDHP at any time during 2005, enter your additional contribution amount (see page 4 of the instructions) | 7 | 450 |
| 8 Add lines 6 and 7 | 8 | 4,200 |
| 9 Employer contributions made to your HSAs for 2005 | 9 | 0 |
| 10 Subtract line 9 from line 8. If zero or less, enter -0- | 10 | 4,200 |
| 11 HSA deduction. Enter the smaller of line 2 or line 10 here and on Form 1040, line 25 Caution: If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions). | 11 | 4,200 |

Part II HSA Distributions. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

| | | |
|--|------------|--|
| 12a Total distributions you received in 2005 from all HSAs (see page 5 of the instructions) | 12a | |
| b Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions) | 12b | |
| c Subtract line 12b from line 12a | 12c | |
| 13 Unreimbursed qualified medical expenses (see page 5 of the instructions) | 13 | |
| 14 Taxable HSA distributions. Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "HSA" and the amount | 14 | |
| 15a If any of the distributions included on line 14 meet any of the Exceptions to the Additional 10% Tax (see page 5 of the instructions), check here ▶ <input type="checkbox"/> | | |
| b Additional 10% tax (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63. On the dotted line next to line 63, enter "HSA" and the amount | 15b | |

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 37621P Form **8889** (2005)

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Observations for George and Hillary's 2005 Form 8889 (Example 4)

- Hillary's SSN (333-33-3333) is entered since she is the HSA owner.
- Hillary's employer made no contributions to her HSA for 2005. Therefore, line 9 is zero.
- No distributions were made from Hillary's HSA during 2005. Therefore, Part II is blank.

Example 5. Sam and Linda Larson, who are both age 60, are retired. Their former employers provided no employee group health coverage. Due to constant increases in the premiums for their traditional health insurance, they switched to a family coverage HDHP with a \$5,000 deductible effective January 1, 2005. Each established an HSA during 2005.

The maximum combined 2005 HSA contributions Sam and Linda can make are \$6,200. **The \$6,200 maximum amount consists of the \$5,000 deductible amount plus the \$600 additional contribution each can make to their separate HSAs.** They decide to each contribute the maximum. They enter their contributions on line 2 on their separate Forms 8889. Their 2005 HSA contributions are shown below.

| HSA Owner | SSN | Normal Contribution | Additional Contribution | Total 2005 HSA Contribution | Total 2005 HSA Distributions |
|-----------|-------------|---------------------|-------------------------|-----------------------------|------------------------------|
| Sam | 444-44-4444 | \$3,000 | \$600 | \$3,600 | \$2,160 |
| Linda | 777-77-7777 | 2,000 | 600 | 2,600 | 1,313 |

Note. Sam and Linda are allowed to choose how they allocate the normal \$5,000 contribution limit between themselves as long as they both agree. If they do not agree, the normal contribution limit is split evenly between them. This allocated amount is entered on line 6 on their separate Forms 8889.

For Example 5 — Sam Larson

| | | |
|---|---|---|
| Form 8889 Department of the Treasury Internal Revenue Service | Health Savings Accounts (HSAs) ▶ Attach to Form 1040. ▶ See separate instructions. | OMB No. 1545-1911 2005 Attachment Sequence No. 138 |
| Name(s) shown on Form 1040 Sam and Linda Larson | | Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶ 444 : 44 : 4444 |
| Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required. | | |
| Part I HSA Contributions and Deduction. See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions). | | |
| 1 Check the box to indicate your coverage under a high-deductible health (HDHP) plan during 2005 (see page 2 of the instructions) ▶ | | <input type="checkbox"/> Self-only <input checked="" type="checkbox"/> Family |
| 2 HSA contributions you made for 2005 (or those made on your behalf), including those made from January 1, 2006, through April 17, 2006, that were for 2005. Do not include employer contributions or rollovers (see page 2 of the instructions) | | 2 3,600 |
| 3 If you were under age 55 at the end of 2005, and on the first day of every month during 2005, you were an eligible individual with the same annual deductible and coverage, enter the smaller of: • Your annual deductible (see page 3 of the instructions), or • \$2,650 (\$5,250 for family coverage). All others, enter the limit from the worksheet on page 3 of the instructions | | 3 5,000 |
| 4 Enter the amount you and your employer contributed to your Archer MSAs for 2005 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2005, also include any amount contributed to your spouse's Archer MSAs | | 4 0 |
| 5 Subtract line 4 from line 3. If zero or less, enter -0- | | 5 5,000 |
| 6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2005, see the instructions on page 4 for the amount to enter. | | 6 3,000 |
| 7 If you were age 55 or older at the end of 2005, married, and you or your spouse had family coverage under an HDHP at any time during 2005, enter your additional contribution amount (see page 4 of the instructions) | | 7 600 |
| 8 Add lines 6 and 7 | | 8 3,600 |
| 9 Employer contributions made to your HSAs for 2005 | | 9 0 |
| 10 Subtract line 9 from line 8. If zero or less, enter -0- | | 10 3,600 |
| 11 HSA deduction. Enter the smaller of line 2 or line 10 here and on Form 1040, line 25 Caution: If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions). | | 11 3,600 |
| | | |
| Part II HSA Distributions. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse. | | |
| 12a Total distributions you received in 2005 from all HSAs (see page 5 of the instructions) | | 12a 2,160 |
| b Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions) | | 12b 0 |
| c Subtract line 12b from line 12a | | 12c 2,160 |
| 13 Unreimbursed qualified medical expenses (see page 5 of the instructions) | | 13 2,160 |
| 14 Taxable HSA distributions. Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "HSA" and the amount | | 14 0 |
| 15a If any of the distributions included on line 14 meet any of the Exceptions to the Additional 10% Tax (see page 5 of the instructions), check here ▶ <input type="checkbox"/> | | |
| b Additional 10% tax (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63. On the dotted line next to line 63, enter "HSA" and the amount | | 15b |

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Cat. No. 37621P

Form **8889** (2005)

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For Example 5 — Linda Larson

| | | |
|--|---|--|
| Form 8889 Department of the Treasury Internal Revenue Service | Health Savings Accounts (HSAs) ▶ Attach to Form 1040. ▶ See separate instructions. | OMB No. 1545-1911 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2005</div> Attachment Sequence No. 138 |
| Name(s) shown on Form 1040 Sam and Linda Larson | | Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶ 777 : 77 : 7777 |

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I HSA Contributions and Deduction. See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions).

| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|--|--|---|-------|--|---|-------|--|---|---|--|---|-------|--|---|-------|--|---|-----|--|---|-------|--|---|---|--|----|-------|--|----|-------|--|
| <p>1 Check the box to indicate your coverage under a high-deductible health (HDHP) plan during 2005 (see page 2 of the instructions) ▶</p> <p>2 HSA contributions you made for 2005 (or those made on your behalf), including those made from January 1, 2006, through April 17, 2006, that were for 2005. Do not include employer contributions or rollovers (see page 2 of the instructions)</p> <p>3 If you were under age 55 at the end of 2005, and on the first day of every month during 2005, you were an eligible individual with the same annual deductible and coverage, enter the smaller of:</p> <ul style="list-style-type: none"> • Your annual deductible (see page 3 of the instructions), or • \$2,650 (\$5,250 for family coverage). <p>All others, enter the limit from the worksheet on page 3 of the instructions</p> <p>4 Enter the amount you and your employer contributed to your Archer MSAs for 2005 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2005, also include any amount contributed to your spouse's Archer MSAs</p> <p>5 Subtract line 4 from line 3. If zero or less, enter -0-</p> <p>6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2005, see the instructions on page 4 for the amount to enter.</p> <p>7 If you were age 55 or older at the end of 2005, married, and you or your spouse had family coverage under an HDHP at any time during 2005, enter your additional contribution amount (see page 4 of the instructions)</p> <p>8 Add lines 6 and 7</p> <p>9 Employer contributions made to your HSAs for 2005</p> <p>10 Subtract line 9 from line 8. If zero or less, enter -0-</p> <p>11 HSA deduction. Enter the smaller of line 2 or line 10 here and on Form 1040, line 25</p> <p>Caution: If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions).</p> | <div style="margin-bottom: 5px;"> <input type="checkbox"/> Self-only <input checked="" type="checkbox"/> Family </div> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">2</td><td style="width: 65%; text-align: center;">2,600</td><td style="width: 30%;"></td></tr> <tr><td style="text-align: center;">3</td><td style="text-align: center;">5,000</td><td></td></tr> <tr><td style="text-align: center;">4</td><td style="text-align: center;">0</td><td></td></tr> <tr><td style="text-align: center;">5</td><td style="text-align: center;">5,000</td><td></td></tr> <tr><td style="text-align: center;">6</td><td style="text-align: center;">2,000</td><td></td></tr> <tr><td style="text-align: center;">7</td><td style="text-align: center;">600</td><td></td></tr> <tr><td style="text-align: center;">8</td><td style="text-align: center;">2,600</td><td></td></tr> <tr><td style="text-align: center;">9</td><td style="text-align: center;">0</td><td></td></tr> <tr><td style="text-align: center;">10</td><td style="text-align: center;">2,600</td><td></td></tr> <tr><td style="text-align: center;">11</td><td style="text-align: center;">2,600</td><td></td></tr> </table> | 2 | 2,600 | | 3 | 5,000 | | 4 | 0 | | 5 | 5,000 | | 6 | 2,000 | | 7 | 600 | | 8 | 2,600 | | 9 | 0 | | 10 | 2,600 | | 11 | 2,600 | |
| 2 | 2,600 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | 5,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | 0 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | 5,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | 2,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | 600 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | 2,600 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | 0 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 10 | 2,600 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 11 | 2,600 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

Part II HSA Distributions. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

| | | | | | | | | | | | | | | | | | | | |
|---|---|-----|-------|--|-----|---|--|-----|-------|--|----|-------|--|----|---|--|-----|--|--|
| <p>12a Total distributions you received in 2005 from all HSAs (see page 5 of the instructions)</p> <p>b Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions)</p> <p>c Subtract line 12b from line 12a</p> <p>13 Unreimbursed qualified medical expenses (see page 5 of the instructions)</p> <p>14 Taxable HSA distributions. Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "HSA" and the amount</p> <p>15a If any of the distributions included on line 14 meet any of the Exceptions to the Additional 10% Tax (see page 5 of the instructions), check here ▶ <input type="checkbox"/></p> <p>b Additional 10% tax (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63. On the dotted line next to line 63, enter "HSA" and the amount</p> | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">12a</td><td style="width: 65%; text-align: center;">1,313</td><td style="width: 30%;"></td></tr> <tr><td style="text-align: center;">12b</td><td style="text-align: center;">0</td><td></td></tr> <tr><td style="text-align: center;">12c</td><td style="text-align: center;">1,313</td><td></td></tr> <tr><td style="text-align: center;">13</td><td style="text-align: center;">1,313</td><td></td></tr> <tr><td style="text-align: center;">14</td><td style="text-align: center;">0</td><td></td></tr> <tr><td style="text-align: center;">15b</td><td></td><td></td></tr> </table> | 12a | 1,313 | | 12b | 0 | | 12c | 1,313 | | 13 | 1,313 | | 14 | 0 | | 15b | | |
| 12a | 1,313 | | | | | | | | | | | | | | | | | | |
| 12b | 0 | | | | | | | | | | | | | | | | | | |
| 12c | 1,313 | | | | | | | | | | | | | | | | | | |
| 13 | 1,313 | | | | | | | | | | | | | | | | | | |
| 14 | 0 | | | | | | | | | | | | | | | | | | |
| 15b | | | | | | | | | | | | | | | | | | | |

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 37621P Form **8889** (2005)

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2005 Distributions. Sam and Linda received 12 separate distributions from their HSAs during 2005 to pay for qualified unreimbursed medical expenses. Their 2005 HSA distributions are shown below.

| HSA Owner | Number of Distributions | Total Amount of 2005 Distributions |
|-----------|-------------------------|------------------------------------|
| Sam | 8 | \$2,160.14 (Box 1, Form 1099-SA) |
| Linda | 4 | 1,312.76 (Box 1, Form 1099-SA) |

Sam and Linda each receive a 2005 Form 1099-SA from their HSA trustees.

☐ CORRECTED (if checked)

| | | | | |
|---|---|--|----------------------------------|--|
| TRUSTEE'S/PAYER'S name, street address, city, state, and ZIP code Midstate Bank | | OMB No. 1545-1517 2005 Form 1099-SA | | Distributions From an HSA, Archer MSA, or Medicare Advantage MSA Copy B For Recipient This information is being furnished to the Internal Revenue Service. |
| PAYER'S Federal identification number | RECIPIENT'S identification number 444-44-4444 | 1 Gross distribution \$ 2160.14 | 2 Earnings on excess cont. \$ | |
| RECIPIENT'S name Sam Larson | | 3 Distribution code 1 | 4 FMV on date of death \$ | |
| Street address (including apt. no.) | | 5 HSA <input checked="" type="checkbox"/> | | |
| City, state, and ZIP code | | Archer MSA <input type="checkbox"/> MA MSA <input type="checkbox"/> | | |
| Account number (see instructions) | | | | |

Form 1099-SA (keep for your records) Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

| | | | | |
|---|---|--|----------------------------------|--|
| TRUSTEE'S/PAYER'S name, street address, city, state, and ZIP code Midstate Bank | | OMB No. 1545-1517 2005 Form 1099-SA | | Distributions From an HSA, Archer MSA, or Medicare Advantage MSA Copy B For Recipient This information is being furnished to the Internal Revenue Service. |
| PAYER'S Federal identification number | RECIPIENT'S identification number 777-77-7777 | 1 Gross distribution \$ 1312.76 | 2 Earnings on excess cont. \$ | |
| RECIPIENT'S name Linda Larson | | 3 Distribution code 1 | 4 FMV on date of death \$ | |
| Street address (including apt. no.) | | 5 HSA <input checked="" type="checkbox"/> | | |
| City, state, and ZIP code | | Archer MSA <input type="checkbox"/> MA MSA <input type="checkbox"/> | | |
| Account number (see instructions) | | | | |

Form 1099-SA (keep for your records) Department of the Treasury - Internal Revenue Service

Note. Distribution code "1" in Box 3 on Form 1099-SA is used for normal distributions. There is no code to indicate when penalties apply, as proper HSA distributions are the sole responsibility of the HSA owner rather than the HSA trustee.

2005 Workbook

Observations for Sam and Linda Larson (Example 5)

- Their maximum allowable normal 2005 HSA contributions are \$5,000, which is the lower of their HDHP deductible amount or \$5,250.
- Both Sam and Linda are entitled to the additional \$600 HSA contribution since both were 55 or older. **Only the owner of the HSA is entitled to the additional contribution. If Linda did not establish her own HSA, their combined maximum 2005 HSA contributions would have been \$5,600 rather than \$6,200.**
- Sam and Linda will each receive Copy B of the 2005 Form 5498-SA by the May 31, 2006, deadline.

☐ CORRECTED (if checked)

| | | | | |
|---|--|---|---|---|
| TRUSTEE'S name, street address, city, state, and ZIP code Midstate Bank | | 1 Employee or self-employed person's Archer MSA contributions made in 2005 and 2006 for 2005 \$ | OMB No. 1545-1518 <div style="font-size: 2em; font-weight: bold;">2005</div> | HSA, Archer MSA, or Medicare Advantage MSA Information |
| | | 2 Total contributions made in 2005 \$ 3600.00 | Form 5498-SA | |
| TRUSTEE'S Federal identification number | PARTICIPANT'S social security number 444-44-4444 | 3 Total HSA or Archer MSA contributions made in 2006 for 2005 \$ | | Copy B For Participant The information in boxes 1 through 6 is being furnished to the Internal Revenue Service. |
| PARTICIPANT'S name Sam Larson Street address (including apt. no.) City, state, and ZIP code | | 4 Rollover contributions \$ | 5 Fair market value of HSA, Archer MSA, or MA MSA \$ 1470.60 | |
| | | 6 HSA <input checked="" type="checkbox"/> Archer MSA <input type="checkbox"/> MA MSA <input type="checkbox"/> | | |
| Account number (see instructions) | | | | |

Form **5498-SA** (keep for your records) Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

| | | | | |
|---|--|---|---|---|
| TRUSTEE'S name, street address, city, state, and ZIP code Midstate Bank | | 1 Employee or self-employed person's Archer MSA contributions made in 2005 and 2006 for 2005 \$ | OMB No. 1545-1518 <div style="font-size: 2em; font-weight: bold;">2005</div> | HSA, Archer MSA, or Medicare Advantage MSA Information |
| | | 2 Total contributions made in 2005 \$ 2600.00 | Form 5498-SA | |
| TRUSTEE'S Federal identification number | PARTICIPANT'S social security number 777-77-7777 | 3 Total HSA or Archer MSA contributions made in 2006 for 2005 \$ | | Copy B For Participant The information in boxes 1 through 6 is being furnished to the Internal Revenue Service. |
| PARTICIPANT'S name Linda Larson Street address (including apt. no.) City, state, and ZIP code | | 4 Rollover contributions \$ | 5 Fair market value of HSA, Archer MSA, or MA MSA \$ 1308.27 | |
| | | 6 HSA <input checked="" type="checkbox"/> Archer MSA <input type="checkbox"/> MA MSA <input type="checkbox"/> | | |
| Account number (see instructions) | | | | |

Form **5498-SA** (keep for your records) Department of the Treasury - Internal Revenue Service


Example 6. Jane's employer changed the company's employee group health coverage to a choice of several HDHPs, effective January 1, 2005. She chose a self-only HDHP plan with a \$2,500 deductible.

Her employer encouraged Jane, age 30, to establish an HSA. She did so in December 2005 with a local bank. Her employer agreed to contribute \$1,000 to each employee's HSA to help offset the high deductible. The 2005 contributions to Jane's HSA are shown below.

| Amount of Contribution | Made By | Date Contribution Made |
|------------------------|-----------------|------------------------|
| \$1,000 | Jane's employer | December 20, 2005 |
| 800 | Jane | April 10, 2006 |

Note. There were no distributions made in 2005 from Jane's HSA. Therefore, she did not receive a 2005 Form 1099-SA.

Jane's 2005 Form W-2 and her completed 2005 Form 8889 are shown. Her 2005 Form 5498-SA is not shown.

| | | | | | | | |
|---|----------------------------|----------------------------|---------------------|--|--|---|--|
| a Control number | | OMB No. 1545-0008 | | Safe, accurate, FAST! Use  | | Visit the IRS website at www.irs.gov/efile . | |
| b Employer identification number (EIN) | | | | 1 Wages, tips, other compensation 32573.40 | 2 Federal income tax withheld 5103.76 | | |
| c Employer's name, address, and ZIP code Midwest Extermination, Inc | | | | 3 Social security wages 32573.40 | 4 Social security tax withheld 2019.55 | | |
| | | | | 5 Medicare wages and tips 32573.40 | 6 Medicare tax withheld 472.31 | | |
| | | | | 7 Social security tips | 8 Allocated tips | | |
| d Employee's social security number 222-22-2222 | | | | 9 Advance EIC payment | | 10 Dependent care benefits | |
| e Employee's first name and initial Last name Jane | | | | 11 Nonqualified plans | | 12a See instructions for box 12 W 1000.00 | |
| | | | | 13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> | | 12b | |
| | | | | 14 Other | | 12c | |
| | | | | | | 12d | |
| f Employee's address and ZIP code | | | | | | | |
| 15 State | Employer's state ID number | 16 State wages, tips, etc. | 17 State income tax | 18 Local wages, tips, etc. | 19 Local income tax | 20 Locality name | |
| | | | | | | | |

Form **W-2** Wage and Tax Statement

2005

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

2005 Workbook

For Example 6

| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|---|---|-----|-----|--|-----|-------|--|-----|---|--|----|-------|--|----|-------|--|-----|---|--|---|-------|--|---|-------|--|----|-------|--|----|-----|--|--|--|--|
| Form 8889 <small>Department of the Treasury Internal Revenue Service</small> | Health Savings Accounts (HSAs) ▶ Attach to Form 1040. ▶ See separate instructions. | OMB No. 1545-1911 2005 Attachment Sequence No. 138 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Name(s) shown on Form 1040 Jane | | Social security number of HSA beneficiary. If both spouses have HSAs, see page 2 of the instructions ▶ 222 22 2222 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Part I HSA Contributions and Deduction. See page 2 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page 2 of the instructions). | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| <p>1 Check the box to indicate your coverage under a high-deductible health (HDHP) plan during 2005 (see page 2 of the instructions) ▶</p> <p>2 HSA contributions you made for 2005 (or those made on your behalf), including those made from January 1, 2006, through April 17, 2006, that were for 2005. Do not include employer contributions or rollovers (see page 2 of the instructions)</p> <p>3 If you were under age 55 at the end of 2005, and on the first day of every month during 2005, you were an eligible individual with the same annual deductible and coverage, enter the smaller of: • Your annual deductible (see page 3 of the instructions), or • \$2,650 (\$5,250 for family coverage). All others, enter the limit from the worksheet on page 3 of the instructions</p> <p>4 Enter the amount you and your employer contributed to your Archer MSAs for 2005 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2005, also include any amount contributed to your spouse's Archer MSAs</p> <p>5 Subtract line 4 from line 3. If zero or less, enter -0-</p> <p>6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2005, see the instructions on page 4 for the amount to enter.</p> <p>7 If you were age 55 or older at the end of 2005, married, and you or your spouse had family coverage under an HDHP at any time during 2005, enter your additional contribution amount (see page 4 of the instructions)</p> <p>8 Add lines 6 and 7</p> <p>9 Employer contributions made to your HSAs for 2005</p> <p>10 Subtract line 9 from line 8. If zero or less, enter -0-</p> <p>11 HSA deduction. Enter the smaller of line 2 or line 10 here and on Form 1040, line 25 Caution: If line 2 is more than line 11, you may have to pay an additional tax (see page 4 of the instructions).</p> | | <div style="text-align: right; margin-bottom: 5px;"><input checked="" type="checkbox"/> Self-only <input type="checkbox"/> Family</div> <table border="1" style="width: 100%; border-collapse: collapse;"><tr><td style="width: 5%; text-align: center;">2</td><td style="width: 85%; text-align: right;">800</td><td style="width: 10%;"></td></tr><tr><td style="text-align: center;">3</td><td style="text-align: right;">2,500</td><td></td></tr><tr><td style="text-align: center;">4</td><td style="text-align: right;">0</td><td></td></tr><tr><td style="text-align: center;">5</td><td style="text-align: right;">2,500</td><td></td></tr><tr><td style="text-align: center;">6</td><td style="text-align: right;">2,500</td><td></td></tr><tr><td style="text-align: center;">7</td><td style="text-align: right;">0</td><td></td></tr><tr><td style="text-align: center;">8</td><td style="text-align: right;">2,500</td><td></td></tr><tr><td style="text-align: center;">9</td><td style="text-align: right;">1,000</td><td></td></tr><tr><td style="text-align: center;">10</td><td style="text-align: right;">1,500</td><td></td></tr><tr><td style="text-align: center;">11</td><td style="text-align: right;">800</td><td></td></tr><tr><td style="text-align: center;"> </td><td style="background-color: #cccccc;"></td><td style="background-color: #cccccc;"></td></tr></table> | 2 | 800 | | 3 | 2,500 | | 4 | 0 | | 5 | 2,500 | | 6 | 2,500 | | 7 | 0 | | 8 | 2,500 | | 9 | 1,000 | | 10 | 1,500 | | 11 | 800 | | | | |
| 2 | 800 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 3 | 2,500 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 4 | 0 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 5 | 2,500 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 6 | 2,500 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 7 | 0 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 8 | 2,500 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 9 | 1,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 10 | 1,500 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 11 | 800 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Part II HSA Distributions. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| <p>12a Total distributions you received in 2005 from all HSAs (see page 5 of the instructions)</p> <p>b Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page 5 of the instructions)</p> <p>c Subtract line 12b from line 12a</p> <p>13 Unreimbursed qualified medical expenses (see page 5 of the instructions)</p> <p>14 Taxable HSA distributions. Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "HSA" and the amount</p> <p>15a If any of the distributions included on line 14 meet any of the Exceptions to the Additional 10% Tax (see page 5 of the instructions), check here ▶ <input type="checkbox"/></p> <p>b Additional 10% tax (see page 5 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 63. On the dotted line next to line 63, enter "HSA" and the amount</p> | | <table border="1" style="width: 100%; border-collapse: collapse;"><tr><td style="width: 5%; text-align: center;">12a</td><td style="width: 85%;"></td><td style="width: 10%;"></td></tr><tr><td style="text-align: center;">12b</td><td></td><td></td></tr><tr><td style="text-align: center;">12c</td><td></td><td></td></tr><tr><td style="text-align: center;">13</td><td></td><td></td></tr><tr><td style="text-align: center;">14</td><td></td><td></td></tr><tr><td style="text-align: center;">15b</td><td></td><td></td></tr></table> | 12a | | | 12b | | | 12c | | | 13 | | | 14 | | | 15b | | | | | | | | | | | | | | | | | |
| 12a | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 12b | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 12c | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 15b | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| <div style="display: flex; justify-content: space-between;"><div>For Paperwork Reduction Act Notice, see page 5 of the instructions.</div><div>Cat. No. 37621P</div><div>Form 8889 (2005)</div></div> <div style="text-align: center; margin-top: 5px;"> Printed on recycled paper</div> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

Question 6A. What is the amount of Jane's maximum 2005 HSA contribution?

Answer 6A. \$1,500, computed as follows:

| | |
|--|----------------|
| Maximum deductible HSA contribution (lesser of the HDHP deductible amount or \$2,650) | \$2,500 |
| Less: Amount of employer's contribution (line 9, Form 8889) | (1,000) |
| Jane's maximum 2005 HSA contribution (line 10, Form 8889) | \$1,500 |

Question 6B. What is Jane's HSA deduction for 2005?

Answer 6B. \$800 as shown on line 11 on her Form 8889, the amount of her HSA contribution. However, if she found funding for an additional \$700 contribution by April 17, 2006, she could deduct the maximum \$1,500 on line 11, Form 8889.

Observations for Jane's 2005 Form 8889 (Example 6)

- The amount shown in Box 12a on Jane's Form W-2 identified by Code W must be entered on line 9, Form 8889. The \$1,000 amount is her employer's contribution to her HSA. It is not subject to income tax withholding, social security, Medicare, or FUTA taxes and is excluded from Jane's gross income.
- Even though her employer's HSA contribution is excludable from Jane's gross income, it must be considered when computing her own HSA maximum contribution amount on Form 8889.

2005 Workbook

HSA TAX SAVINGS TABLE

The following table was released by the U.S. Treasury Dept. in November 2004. It shows the potential federal income tax savings generated by an individual taxpayer who makes tax-deductible 2005 HSA contributions.

HSA Tax Savings Reduction in Federal Income Tax from HSA Contributions in 2005 Illustrative Examples

| HSA Contribution | Income | | | | | |
|---|----------|----------|----------|----------|-----------|-----------|
| | \$20,000 | \$40,000 | \$60,000 | \$80,000 | \$100,000 | \$120,000 |
| Single Taxpayer | | | | | | |
| \$500 | 75 | 75 | 125 | 125 | 140 | 140 |
| \$1,000 | 150 | 150 | 250 | 250 | 280 | 280 |
| \$1,500 | 225 | 225 | 375 | 375 | 420 | 420 |
| \$2,000 | 300 | 300 | 500 | 500 | 560 | 560 |
| \$2,500 | 375 | 375 | 625 | 625 | 700 | 700 |
| \$2,650 ^{1/} | 397 | 397 | 662 | 662 | 742 | 742 |
| Head of Household with 1 Dependent Child | | | | | | |
| \$1,000 | 100 | 150 | 250 | 300 | 250 | 250 |
| \$2,000 | 200 | 300 | 500 | 600 | 500 | 500 |
| \$3,000 | 300 | 450 | 750 | 900 | 750 | 750 |
| \$4,000 | 400 | 600 | 900 | 1,200 | 1,000 | 1,000 |
| \$5,000 | 500 | 750 | 1,050 | 1,500 | 1,250 | 1,250 |
| \$5,250 ^{1/} | 525 | 788 | 1,088 | 1,563 | 1,313 | 1,313 |
| Married Couple with No Dependents | | | | | | |
| \$1,000 | 100 | 150 | 150 | 150 | 250 | 250 |
| \$2,000 | 200 | 300 | 300 | 300 | 500 | 500 |
| \$3,000 | 300 | 450 | 450 | 450 | 750 | 750 |
| \$4,000 | 360 | 600 | 600 | 600 | 1,000 | 1,000 |
| \$5,000 | 360 | 750 | 750 | 750 | 1,250 | 1,250 |
| \$5,250 ^{1/} | 360 | 787 | 787 | 787 | 1,312 | 1,312 |
| Married Couple with 2 Dependent Children | | | | | | |
| \$1,000 | 0 | 150 | 150 | 150 | 250 | 300 |
| \$2,000 | 0 | 300 | 300 | 300 | 500 | 600 |
| \$3,000 | 0 | 430 | 450 | 450 | 750 | 900 |
| \$4,000 | 0 | 530 | 600 | 600 | 1,000 | 1,200 |
| \$5,000 | 0 | 630 | 750 | 750 | 1,250 | 1,500 |
| \$5,250 ^{1/} | 0 | 655 | 787 | 787 | 1,312 | 1,562 |

November 16, 2004

^{1/} Maximum contribution generally allowable.

Note: Assumes: all income is from wages and salaries; taxpayers use the larger of the standard deduction or itemized deductions of 18 percent of income before HSA contributions; and heads of household and married couples with children have dependents eligible for the child tax credit and the earned income tax credit. HSA contribution may not exceed the health plan deductible.

Note. For a very informative website on the latest HSA developments, see www.hsainsider.com. HSA information can also be found in the Deductions section of the “Rulings and Cases” chapter in this workbook.

PROBLEM 3: TIMELY TRADITIONAL IRA CONTRIBUTIONS

BACKGROUND INFORMATION

Many financial advisors and tax practitioners advise clients to make traditional IRA contributions sooner rather than later. In some cases, taxpayers who are prone to procrastination may forget to make their allowable IRA contributions by the deadline. **Example 7** shows the adverse tax consequences of a failure to make a claimed \$3,000 contribution for 2004 to a traditional IRA.

Example 7. Tom and Mary, a married couple, filed their 2004 joint return in March 2005. They told their tax preparer that Mary would make her \$3,000 IRA contribution for 2004 by the April 15 deadline. **The original 2004 return reported the following:**

| | | |
|--|--------------|-------------------------|
| Wages (Tom) | | \$ 75,322 |
| Schedule C net profit (Mary) | | 60,221 |
| Total income before adjustments | | <u>\$135,543</u> |
| Adjustments in arriving at AGI | | |
| IRA deduction (Mary) | \$ 3,000 | |
| Tuition and fees deduction | 4,000 | |
| One-half of SE tax (Mary) | <u>4,255</u> | |
| | \$11,255 | (11,255) |
| AGI | | <u>\$124,288</u> |
| Less: itemized deductions | | (15,106) |
| Less: exemptions (5 including 3 children) | | <u>(15,500)</u> |
| Taxable income | | \$ 93,682 |
| Income tax | | \$16,894 |
| Less: child tax credit for 2 qualifying children (limited due to high AGI) | | <u>(1,250)</u> |
| Income tax after subtracting allowable child tax credit | | \$15,644 |
| Plus: SE tax (Mary) | | <u>8,509</u> |
| Total tax | | \$24,153 |

However, Mary forgot to make her \$3,000 IRA contribution by the April 15, 2005 deadline. Her procrastination resulted in the following adjustments to the original return they filed.

Adjustments to the amounts reported on the original return:

- Decrease in Mary's IRA deduction \$3,000
- Decrease in the tuition and fees deduction
(\$4,000 deduction now limited to \$2,000) 2,000
Total increase in AGI (the corrected AGI is \$129,288) \$5,000
- In addition, the \$1,250 limited child tax credit claimed on the original return is now reduced to \$1,000 (due to the \$5,000 increase in AGI).

The result of these adjustments is additional tax of \$1,500 on a 2004 Form 1040X (amended return).

| | |
|---|----------------|
| Additional tax on the \$5,000 adjustment to AGI ($\$5,000 \times 25\%$) | \$1,250 |
| Plus: decrease in child tax credit | <u>250</u> |
| Additional tax due on the 2004 Form 1040X | \$1,500 |

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Excerpt from IRS Pub. 590, *Individual Retirement Accounts (IRAs)*

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. However, the contribution must be made by the due date of your return, not including extensions.

Observations for Tom and Mary (Example 7)

- If Mary established a different type of retirement account such as a SEP-IRA, her contributions would be due by the due date of the return, **including** extensions.
- The result for Tom and Mary would be even worse if any of their itemized deductions were limited by AGI, such as medical or unreimbursed employee expenses.

PROBLEM 4: EDUCATION-RELATED TAX BENEFITS

BACKGROUND INFORMATION

Education-related tax benefits were implemented to lower the cost of education. These tax benefits are mainly limited to middle-class families due to the many phaseout provisions which often make them unavailable to those with higher incomes. Because of the number of education-related tax benefits and the different qualifications and phaseouts that apply to each, trying to determine the best choice for maximum tax savings can be difficult.

2005 EDUCATION INCENTIVES OVERVIEW

Education Credits (Claimed on Form 8863)

The following education credits are available:

- **Hope Credit:** Up to \$1,500 **per student** for the first two years of qualified education expenses
- **Lifetime Learning Credit:** Up to \$2,000 **per return** for all years for postsecondary education expenses

| Filing Status | Modified AGI Phaseout Range |
|---|--------------------------------|
| Married filing jointly | \$87,000–107,000 |
| Other taxpayers (excluding married filing separately) | \$43,000– 53,000 |

Caution. No 2005 education credit is allowed if the tuition and fees deduction is taken in 2005 for the same student. The credits are also not allowed to married taxpayers who file separately.

Tuition and Fees Deduction (in Arriving at Modified AGI)

1. The maximum deduction is **\$4,000** if 2005 Modified AGI does not exceed:
 - \$130,000 for married taxpayers filing jointly, or
 - \$65,000 for other taxpayers
2. The maximum deduction is **\$2,000** if 2005 Modified AGI is between:
 - \$130,001 and \$160,000 for married taxpayers filing jointly, or
 - \$65,001 and \$80,000 for other taxpayers

3. No deduction is allowed:

- If 2005 Modified AGI exceeds \$160,000 for married taxpayers filing jointly, or \$80,000 for other taxpayers.
- For married taxpayers who file separately.
- If a Hope or Lifetime Learning credit is claimed in 2005 for the same student.

4. Unless this temporary deduction is extended, it will terminate after 2005.

Coverdell Education Savings Accounts

The maximum nondeductible annual contribution per beneficiary is \$2,000. When contributions are made, the designated beneficiary must be under age 18 or have special needs. The maximum \$2,000 contribution is reduced if a contributor's 2005 Modified AGI is between:

- \$95,000 and \$110,000, for individual filers
- \$190,000 and \$220,000, for contributors who file a joint return
- No contribution is allowable if the contributor's Modified AGI exceeds the phaseout ceiling amounts.

Observation. The contributor does not have to be the beneficiary's parent. If the parents' Modified AGI is too high, another family member could make the contribution.

Account earnings grow tax free and distributions are tax free if they are used to pay for the beneficiary's qualified education expenses. The education credits on Form 8863 can be claimed in the same year the beneficiary receives a tax-free Coverdell ESA distribution. However, the expenses used to compute the credit(s) cannot be used again for Coverdell ESA computation purposes.

An investment loss may be claimed as a miscellaneous itemized deduction on Schedule A, subject to the 2% of AGI limitation. The loss may be claimed only when all amounts from that account have been distributed and the total distributions are less than the total contributions to that Coverdell ESA.

The entire fund must be distributed by the time the beneficiary is age 30, unless the beneficiary meets the "special needs" definition. However, the balance can be rolled over to certain family members.

Qualified Tuition Programs (QTPs — 529 Plans)

QTPs can be either a:

- Prepaid college tuition plan that locks in today's tuition rates for future use, or
- An account established with a qualified trustee to pay a student's future college expenses (college savings plan)

Characteristics of QTPs are listed below:

- Qualified distributions used to pay college expenses are tax free for federal tax purposes.
- Contributions are not deductible on the federal tax return but may be on state tax returns, depending on state tax law.
- Contributions are treated as a gift of a present interest from the contributor to the beneficiary. Contributions qualify for the annual gift tax exclusion, which is \$11,000 for 2005 for individuals and \$22,000 for married couples who elect the gift splitting rules.
- Special rules permit contributions of \$55,000 for single contributors or \$110,000 for married couples in 2005 without any gift tax liability. If done, no additional gifting to that donee is allowed for five years.

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- The education credits on Form 8863 can be claimed in the same year the beneficiary receives a tax-free distribution from a §529 plan. However, the same expenses cannot be used for both purposes.
- Investment losses in a §529 plan are deductible as a miscellaneous itemized deduction on Schedule A subject to the 2% of AGI limitation. The loss may be claimed only when all amounts from that account have been distributed and the total distributions are less than the total contributions to that plan.
- Taxpayers may make contributions to both a Coverdell ESA and a §529 plan for the same beneficiary in the same tax year.

Student Loan Interest Deduction (in Arriving at AGI)

The maximum 2005 deduction is \$2,500 and is subject to the following AGI phaseouts:

| Filing Status | AGI Phaseout Range |
|---|--------------------|
| Married filing jointly | \$105,000–135,000 |
| Single, head of household, qualifying widow(er) | 50,000– 65,000 |

No deduction is allowed for:

- Taxpayers who are claimed as dependents on another taxpayer's return, or
- Married taxpayers who file separately.

The taxpayer who makes the payments must be legally obligated to pay the interest in order to claim the deduction.

Exclusion of U.S. Savings Bond Interest (on Form 8815)

This exclusion applies to interest earned on Series EE bonds issued after 1989 and any I bonds if redemption proceeds (principal and interest) do not exceed qualified higher education expenses paid in the redemption year.

Note. There is no requirement that the redemption proceeds must be used to pay the qualified higher education expenses. However, such expenses must be paid during the year of redemption in order to exclude the interest.

Bonds must be issued in the names of the taxpayer and his spouse. They cannot be issued in the name of the dependent student.

The owner must be at least age 24 before the bonds are issued.

The interest exclusion is subject to the following 2005 AGI phaseouts:

| Filing Status | AGI Phaseout Range |
|---|--------------------|
| Married filing jointly | \$91,850–121,850 |
| Single, head of household, qualifying widow(er) | 61,200– 76,200 |

No exclusion is allowed to married taxpayers who file separately.

PLANNING SUGGESTIONS

1. The tuition and fees deduction may provide more tax savings than the education credits. This is true even for middle-income taxpayers, especially if their student children have completed their sophomore year of college.

Example 8. Greg and Carley Brandt are married. They have one dependent child, Sydney, who began her senior year in college in the fall of 2004. Their **2005** joint return will show the following:

| | |
|--|----------------|
| Wages | \$85,000 |
| Less: standard deduction | (10,000) |
| Less: exemptions (3) | <u>(9,600)</u> |
| Taxable income before considering education tax benefits | \$65,400 |

With a 2005 taxable income of \$65,400, they are in the 25% tax rate bracket. That tax rate bracket begins at \$59,401 for 2005. Sydney's 2005 qualified expenses are \$13,000.

Education Tax Options for Greg and Carley for Example 8

- If the maximum Lifetime Learning credit is claimed, Greg and Carley will have **\$2,000 in tax savings** from their 2005 Form 8863. (Form 8863 is shown on the following page.)
- If they choose the maximum \$4,000 tuition and fees deduction, **their tax savings will only be \$1,000**, or 25% of \$4,000. (Worksheet from Form 1040 instructions is not shown.)

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For Example 8

| | | | | | |
|--|--|--|--|--|--|
| Form 8863 Department of the Treasury Internal Revenue Service (99) | Education Credits (Hope and Lifetime Learning Credits) ▶ See instructions. ▶ Attach to Form 1040 or Form 1040A. | OMB No. 1545-1618 <div style="font-size: 2em; font-weight: bold;">2005</div> Attachment Sequence No. 50 | | | |
| Name(s) shown on return Greg and Carley Brandt | | Your social security number 123 : 45 : 6789 | | | |
| Caution: You cannot take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the same student in the same year. | | | | | |
| Part I Hope Credit. Caution: You cannot take the Hope credit for more than 2 tax years for the same student . | | | | | |
| 1 (a) Student's name (as shown on page 1 of your tax return) First name Last name | (b) Student's social security number (as shown on page 1 of your tax return) | (c) Qualified expenses (see instructions). Do not enter more than \$2,000 for each student. | (d) Enter the smaller of the amount in column (c) or \$1,000 | (e) Add column (c) and column (d) | (f) Enter one-half of the amount in column (e) |
| | | | | | |
| | | | | | |
| | | | | | |
| 2 Tentative Hope credit. Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . ▶ | | | | | 2 |
| Part II Lifetime Learning Credit | | | | | |
| 3 Caution: You cannot take the Hope credit and the lifetime learning credit for the same student in the same year. | | (a) Student's name (as shown on page 1 of your tax return) First name Last name Sydney Brandt | (b) Student's social security number (as shown on page 1 of your tax return) 888 : 88 : 8888 | (c) Qualified expenses (see instructions) 13,000 | |
| 4 Add the amounts on line 3, column (c), and enter the total | | 4 | | 13,000 | |
| 5 Enter the smaller of line 4 or \$10,000 | | 5 | | 10,000 | |
| 6 Tentative lifetime learning credit. Multiply line 5 by 20% (.20) and go to Part III . . . ▶ | | 6 | | 2,000 | |
| Part III Allowable Education Credits | | | | | |
| 7 Tentative education credits. Add lines 2 and 6 | | | 7 | | 2,000 |
| 8 Enter: \$107,000 if married filing jointly; \$53,000 if single, head of household, or qualifying widow(er) | | | 8 | 107,000 | |
| 9 Enter the amount from Form 1040, line 38*, or Form 1040A, line 22 | | | 9 | 85,000 | |
| 10 Subtract line 9 from line 8. If zero or less, stop ; you cannot take any education credits | | | 10 | 22,000 | |
| 11 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er) | | | 11 | 20,000 | |
| 12 If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places) | | | 12 | | × . |
| 13 Multiply line 7 by line 12 ▶ | | | 13 | 2,000 | |
| 14 Enter the amount from Form 1040, line 46, or Form 1040A, line 28 | | | 14 | 9,686 | |
| 15 Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30 | | | 15 | 0 | |
| 16 Subtract line 15 from line 14. If zero or less, stop ; you cannot take any education credits ▶ | | | 16 | 9,686 | |
| 17 Education credits. Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶ | | | 17 | 2,000 | |
| * If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter. | | | | | |

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Example 9. The facts are identical to those shown in **Example 8**, except Sydney's qualified education expenses for 2005 are only \$4,000.

Education Tax Options for Greg and Carley for Example 9

- If the Lifetime Learning credit is claimed, Greg and Carley will have **\$800 in tax savings** from their 2005 Form 8863, or 20% of \$4,000. (Form 8863 is not shown.)
- If they choose the maximum \$4,000 tuition and fees deduction, they will have **\$1,000 in tax savings**, or 25% of \$4,000. (Worksheet from Form 1040 instructions is not shown.)

2. Choosing between a prepaid college tuition plan and a college savings plan is usually a difficult choice.

Declines in the stock market have discouraged some taxpayers from choosing to invest in college savings plans.

In addition to the various state-sponsored prepaid tuition plans, the **Tuition Plan Consortium** was created by private colleges in 2003. This fairly recent development resulted in more participation in prepaid tuition plans. With the consortium, taxpayers purchase tuition certificates at current rates. These certificates can be redeemed at any college participating in the consortium. As of May 1, 2005, this includes over 240 private colleges nationwide.

This option may be attractive if a student is interested in attending one or several of the participating colleges and if admission requirements likely pose no obstacle. If the student does not attend one of the participating colleges, the certificates can be redeemed for cash value. The proceeds are tax free if they are used for higher education expenses.

Note. See www.independent529plan.org for more details.

3. Parents who own appreciated long-term stock should consider gifting the stock to children who are nearing college age. The children can sell the gifted stock and take advantage of the low 5% tax rate on the long-term capital gain. The children can then use the proceeds to pay for some of their college expenses. Married couples can each give \$11,000 worth of appreciated stock per year before gift tax requirements apply.

Example 10. Ed and Hazel own 300 shares of Johnson & Johnson which they bought 20 years ago for \$8,000. It is now worth approximately \$18,000. They give the 300 shares in 2005 to Chad, their 17-year old son. Chad sells the stock in 2005 and realizes a \$10,000 long-term gain.

Chad's 2005 tax return reports the following:

| | |
|-----------------------------------|--------------------------|
| Wages | \$10,000 |
| Long-term capital gain | 10,000 |
| AGI | \$20,000 |
| Less: standard deduction | (5,000) |
| Less: exemption | (0) (claimed by parents) |
| Chad's 2005 taxable income | \$15,000 |

- Chad's tax on the \$10,000 gain on sale of the stock: \$500 (5% × \$10,000)
- Ed and Hazel's tax on the gain if they sell the stock: \$1,500 (15% × \$10,000)
- **2005 family tax savings by gifting the stock to Chad** **\$1,000**

Note. The \$1,000 family tax savings figure ignores potential state income tax savings.

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4. The opportunity to exclude interest on Series EE and I savings bonds is sometimes overlooked.

Example 11. Barry and Gaylynn Meek bought Series EE savings bonds in 1995. They redeemed them in 2005 and received \$21,000 which included \$5,000 of deferred interest. They used most of the proceeds from the redemption of the savings bonds as a down payment on an apartment building.

Gaylynn began her undergraduate degree program in elementary education in August 2004. **She paid \$6,000 of tuition and fees to a local university in 2005.** The first \$2,000 of expenses is reported on line 1, column (c) of Form 8863. The remaining \$4,000 is reported on line 2 of Form 8815.

Even though the bond proceeds were not used directly to pay for education expenses, Gaylynn's college expenses qualify for the interest exclusion. The Meeks report the following **2005** gross income:

| | |
|---|--------------|
| Wages | \$75,000 |
| Series EE bond interest before exclusion on Form 8815 | <u>5,000</u> |
| Modified AGI (line 9, Form 8815) | \$80,000 |

Their 2005 Form 8863 for Gaylynn's Hope credit is shown on the following page:

For Example 11sm

| | | | | | | | |
|---|--|---|---|--|---|---|----------------|
| Form 8863 Department of the Treasury Internal Revenue Service (99) | Education Credits (Hope and Lifetime Learning Credits) ▶ See instructions. ▶ Attach to Form 1040 or Form 1040A. | OMB No. 1545-1618 <div style="font-size: 2em; font-weight: bold;">2005</div> Attachment Sequence No. 50 | | | | | |
| Name(s) shown on return Barry and Gaylynn Meek | | Your social security number 444 : 44 : 4444 | | | | | |
| Caution: You cannot take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the same student in the same year. | | | | | | | |
| Part I Hope Credit. Caution: You cannot take the Hope credit for more than 2 tax years for the same student . | | | | | | | |
| 1 | (a) Student's name (as shown on page 1 of your tax return) First name Last name Gaylynn Meek | (b) Student's social security number (as shown on page 1 of your tax return) 333 : 33 : 3333 | (c) Qualified expenses (see instructions). Do not enter more than \$2,000 for each student. 2,000 | (d) Enter the smaller of the amount in column (c) or \$1,000 1,000 | (e) Add column (c) and column (d) 3,000 | (f) Enter one-half of the amount in column (e) 1,500 | |
| 2 | Tentative Hope credit. Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶ | | | | | 2 | 1,500 |
| Part II Lifetime Learning Credit | | | | | | | |
| 3 | Caution: You cannot take the Hope credit and the lifetime learning credit for the same student in the same year. | | (a) Student's name (as shown on page 1 of your tax return) First name Last name | | (b) Student's social security number (as shown on page 1 of your tax return) | (c) Qualified expenses (see instructions) | |
| 4 | Add the amounts on line 3, column (c), and enter the total | | | | | 4 | |
| 5 | Enter the smaller of line 4 or \$10,000 | | | | | 5 | |
| 6 | Tentative lifetime learning credit. Multiply line 5 by 20% (.20) and go to Part III . . . ▶ | | | | | 6 | |
| Part III Allowable Education Credits | | | | | | | |
| 7 | Tentative education credits. Add lines 2 and 6 | | | | | 7 | 1,500 |
| 8 | Enter: \$107,000 if married filing jointly; \$53,000 if single, head of household, or qualifying widow(er) | | | | | 8 | 107,000 |
| 9 | Enter the amount from Form 1040, line 38*, or Form 1040A, line 22 | | | | | 9 | 79,050 |
| 10 | Subtract line 9 from line 8. If zero or less, stop ; you cannot take any education credits | | | | | 10 | 27,950 |
| 11 | Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er) | | | | | 11 | 20,000 |
| 12 | If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places) | | | | | 12 | × . |
| 13 | Multiply line 7 by line 12 ▶ | | | | | 13 | 1,500 |
| 14 | Enter the amount from Form 1040, line 46, or Form 1040A, line 28 | | | | | 14 | 8,580 |
| 15 | Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30 | | | | | 15 | 0 |
| 16 | Subtract line 15 from line 14. If zero or less, stop ; you cannot take any education credits ▶ | | | | | 16 | 8,580 |
| 17 | Education credits. Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶ | | | | | 17 | 1,500 |

* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.

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| | |
|---|-----------------|
| Wages | \$75,000 |
| Bond interest | 5,000 |
| Less: exclusion from line 14, Form 8815 | (950) |
| Line 9, Form 8863 | \$79,050 |

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Continuation of Example 11 for Barry and Gaylynn Meek. The \$5,000 of Series EE bond interest is reported on their 2005 Schedule B. Then the excludable amount of \$950 is subtracted on line 3 of Schedule B (not shown). The excludable amount is calculated on Form 8815 as shown.

| | | | | | | |
|---|--|--|--|--|---------------------|---|
| Form 8815 <small>Department of the Treasury Internal Revenue Service (99)</small> | Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses) Attach to Form 1040 or Form 1040A. | OMB No. 1545-1173 <div style="font-size: 2em; font-weight: bold;">2005</div> Attachment Sequence No. 57 | | | | |
| Name(s) shown on return Barry and Gaylynn Meek | | Your social security number 4444 44 4444 | | | | |
| <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 45%; vertical-align: top;"> 1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution </td> <td style="width: 55%; vertical-align: top;"> (b) Name and address of eligible educational institution </td> </tr> <tr> <td style="height: 40px; vertical-align: bottom;"> Gaylynn Meek </td> <td style="height: 40px; vertical-align: bottom;"> Indiana University Bloomington, IN </td> </tr> </table> | | | 1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution | (b) Name and address of eligible educational institution | Gaylynn Meek | Indiana University Bloomington, IN |
| 1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution | (b) Name and address of eligible educational institution | | | | | |
| Gaylynn Meek | Indiana University Bloomington, IN | | | | | |
| If you need more space, attach a statement. | | | | | | |
| 2 Enter the total qualified higher education expenses you paid in 2005 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">2</td> <td style="width: 75%; text-align: right;">4,000</td> <td style="width: 20%;"></td> </tr> </table> | 2 | 4,000 | | |
| 2 | 4,000 | | | | | |
| 3 Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2005 for the person(s) listed in column (a) of line 1 (see instructions) | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">3</td> <td style="width: 75%; text-align: right;">0</td> <td style="width: 20%;"></td> </tr> </table> | 3 | 0 | | |
| 3 | 0 | | | | | |
| 4 Subtract line 3 from line 2. If zero or less, stop . You cannot take the exclusion | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">4</td> <td style="width: 75%; text-align: right;">4,000</td> <td style="width: 20%;"></td> </tr> </table> | 4 | 4,000 | | |
| 4 | 4,000 | | | | | |
| 5 Enter the total proceeds (principal and interest) from all series EE and I U.S. savings bonds issued after 1989 that you cashed during 2005 | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">5</td> <td style="width: 75%; text-align: right;">21,000</td> <td style="width: 20%;"></td> </tr> </table> | 5 | 21,000 | | |
| 5 | 21,000 | | | | | |
| 6 Enter the interest included on line 5 (see instructions) | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">6</td> <td style="width: 75%; text-align: right;">5,000</td> <td style="width: 20%;"></td> </tr> </table> | 6 | 5,000 | | |
| 6 | 5,000 | | | | | |
| 7 If line 4 is equal to or more than line 5, enter "1.000." If line 4 is less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places) | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">7</td> <td style="width: 75%; text-align: right;">× .190</td> <td style="width: 20%;"></td> </tr> </table> | 7 | × .190 | | |
| 7 | × .190 | | | | | |
| 8 Multiply line 6 by line 7 | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">8</td> <td style="width: 75%; text-align: right;">950</td> <td style="width: 20%;"></td> </tr> </table> | 8 | 950 | | |
| 8 | 950 | | | | | |
| 9 Enter your modified adjusted gross income (see instructions) Note: If line 9 is \$76,200 or more if single or head of household, or \$121,850 or more if married filing jointly or qualifying widow(er), stop . You cannot take the exclusion. | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">9</td> <td style="width: 75%; text-align: right;">80,000</td> <td style="width: 20%;"></td> </tr> </table> | 9 | 80,000 | | |
| 9 | 80,000 | | | | | |
| 10 Enter: \$61,200 if single or head of household; \$91,850 if married filing jointly or qualifying widow(er) | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">10</td> <td style="width: 75%; text-align: right;">91,850</td> <td style="width: 20%;"></td> </tr> </table> | 10 | 91,850 | | |
| 10 | 91,850 | | | | | |
| 11 Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14 | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">11</td> <td style="width: 75%; text-align: right;">0</td> <td style="width: 20%;"></td> </tr> </table> | 11 | 0 | | |
| 11 | 0 | | | | | |
| 12 Divide line 11 by: \$15,000 if single or head of household; \$30,000 if married filing jointly or qualifying widow(er). Enter the result as a decimal (rounded to at least three places) | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">12</td> <td style="width: 75%; text-align: right;">×</td> <td style="width: 20%;"></td> </tr> </table> | 12 | × | | |
| 12 | × | | | | | |
| 13 Multiply line 8 by line 12 | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">13</td> <td style="width: 75%; text-align: right;">0</td> <td style="width: 20%;"></td> </tr> </table> | 13 | 0 | | |
| 13 | 0 | | | | | |
| 14 Excludable savings bond interest. Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3, or Schedule 1 (Form 1040A), line 3, whichever applies | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">14</td> <td style="width: 75%; text-align: right;">950</td> <td style="width: 20%;"></td> </tr> </table> | 14 | 950 | | |
| 14 | 950 | | | | | |

Observations for Barry and Gaylynn Meek (Example 11). In most situations, the maximum tax savings are achieved by:

- Allocating tuition and fees first to the Hope or Lifetime Learning credit on Form 8863, and
- Using any remaining tuition and fees to exclude bond interest on Form 8815.

The total tuition and fees paid in 2005 was \$6,000. Of this, \$2,000 was used for the Hope credit on line 1, column (c) on Form 8863. The remaining \$4,000 is used for the interest exclusion on line 2, Form 8815.

Since their 2005 AGI was less than the \$91,850 phaseout ceiling amount, the entire \$950 is excluded from their 2005 gross income.

5. If a child expects to qualify for need-based financial aid when entering college, 529 college savings plans might not be the preferred way to save for future college expenses. The reason is that under financial aid formulas, college savings plans are deemed assets of the parents until distributions are made to the child (the beneficiary).

6. Parents may also want to consider investing in Roth IRAs as part of their education plan. The values of retirement plans are not disclosed on the federal financial aid application. Since contributions from Roth IRAs are withdrawn before earnings, and the contributions have already been taxed, it may be possible to fund a child's entire education without paying additional taxes.

Earnings from Roth IRAs which are used to pay education expenses are not "qualified distributions." However, the earnings are not subject to the 10% early withdrawal penalty if used for qualifying education expenses. For both Roth and traditional IRAs, qualified education expenses include tuition, fees, books, and supplies.

PROBLEM 5: LUMP-SUM SOCIAL SECURITY DISABILITY PAYMENT

BACKGROUND INFORMATION

Obtaining approval for social security disability benefits can take years. When the Social Security Administration (SSA) finally approves the disability claim, the first payment is often a lump-sum payment, which includes prior year benefits. This can create adverse tax consequences in the year the lump-sum payment is received.

Note. Social security disability benefits are not excludable. They are reported in Box 3 (Benefits Paid in 2005) on Form SSA-1099, *Social Security Benefit Statement*, sent to recipients.

Further tax complications exist if the taxpayer receives disability payments from an insurance company prior to approval of benefits by the SSA. These insurance payments are normally reported as wages on a Form W-2 by the insurance company. Once the lump-sum SSA disability payment is received, the taxpayer frequently is forced to repay the insurer all of the disability benefits received from the SSA.

However, two sections of the tax code shown below can help alleviate the adverse tax consequences:

- **Lump-sum election** provisions under IRC §86(e), and
- **Repayment of previously taxed income** provisions of IRC §1341 (claim of right provision).

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Note. **Example 12** shows how the lump-sum election provisions apply. It does not involve repayments under a claim of right. **Problem 6** explains the provisions of IRC §1341 for repayments of previously taxed income.

Example 12. Sam and Debbie, a married couple, file jointly. Due to chronic back pain, Sam applied for social security disability benefits in 2002. After a protracted legal battle, the SSA approved his disability claim in 2004. He received a lump-sum payment of \$41,593.40 in 2004. See **Sam's 2004 Form SSA-1099, Social Security Benefit Statement**, shown on the next page.

The \$41,593.40 lump-sum payment included the following retroactive benefits (shown in the "Description of Amount in Box 3" section of the Form SSA-1099):

| For Tax Year | Amount of Prior Year Benefits Paid in 2004 |
|--------------|--|
| 2003 | \$16,104 |
| 2002 | 9,156 |

Sam and Debbie's other gross income for 2004, 2003 and 2002 is shown in the chart below:

| Type of Income | 2004 | 2003 | 2002 |
|-----------------------|-----------------|-----------------|-----------------|
| Wages | \$30,000 | \$31,000 | \$25,000 |
| Interest | 2,000 | 2,000 | 1,000 |
| Fully taxable pension | 8,000 | 0 | 0 |
| Gross income | \$40,000 | \$33,000 | \$26,000 |

Question 12A. How do Sam and Debbie determine if the lump-sum election provisions are beneficial to them?

Answer 12A. They will complete Worksheets 1, 2 and 4 found in IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits*.

Question 12B. Do they benefit from the lump-sum election provisions?

Answer 12B. Yes. Only \$14,068 of the \$41,593.40 lump-sum payment is taxable on their 2004 tax return. If they had not made the lump-sum election, \$20,277 would have been taxable.

- See line 18 on Worksheet 1 for the \$20,277 taxable amount if the lump-sum election had been ignored.
- See line 20 on Worksheet 4 for the \$14,068 taxable amount of the lump-sum payment. On Form 1040 line 20, the taxpayers printed "LSE" to indicate to the IRS that the lump-sum election was used to calculate the taxable benefits for 2004.

Note. The IRS often overlooks this indicator and sends taxpayers an additional tax due notice. Taxpayers should be prepared to send copies of the worksheets to the IRS in response to such notices.

2005 Workbook

Assume that Sam and Debbie did not claim the standard deduction on their 2004 return. They are entitled to deduct their \$5,300 legal expense as a miscellaneous itemized deduction. The \$5,300 is reported on line 22 on their 2004 Schedule A, a portion of which is shown below.

| SCHEDULES A&B (Form 1040) | | Schedule A—Itemized Deductions (Schedule B is on back) | | OMB No. 1545-0074 | |
|--|--|--|--|---|--|
| Department of the Treasury Internal Revenue Service (99) | | ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040). | | 2004 Attachment Sequence No. 07 | |
| Name(s) shown on Form 1040 Sam and Debbie | | | | Your social security number 222 33 4444 | |
| Caution: Do not deduct expenses for the year 2004. (See page 19) | | | | | |
| Theft Losses 19 | | | | | |
| Job Expenses 20 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶ | | | | | |
| and Most 21 Tax preparation fees. | | | | | |
| Other 22 Other expenses—investment, safe deposit box, etc. List type and amount ▶ Legal fees paid to obtain social security disability | | | | | |
| (See page A-5.) | | | | | |
| 23 Add lines 20 through 22 | | | | | |
| 24 Enter amount from Form 1040, line 37 24 54,068 | | | | | |
| 25 Multiply line 24 by 2% (.02) 25 1,081 | | | | | |
| 26 Subtract line 25 from line 23. If line 25 is more than line 23, enter -0- 26 4,219 | | | | | |
| Other—from page A-6. List type and amount | | | | | |

For Example 12

Form **1040** Department of the Treasury—Internal Revenue Service **2004** (99) IRS Use Only—Do not write or staple in this space.

Label
(See instructions on page 16.)
Use the IRS label. Otherwise, please print or type.
Presidential Election Campaign
(See page 16.)

Label HERE

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20

OMB No. 1545-0074

Your first name and initial **Sam** Last name

If a joint return, spouse's first name and initial **Debbie** Last name

Home address (number and street). If you have a P.O. box, see page 16. Apt. no.
110 Elm Street

City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.
Herrin, IL 62948

Your social security number
222 : 33 : 4444

Spouse's social security number
666 : 77 : 8888

Important!
You must enter your SSN(s) above.

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 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions
6a ☒ Yourself. If someone can claim you as a dependent, 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 18)
If more than four dependents, see page 18.
d Total number of exemptions claimed

Income
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
If you did not get a W-2, see page 19.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.




| | | | |
|-----|---|-----|-------------------|
| 7 | Wages, salaries, tips, etc. Attach Form(s) W-2 | 7 | 30,000 |
| 8a | Taxable interest. Attach Schedule B if required | 8a | 2,000 |
| b | Tax-exempt interest. Do not include on line 8a | 8b | |
| 9a | Ordinary dividends. Attach Schedule B if required | 9a | |
| b | Qualified dividends (see page 20) | 9b | |
| 10 | Taxable refunds, credits, or offsets of state and local income taxes (see page 20) | 10 | |
| 11 | Alimony received | 11 | |
| 12 | Business income or (loss). Attach Schedule C or C-EZ | 12 | |
| 13 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/> | 13 | |
| 14 | Other gains or (losses). Attach Form 4797 | 14 | |
| 15a | IRA distributions | 15a | |
| b | Taxable amount (see page 22) | 15b | |
| 16a | Pensions and annuities | 16a | |
| b | Taxable amount (see page 22) | 16b | 8,000 |
| 17 | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E | 17 | |
| 18 | Farm income or (loss). Attach Schedule F | 18 | |
| 19 | Unemployment compensation | 19 | |
| 20a | Social security benefits | 20a | LSE 41,593 |
| b | Taxable amount (see page 24) | 20b | 14,068 |
| 21 | Other income. List type and amount (see page 24) | 21 | |
| 22 | Add the amounts in the far right column for lines 7 through 21. This is your total income ▶ | 22 | 54,068 |
| 23 | Charitable expenses (see page 24) | 23 | |

2005 Workbook

For Example 12

Worksheet 1. Figuring Your Taxable Benefits

Keep for your records

| | |
|--|-------------------|
| <p>Before you begin: Is your filing status <i>Married filing separately</i>? </p> <p>No. Go to line 1 below.</p> <p>Yes. Did you live apart from your spouse all year?</p> <p>No. Go to line 1 below.</p> <p>Yes. Do the following if you file:</p> <p>Form 1040: Enter "D" to the right of the word "benefits" on line 20a, then go to line 1 below.</p> <p>Form 1040A: Enter "D" to the right of the word "benefits" on line 14a, then go to line 1 below.</p> | |
| 1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 | 1. <u>41,593</u> |
| Note: If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2. | |
| 2. Enter one-half of line 1 | 2. <u>20,797</u> |
| 3. Enter the total of the amounts from: | |
| Form 1040: Lines 7, 8a, 8b, 9a, 10-14, 15b, 16b, 17-19, and 21 | |
| Form 1040A: Lines 7, 8a, 8b, 9a, 10, 11b, 12b, and 13 | 3. <u>40,000</u> |
| 4. Form 1040 filers: Enter the total of any exclusions/adjustments for: | |
| • Qualified U.S. savings bond interest (Form 8815, line 14) | |
| • Adoption benefits (Form 8839, line 30) | |
| • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and | |
| • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico | |
| Form 1040A filers: Enter the total of any exclusions for: | |
| • Qualified U.S. savings bond interest (Form 8815, line 14) | |
| • Adoption benefits (Form 8839, line 30) | 4. <u>0</u> |
| 5. Add lines 2, 3, and 4 | 5. <u>60,797</u> |
| 6. Form 1040 filers: Enter the amount from Form 1040, line 35, minus any amounts on Form 1040, lines 26 and 27. | |
| Form 1040A filers: Enter the amount from Form 1040A, line 20, minus any amounts on Form 1040A, lines 18 and 19 | 6. <u>0</u> |
| 7. Is the amount on line 6 less than the amount on line 5? | |
| No.  None of your social security benefits are taxable. | |
| Yes. Subtract line 6 from line 5 | 7. <u>60,797</u> |
| 8. If you are: | |
| • Married filing jointly, enter \$32,000 | |
| • Single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for all of 2004, enter \$25,000 | 8. <u>32,000</u> |
| Note: If you are married filing separately and you lived with your spouse at any time in 2004, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17. | |
| 9. Is the amount on line 8 less than the amount on line 7? | |
| No.  None of your benefits are taxable. Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2004, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. | |
| Yes. Subtract line 8 from line 7 | 9. <u>28,797</u> |
| 10. Enter \$12,000 if married filing jointly; \$9,000 if single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for all of 2004 | 10. <u>12,000</u> |
| 11. Subtract line 10 from line 9. If zero or less, enter -0- | 11. <u>16,797</u> |
| 12. Enter the smaller of line 9 or line 10 | 12. <u>12,000</u> |
| 13. Enter one-half of line 12 | 13. <u>6,000</u> |
| 14. Enter the smaller of line 2 or line 13 | 14. <u>6,000</u> |
| 15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- | 15. <u>14,277</u> |
| 16. Add lines 14 and 15 | 16. <u>20,277</u> |
| 17. Multiply line 1 by 85% (.85) | 17. <u>35,354</u> |
| 18. Taxable benefits. Enter the smaller of line 16 or line 17 | 18. <u>20,277</u> |
| <p> • Enter the amount from line 1 above on Form 1040, line 20a, or on Form 1040A, line 14a.</p> <p> • Enter the amount from line 18 above on Form 1040, line 20b, or on Form 1040A, line 14b.</p> | |
| <p>Note: If you received a lump-sum payment in this year that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see whether you can report a lower taxable benefit.</p> | |

For Example 12



Worksheet 2. Figure Your Additional Taxable Benefits (From a Lump-Sum Payment for a Year After 1993)

Enter earlier year 2003

Keep for your records

| | | |
|---|-----|---------------|
| 1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 for the earlier year, plus the lump-sum payment for the earlier year received after that year | 1. | <u>16,104</u> |
| Note: If line 1 is zero or less, skip lines 2 through 20 and enter -0- on line 21. Otherwise, go on to line 2. | | |
| 2. Enter one-half of line 1 | 2. | <u>8,052</u> |
| 3. Enter the adjusted gross income reported on your return for the earlier year | 3. | <u>33,000</u> |
| 4. Enter the total of any exclusions/adjustments you claimed in the earlier year for: | | |
| • Adoption benefits (Form 8839) | | |
| • Qualified U.S. savings bond interest (Form 8815) | | |
| • Student loan interest (Form 1040, page 1, or Form 1040A, page 1) | | |
| • Tuition and fees (Form 1040, page 1, or Form 1040A, page 1) | | |
| • Foreign earned income or housing (Form 2555 or Form 2555-EZ) | | |
| • Certain income of bona fide residents of American Samoa (Form 4563) or Puerto Rico | 4. | <u>0</u> |
| 5. Enter any tax-exempt interest received in the earlier year | 5. | <u>0</u> |
| 6. Add lines 2, 3, 4, and 5 | 6. | <u>41,052</u> |
| 7. Enter taxable benefits reported on your return for the earlier year | 7. | <u>0</u> |
| 8. Subtract line 7 from line 6 | 8. | <u>41,052</u> |
| 9. If for the earlier year you were: | | |
| • Married filing jointly, enter \$32,000 | | |
| • Single, head of household, qualifying widow(er), married filing separately and lived apart from your spouse for all of the earlier year, enter \$25,000 | | |
| • Married filing separately and lived with your spouse at any time during the earlier year, enter -0- | 9. | <u>32,000</u> |
| 10. Is the amount on line 8 more than the amount on line 9? | | |
| No. Skip lines 10-20 and enter -0- on line 21. | | |
| Yes. Subtract line 9 from line 8 | 10. | <u>9,052</u> |
| 11. Enter \$9,000 (\$12,000 if married filing jointly for the earlier year; \$0 if married filing separately for the earlier year and you lived with your spouse at any time during the year) | 11. | <u>12,000</u> |
| 12. Subtract line 11 from line 10. If zero or less, enter -0- | 12. | <u>0</u> |
| 13. Enter the smaller of line 10 or line 11 | 13. | <u>9,052</u> |
| 14. Enter one-half of line 13 | 14. | <u>4,526</u> |
| 15. Enter the smaller of line 2 or line 14 | 15. | <u>4,526</u> |
| 16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0- | 16. | <u>0</u> |
| 17. Add lines 15 and 16 | 17. | <u>4,526</u> |
| 18. Multiply line 1 by 85% (.85) | 18. | <u>13,688</u> |
| 19. Refigured taxable benefits. Enter the smaller of line 17 or line 18 | 19. | <u>4,526</u> |
| 20. Enter taxable benefits reported on your return for the earlier year (or as refigured due to a previous lump-sum payment for the year) | 20. | <u>0</u> |
| 21. Additional taxable benefits. Subtract line 20 from line 19. Also enter this amount on line 19 of Worksheet 4 | 21. | <u>4,526</u> |

Note: Do not file an amended return for this earlier year. Complete a separate Worksheet 2 or Worksheet 3 for each earlier year for which you received a lump-sum payment in 2004.

2005 Workbook

For Example 12



Worksheet 2. Figure Your Additional Taxable Benefits (From a Lump-Sum Payment for a Year After 1993)

Enter earlier year 2002

Keep for your records

| | | |
|---|-----|-------------------|
| 1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 for the earlier year, plus the lump-sum payment for the earlier year received after that year | 1. | <u>9,156</u> |
| Note: If line 1 is zero or less, skip lines 2 through 20 and enter -0- on line 21. Otherwise, go on to line 2. | | |
| 2. Enter one-half of line 1 | 2. | <u>4,578</u> |
| 3. Enter the adjusted gross income reported on your return for the earlier year | 3. | <u>26,000</u> |
| 4. Enter the total of any exclusions/adjustments you claimed in the earlier year for: | | |
| • Adoption benefits (Form 8839) | | |
| • Qualified U.S. savings bond interest (Form 8815) | | |
| • Student loan interest (Form 1040, page 1, or Form 1040A, page 1) | | |
| • Tuition and fees (Form 1040, page 1, or Form 1040A, page 1) | | |
| • Foreign earned income or housing (Form 2555 or Form 2555-EZ) | | |
| • Certain income of bona fide residents of American Samoa (Form 4563) or Puerto Rico | 4. | <u>0</u> |
| 5. Enter any tax-exempt interest received in the earlier year | 5. | <u>0</u> |
| 6. Add lines 2, 3, 4, and 5 | 6. | <u>30,578</u> |
| 7. Enter taxable benefits reported on your return for the earlier year | 7. | <u>0</u> |
| 8. Subtract line 7 from line 6 | 8. | <u>30,578</u> |
| 9. If for the earlier year you were: | | |
| • Married filing jointly, enter \$32,000 | | |
| • Single, head of household, qualifying widow(er), married filing separately and lived apart from your spouse for all of the earlier year, enter \$25,000 | | |
| • Married filing separately and lived with your spouse at any time during the earlier year, enter -0- | 9. | <u>32,000</u> |
| 10. Is the amount on line 8 more than the amount on line 9? | | |
| No. Skip lines 10-20 and enter -0- on line 21. | | |
| Yes. Subtract line 9 from line 8 | 10. | <u> </u> |
| 11. Enter \$9,000 (\$12,000 if married filing jointly for the earlier year; \$0 if married filing separately for the earlier year and you lived with your spouse at any time during the year) | 11. | <u> </u> |
| 12. Subtract line 11 from line 10. If zero or less, enter -0- | 12. | <u> </u> |
| 13. Enter the smaller of line 10 or line 11 | 13. | <u> </u> |
| 14. Enter one-half of line 13 | 14. | <u> </u> |
| 15. Enter the smaller of line 2 or line 14 | 15. | <u> </u> |
| 16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0- | 16. | <u> </u> |
| 17. Add lines 15 and 16 | 17. | <u> </u> |
| 18. Multiply line 1 by 85% (.85) | 18. | <u> </u> |
| 19. Refigured taxable benefits. Enter the smaller of line 17 or line 18 | 19. | <u> </u> |
| 20. Enter taxable benefits reported on your return for the earlier year (or as refigured due to a previous lump-sum payment for the year) | 20. | <u> </u> |
| 21. Additional taxable benefits. Subtract line 20 from line 19. Also enter this amount on line 19 of Worksheet 4 | 21. | <u>0</u> |
| Note: Do not file an amended return for this earlier year. Complete a separate Worksheet 2 or Worksheet 3 for each earlier year for which you received a lump-sum payment in 2004. | | |

For Example 12



Worksheet 4. Figure Your Taxable Benefits Under the Lump-Sum Election Method (Use With Worksheet 2 or 3)

Keep for your records

Complete Worksheet 1 and Worksheets 2 and 3 as appropriate before completing this worksheet.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 for 2004,
minus the lump-sum payment for years before 2004 1. **16,333**
Note: If line 1 is zero or less, enter zero on lines 2 and 11 and skip lines 3 through 10.
Otherwise, go on to line 2.
2. Enter one-half of line 1 2. **8,167**
3. Enter the amount from line 3 of Worksheet 1 3. **40,000**
4. Enter the amount from line 4 of Worksheet 1 4. **0**
5. Add lines 2, 3, and 4 5. **48,167**
6. Enter the amount from line 6 of Worksheet 1 6. **0**
7. Subtract line 6 from line 5 7. **48,167**
8. Enter the amount from line 8 of Worksheet 1. (Enter -0- if you are married filing separately and lived with your
spouse at any time during 2004.) 8. **32,000**
9. Is line 7 more than line 8?
No. Skip lines 9–17 and enter -0- on line 18.
Yes. Subtract line 8 from line 7 9. **16,167**
10. Enter the amount from line 10 of Worksheet 1. (Enter -0- if you are married filing separately and lived with your
spouse at any time during 2004.) 10. **12,000**
11. Subtract line 10 from line 9. If zero or less, enter -0- 11. **4,167**
12. Enter the **smaller** of line 9 or line 10 12. **12,000**
13. Enter one-half of line 12 13. **6,000**
14. Enter the **smaller** of line 2 or line 13 14. **6,000**
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- 15. **3,542**
16. Add lines 14 and 15 16. **9,542**
17. Multiply line 1 by 85% (.85) 17. **13,883**
18. Enter the **smaller** of line 16 or line 17 18. **9,542**
19. Enter the total of the amounts from line 21 of Worksheet 2 and line 14 of Worksheet 3 for all earlier years for
which the lump-sum payment was received **(4,526 + 0)** 19. **4,526**
20. **Taxable benefits under lump-sum election method.** Add lines 18 and 19 20. **14,068**

Next: Is line 20 above smaller than line 18 of Worksheet 1?

- No.** You cannot use this method to figure your taxable benefits. Follow the instructions on Worksheet 1 to report your benefits.
Yes. You can elect to report your taxable benefits under this method. **To elect this method:**

- Make the following entries on your return:
On Form 1040, enter "LSE" to the left of line 20a.
On Form 1040A, enter "LSE" to the left of line 14a.
- Enter the amount from line 1 of Worksheet 1 on Form 1040, line 20a, or on Form 1040A, line 14a. If you are married
filing separately and you lived apart from your spouse for all of 2004, also make the entries described at the top of
Worksheet 1.
- If line 20 above is zero, follow the instructions in line 9 for "No" on Worksheet 1. Otherwise, enter the amount from
line 20 above on Form 1040, line 20b, or on 1040A, line 14b.

PROBLEM 6: REPAYMENT OF PREVIOUSLY TAXED INCOME UNDER A CLAIM OF RIGHT⁷

BACKGROUND INFORMATION

Example 12 for Sam and Debbie in **Problem 5** did not deal with repayments of previously taxed disability payments Sam received from his employer's insurance company in 2002 and 2003. However, Sam was required to repay the insurance company **if** he was approved for social security disability payments for those years.

Normally, disability payments made by insurers or employers are reported on Form W-2 as wages and are reported as gross income when received.

Caution. Usually the current year Form W-2 is adjusted for any repayments that applied to the current year. However, when the repayments occur near the end of the year, the insurance company may omit the repayment, which causes the W-2 wages to be overstated.

Excerpt from IRS Pub. 915, *Social Security Benefits*

Disability payments. You may have received disability payments from your employer or an insurance company that you included as income on your tax return in an earlier year. If you received a lump-sum payment from SSA, and you had to repay the employer or insurance company for the disability payments, you can take an **itemized deduction** for the part of the payments you included in gross income in the earlier year. If the amount you repay is more than \$3,000, you may be able to claim a **tax credit** instead. (Emphasis added)

IRC §1341 relief is not limited to repayments of previously taxed disability payments. The following examples explain how §1341 applies to various tax situations.

REPAYMENTS OF SOCIAL SECURITY BENEFITS

Normally repayments of social security benefits are deducted from the current year's benefits, and only the net benefits are used to calculate the taxable social security.

Example 13. Rita is now retired. She began receiving social security benefits in 2004 at age 62 when she worked part-time as a clerk. In 2005, she was notified by SSA that she should have received only \$4,000 in 2004 benefits rather than the \$7,000 she actually received because of the earned income limits. Her 2005 Form SSA-1099, *Social Security Benefit Statement*, shows the following:

| | |
|---|----------|
| Box 3. Benefits paid in 2005 | \$12,000 |
| Box 4. Benefits repaid to SSA in 2005 | 3,000 |
| Box 5. Net benefits (Box 3 minus Box 4) | 9,000 |

Rita's \$3,000 social security overpayment for 2004 is automatically "deducted" on her 2005 Form SSA-1099. The \$9,000 net amount reported in Box 5 is used for her 2005 tax reporting purposes.

⁶. IRC §1341

REPAYMENTS OF \$3,000 OR LESS

Example 14. Corey received \$5,000 of unemployment compensation in 2004 which he properly reported as gross income on his 2004 tax return. In 2005, he was notified that he had been overpaid by \$2,000, which he repaid in December 2005.

Question 14A. What are the tax consequences of Corey's \$2,000 repayment in 2005?

Answer 14A. If he itemizes deductions for 2005, Corey deducts the \$2,000 on line 22, Schedule A as a miscellaneous deduction subject to the 2% AGI limitation.

Explanation. The following **repayments under a claim of right of \$3,000 or less** should be reported on line 22, Schedule A:⁷

- Wages
- Unemployment compensation
- Other nonbusiness income

Observation. This tax treatment may be inequitable for several reasons. The 2% AGI limitation may diminish or eliminate Corey's \$2,000 repayment. Also, he may not itemize deductions on a 2005 Schedule A.

Excerpt from IRS Pub. 525, *Taxable and Nontaxable Income*

REPAYMENTS

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than \$3,000, you may be able to take a credit against your tax for the year in which you repaid it.

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

REPAYMENTS IN EXCESS OF \$3,000

If the amount of repayment exceeds \$3,000, **either** a deduction or a tax credit may be taken. Taxpayers can use the method that results in the least tax.

Method 1—Deduction. The deduction is reported as an "Other Miscellaneous Deduction" on Schedule A and is **not** subject to the 2% AGI limitation.

Note. In 2005, the amount of the repayment is deducted on line 27 of Schedule A.

Method 2—Credit. Claim a **credit** for the repaid amount. Follow these four steps:

1. Figure the tax for the current year without deducting the repaid amount.
2. Refigure the tax from the earlier year(s) without including in income the amount repaid in the current year.

⁷ IRS Pub. 525, *Taxable and Nontaxable Income*

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3. Subtract the Step 2 tax amount from the tax shown on the return(s) for the earlier year(s). This is the credit amount.
4. Subtract the Step 3 credit amount from the Step 1 tax amount for the current year.
 - If Method 1 results in less tax, deduct the repaid amount in the current year.
 - If Method 2 results in less tax, claim the credit amount in the current year. If the current year is 2005, the credit is claimed on line 70 on the 2005 Form 1040. Enter **“IRC §1341”** next to line 70.

Example 15. Ruth, who is single, received a lump-sum social security disability payment of \$38,000 on January 2, 2005. (Her Form SSA-1099 is similar to Sam’s in **Example 12.**) She had been receiving disability payments from CIGNA Group Insurance since 2003. The CIGNA payments for 2003 and 2004 were reported to Ruth on Forms W-2.

After she received the lump-sum SSA disability payment in 2005, she was required to repay CIGNA the entire \$38,000. The \$38,000 repayment was reported on the demand for repayment notice she received from CIGNA as follows:

| Tax Year | Amount Overpaid by CIGNA |
|--|--------------------------|
| 2004 | \$19,000 |
| 2003 | 19,000 |
| Amount Ruth repaid to CIGNA in 2005 | \$38,000 |

Before Ruth can decide which method of claiming the repayment is best, she should make the Lump Sum Election calculations for the \$38,000 lump sum social security benefits received in January. The LSE worksheets show that the election does not reduce her taxable social security amount.

Ruth must make the computations for both methods for her 2005 return. The results are shown below.

Method 1 Tax Result for 2005. Ruth deducts the \$38,000 repayment amount on line 27 of Schedule A as an “Other Miscellaneous Deduction.” **With the deduction, her total tax for 2005 is \$7,500.**

Method 2 Tax Result for 2005

1. Ruth’s total tax for 2005 without deducting the \$38,000 repayment on Schedule A is \$16,000.
2. Ruth’s 2003 and 2004 returns reported the \$19,000 disability payments received from CIGNA each year. Ruth recomputes her 2003 and 2004 tax liabilities without including the \$19,000 for each year. The following chart shows results of these computations:

| | 2003 | | 2004 | |
|-----|-------------|----------------|-------------|----------------|
| | With Income | Without Income | With Income | Without Income |
| Tax | \$15,000 | \$10,250 | \$16,000 | \$11,250 |

3. Ruth subtracts the Step 2 tax amount without income from the actual tax shown on the 2003 and 2004 returns. This is the credit amount. The following chart shows these computations:

| Year | Tax Shown on Return with Income | Recomputed Tax without Income | Difference |
|----------------------------|------------------------------------|----------------------------------|----------------|
| 2003 | \$15,000 | \$10,250 | \$4,750 |
| 2004 | 16,000 | 11,250 | 4,750 |
| Total credit amount | | | \$9,500 |

4. Ruth subtracts the Step 3 credit amount of \$9,500 from the Step 1 2005 tax amount of \$16,000.

| | |
|------------------------------|-----------------|
| Step 1 amount | \$16,000 |
| Less: Step 3 credit amount | (9,500) |
| Step 4 net tax result | \$ 6,500 |

Comparison of Methods 1 and 2

- Using Method 1, Ruth's 2005 net tax after claiming the deduction is \$7,500.
- Using Method 2, Ruth's 2005 net tax after applying the credit is \$6,500.

Therefore, Ruth uses **Method 2** for 2005 tax reporting purposes. She does **not** deduct the \$38,000 repaid amount on Schedule A. Instead she reports a \$9,500 credit on line 70 on her 2005 Form 1040 as shown on the next page:

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For Example 15

Form 1040 (2005)

Page **2**

Tax and Credits

Standard Deduction for—

- People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 31.

- All others:
Single or Married filing separately, \$5,000

- Married filing jointly or Qualifying widow(er), \$10,000

- Head of household, \$7,300

| | | | |
|-----|--|-----|--|
| 38 | Amount from line 37 (adjusted gross income) | 38 | |
| 39a | Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind. Total boxes checked 39a | | |
| b | If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here 39b | | |
| 40 | Itemized deductions (from Schedule A) or your standard deduction (see left margin) | 40 | |
| 41 | Subtract line 40 from line 38 | 41 | |
| 42 | If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33 | 42 | |
| 43 | Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- | 43 | 16,000 |
| 44 | Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 | 44 | |
| 45 | Alternative minimum tax (see page 35). Attach Form 6251 | 45 | |
| 46 | Add lines 44 and 45 | 46 | 16,000 |
| 47 | Foreign tax credit. Attach Form 1116 if required | 47 | |
| 48 | Credit for child and dependent care expenses. Attach Form 2441 | 48 | |
| 49 | Credit for the elderly or the disabled. Attach Schedule R | 49 | |
| 50 | Education credits. Attach Form 8863 | 50 | |
| 51 | Retirement savings contributions credit. Attach Form 8880 | 51 | |
| 52 | Child tax credit (see page 37). Attach Form 8901 if required | 52 | |
| 53 | Adoption credit. Attach Form 8839 | 53 | |
| 54 | Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859 | 54 | |
| 55 | Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify | 55 | |
| 56 | Add lines 47 through 55. These are your total credits | 56 | |
| 57 | Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- | 57 | 16,000 |
| 58 | Self-employment tax. Attach Schedule SE | 58 | |
| 59 | Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 | 59 | |
| 60 | Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required | 60 | |
| 61 | Advance earned income credit payments from Form(s) W-2 | 61 | |
| 62 | Household employment taxes. Attach Schedule H | 62 | |
| 63 | Add lines 57 through 62. This is your total tax | 63 | 16,000 |
| 64 | Federal income tax withheld from Forms W-2 and 1099 | 64 | |
| 65 | 2005 estimated tax payments and amount applied from 2004 return | 65 | 3,000 |
| 66a | Earned income credit (EIC) | 66a | |
| b | Nontaxable combat pay election 66b | | |
| 67 | Excess social security and tier 1 RRTA tax withheld (see page 54) | 67 | |
| 68 | Additional child tax credit. Attach Form 8812 | 68 | |
| 69 | Amount paid with request for extension to file (see page 54) | 69 | |
| 70 | Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885 | 70 | 9,500 |
| 71 | Add lines 64, 65, 66a, and 67 through 70. These are your total payments | 71 | 12,500 |
| 72 | If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid | 72 | |
| 73a | Amount of line 72 you want refunded to you | 73a | |
| b | Routing number | c | Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings |
| d | Account number | | |
| 74 | Amount of line 72 you want applied to your 2006 estimated tax | 74 | |
| 75 | Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55 | 75 | 3,500 |
| 76 | Estimated tax penalty (see page 55) | 76 | |

If you have a qualifying child, attach Schedule EIC.

IRC §1341

Refund

Direct deposit? See page 54 and fill in 73b, 73c, and 73d.



PROBLEM 7: ADOPTION CREDIT AND EXCLUSION OF EMPLOYER-PROVIDED ADOPTION BENEFITS

CHANGES FOR 2005

1. The maximum nonrefundable credit per child increases to **\$10,630**.
2. The credit begins to phase out for taxpayers with 2005 modified AGI in excess of \$159,450. The credit is completely phased out for taxpayers with 2005 modified AGI of \$199,450 or more. The phaseout rules apply to all taxpayers **regardless of filing status**.

Income Limit

The income limit on the adoption credit or exclusion is based on modified adjusted gross income (modified AGI). For 2005, use the following table to see if the income limit will affect your credit or exclusion.

| IF your modified AGI is... | THEN the income limit... |
|----------------------------|--|
| \$159,450 or less | will <u>not</u> affect your credit or exclusion. |
| \$159,451 to \$199,449 | will reduce your credit or exclusion. |
| \$199,450 or more | will eliminate your credit or exclusion. |

3. For 2005, a \$10,630 credit is allowed for the adoption of a **Special Needs Child** regardless of whether the taxpayer incurs any adoption expenses. See **Example 16** shown later for clarification.
4. Up to \$10,630 paid or reimbursed by employers in 2005 for qualified adoption expenses under an adoption assistance program may be excluded from an employee's gross income.
5. **Rev. Proc. 2005-31** finalizes the safe harbors for determining when the adoption of foreign-born children occurs and affirms that "re-adoption" expenses are qualified expenses for tax purposes.

MODIFIED AGI FOR CREDIT PURPOSES

The phaseout for taking the adoption credit is based on the taxpayer's AGI plus certain items of foreign income that have been excluded from AGI. The instructions for Form 8839, *Qualified Adoption Expenses*, include a chart which lists exactly where to find these amounts on the return.

MODIFIED AGI FOR EXCLUSION PURPOSES

For exclusion purposes, add back to AGI:

- The employer-provided adoption assistance benefits,
- Any deductions taken for student loan interest and tuition and fees, and
- The items of foreign income added back for credit purposes.

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QUALIFYING EXPENSES⁸

Qualifying adoption expenses include:

- Adoption fees,
- Court costs,
- Attorney fees,
- Travel expenses (including meals and lodging),
- Re-adoption expenses, and
- Other reasonable and necessary fees.

Qualifying expenses do **not** include:

- Illegal payments,
- Payments to surrogate parents,
- Expenses to adopt your spouse's child,
- Amounts paid by anyone else (e.g. an employer),
- Amounts reimbursed to you by someone else (e.g. the taxpayer's church),
- Amounts allowed as a credit or deduction under any other provision of federal income tax law.

SPECIAL NEEDS CHILDREN

Taxpayers who adopt children with special needs can claim the credit and exclusion, **even if they did not incur any expenses in the adoption.**

To qualify as a special needs child, the child must be:

1. A U.S. citizen or U.S. resident,
2. Determined by the state as unreturnable to her parents,
3. Determined by the state as unplaceable without adoption assistance.

Example 16. Phil and Sandra are residents of Illinois. They adopt Troy, a 4-year old boy from Chicago, in 2005. The adoption process began and is finalized in 2005.

The Illinois Department of Children and Family Service (DCFS) determined that Troy:

- Should not be returned to his parents' home, and
- Probably will not be adopted unless adoption assistance is provided to the adoptive parents.

Therefore, **Troy meets the definition of a special needs child.**

Phil and Sandra paid only \$500 in 2005 qualified adoption expenses consisting of travel expenses. All other adoption expenses were furnished by DCFS. **Their modified 2005 AGI is \$145,000 and their 2005 tax liability before any credits is \$22,000.**

Tax Solution for Example 16. Phil and Sandra are **deemed to have paid \$10,630** of qualified adoption expenses in 2005. This is the amount they will enter on line 5 on their 2005 Form 8839 for total qualified

⁸. IRS Pub. 968, *Tax Benefits for Adoption*

adoption expenses. Since their 2005 modified AGI of \$145,000 is below the \$159,450 phaseout floor, **they are entitled to claim the entire maximum \$10,630 adoption credit** against their \$22,000 tax.

WHEN TO TAKE THE CREDIT OR EXCLUSION

When the credit or exclusion is allowed depends on whether the child is a citizen or resident of the United States (including U.S. possessions) at the time the adoption process **begins**.

Child Who Is a U.S. Citizen or Resident. If the child is a U.S. citizen or resident, the credit or exclusion may be claimed even if the adoption never becomes final. The credit or exclusion is taken as shown in the following chart.

Child Who Is a U.S. Citizen or Resident

| IF you pay qualifying expenses in... | THEN take the credit in... |
|---|--|
| any year before the year the adoption becomes final | the year <u>after</u> the year of the payment. |
| the year the adoption becomes final | the year the adoption becomes final. |
| any year after the year the adoption becomes final | the year of the payment. |

| IF your employer pays for qualifying expenses under an adoption assistance program in... | THEN take the exclusion in... |
|--|-------------------------------|
| any year | the year of the payment. |

Foreign Child. If the child is **not** a U.S. citizen or resident, the credit or exclusion cannot be claimed unless the adoption becomes final. **The earliest year in which the tax benefit can be taken is in the year the adoption is finalized.** The credit or exclusion is taken as shown in the following chart.

Child Who Is Not a U.S. Citizen or Resident

| IF you pay qualifying expenses in... | THEN take the credit or exclusion in... |
|---|---|
| any year before the year the adoption becomes final | the year the adoption becomes final. |
| the year the adoption becomes final | the year the adoption becomes final. |
| any year after the year the adoption becomes final | the year of the payment. |

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Example 17. Kelly and Jan finally adopt a child in 2005. Neither of their employers offers adoption benefits. They have incurred the following expenses while trying to adopt their child:

| Year | Expense Incurred |
|------|------------------|
| 2003 | \$1,000 |
| 2004 | 2,000 |
| 2005 | 3,000 |

The amount of the credit they can claim each year, based on the citizenship/residency of the child, is shown in the following chart:

| Year | U.S. Child | Non-U.S. Child |
|------|--------------------------------|---------------------------------------|
| 2003 | \$ 0 | \$ 0 |
| 2004 | 1,000 | 0 |
| 2005 | \$5,000 (2004 + 2005 expenses) | \$6,000 (2003 + 2004 + 2005 expenses) |

ADOPTION EXPENSES OF FOREIGN CHILDREN

As the chart above shows, the adoption credit or exclusion for a child who is **not** a U.S. citizen or resident when adoption procedures begin is allowed **only**:

- In the tax year the adoption becomes final (including expenses paid in any year **before** the tax year the adoption become final), or
- In a **later tax year** if any qualified expenses are paid **after the year the adoption becomes final**.⁹

The IRS established safe harbors for determining the finality of adoptions of foreign-born children.¹⁰ However, these safe harbors apply only to foreign-born children who are adopted from **nonparticipating** countries under the Hague Convention treaty. Children from **nonparticipating** countries who receive an “**immediate relative**” (**IR**) visa from the State Department fall under the safe harbor protection of Rev. Proc. 2005-31.

Hague Convention.¹¹ The Intercountry Adoption Act of 2000¹² (IAA) specifies when adoptions from participating countries become final. **As of August 1, 2005, the IAA has not been implemented.** Implementation will not occur until the Department of State finalizes the related regulations. **Until the treaty is implemented, all children with IR visas fall under the safe harbors provided by Rev. Proc. 2005-31.**

IR (Immediate Relative) Visas. These visas are issued only to foreign-born children who enter the United States after a **competent authority** of a foreign government has issued a decree of adoption or guardianship.

A **competent authority** of a foreign government can be either a court or governmental agency that has jurisdiction and authority to make decisions in matters of child welfare, including adoption.

⁹ IRC §23(e)

¹⁰ Rev. Proc. 2005-31, June 15, 2005

¹¹ Hague Convention of Protection of Children and Co-operation in Respect of Intercountry Adoption. See Senate Treaty Doc. 105-51, September 20, 2000

¹² Intercountry Adoption Act of 2000, Pub. L. 106-29, 42 USC §§14901-14954 (IAA). Section 301 of the IAA provides rules for certification of Hague Convention adoptions.

For tax purposes, **the adoption is considered final when the IR visa is issued.** The issuance of the visa by the State Department normally occurs after the competent authority of a foreign government issues a decree of adoption or guardianship.

The rules provided by Rev. Proc. 2005-31 apply to **adoption expenses incurred after June 15, 2005.** However, taxpayers **may** use these advantageous rules for **expenses paid on or before June 15, 2005** for any open tax year instead of the more restrictive rules provided by Notice 2003-15.

Note. See pages 21–22 of the *2003 University of Illinois Federal Tax Workbook* for explanation of the previous safe harbor rules under Notice 2003-15.

Example 18. Brett and Melanie Grant went to China in August 2004 to begin the adoption process for a one-year-old Chinese girl. They returned to China in October 2005 after the Chinese authorities completed and approved the adoption.

Brett and Melanie and their adopted daughter, Crystal, returned to Nebraska in November 2005. The State Department issued an IR-3 visa to Crystal. A county court in Nebraska entered a re-adoption decree for Crystal on March 1, 2006.

They paid the following qualified adoption expenses. The amounts shown below were paid **before** any reimbursement from the adoption assistance program of Brett’s employer.


| Year | Expenses Paid |
|------|---------------|
| 2004 | \$8,400 |
| 2005 | 3,000 |
| 2006 | 500 |

Brett’s employer reimbursed him \$5,000 for the adoption expenses in 2005, the maximum amount allowable under his employer’s adoption assistance program.

Note. The maximum excludable amount of employer-provided adoption benefits in 2005 is \$10,630. However, the adoption assistance program of Brett’s employer provided for a maximum per child limitation of \$5,000. See Chapter 13, “Rulings and Cases,” for more information in the “Credits” section about Rev. Proc. 2005-31 which deals with foreign adoptions.

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For Example 18

| | | | | | |
|---|----------------------------|---|---------------------------------------|--|---|
| a Control number | | OMB No. 1545-0008 | | Safe, accurate, FAST! Use  Visit the IRS website at www.irs.gov/efile . | |
| b Employer identification number (EIN) | | | | 1 Wages, tips, other compensation 72314.07 | 2 Federal income tax withheld 9236.53 |
| c Employer's name, address, and ZIP code Superior Consulting Company 26 Industrial Park Road Grand Island, NE 68801 | | | | 3 Social security wages 84314.07 | 4 Social security tax withheld 5227.47 |
| | | | | 5 Medicare wages and tips 84314.07 | 6 Medicare tax withheld 1222.55 |
| | | | | 7 Social security tips | 8 Allocated tips |
| d Employee's social security number 333-45-6789 | | | | 9 Advance EIC payment | 10 Dependent care benefits |
| e Employee's first name and initial Last name Brett L. Grant 101 Fifth St. Grand Island, NE 68801 | | | | 11 Nonqualified plans | 12a See instructions for box 12 D 7000.00 |
| | | | | 13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input checked="" type="checkbox"/> <input type="checkbox"/> | 12b T 5000.00 |
| | | | | 14 Other | 12c |
| | | | | | 12d |
| f Employee's address and ZIP code | | | | | |
| 15 State NE | Employer's state ID number | 16 State wages, tips, etc. 72314.07 | 17 State income tax 2430.27 | 18 Local wages, tips, etc. | 19 Local income tax |
| | | | | 20 Locality name | |

Form W-2 Wage and Tax Statement **2005** Department of the Treasury—Internal Revenue Service
Copy B—To Be Filed With Employee's FEDERAL Tax Return.
 This information is being furnished to the Internal Revenue Service.

The 2005 Form 1040 of Brett and Melanie reports the following:

- AGI of \$121,300 (\$120,300 of wages + \$1,000 of ordinary dividends)
- Tax liability before any credits of \$16,000
- Foreign tax credit of \$40

Question 18A. When is Crystal's adoption considered final?

Answer 18A. In 2005, the year the Chinese governmental authorities entered an adoption decree **and** when she was issued an IR-3 visa by the State Department.

Question 18B. In which tax years can Brett and Melanie claim the adoption credit in Part II of Form 8839?

Answer 18B. They are entitled to claim the adoption credit in **two** tax years:

- In **2005**, for the **\$6,400** of unreimbursed adoption expenses they paid in 2004 and 2005

| | |
|--------------------------------------|----------------|
| Expenses paid in 2004 | \$8,400 |
| Expenses paid in 2005 | 3,000 |
| Less: employer reimbursement in 2005 | (5,000) |
| 2005 adoption credit | \$6,400 |

- In **2006** for the **\$500** of unreimbursed adoption expense they paid in 2006

Question 18C. In which tax years can they exclude employer-provided adoption benefits in Part III of Form 8839?

Answer 18C. In 2005, the year of the employer's reimbursement, since the adoption is considered finalized in 2005.

Question 18D. May Brett and Melanie claim the \$3,200 dependency exemption for Crystal on their 2005 joint return?

Answer 18D. No, under the new “**uniform definition of a qualifying child**” rules effective for 2005. Crystal is not a “qualifying child” under the new rules because she did **not** meet the **residency test** in 2005. Since Crystal resided with the Grants for only November and December 2005, she did **not** live with her adoptive parents for **more than half of 2005**.

However, Crystal may still qualify as a dependent under the “qualifying relative” rules if the five dependency tests are met (the old rules).

1. **Did Brett and Melanie provide over 50% of Crystal's support?** Maybe, depending on how much they spent on her in 2005 compared to how much others spent.
2. **Is Crystal's gross income too high?** No, she had none.
3. **Did Crystal file a joint return with someone else?** No.
4. **Does Crystal meet the U.S. citizenship test?** Yes, she automatically acquired U.S. citizenship when her adoptive parents brought her into the country.¹³ She also qualifies because she was a resident of the U.S. during some part of the year.¹⁴

Note. The special rules for adopted children under the citizenship test only apply if the child was **not a citizen and not a resident** of the U.S. during the year.¹⁵

5. **Does Crystal meet the relationship test?** Yes, she was adopted in 2005 and therefore qualifies as a relative.

Note. If the adoption had not been finalized in 2005, she would not meet this test, because she did not live with the taxpayers for the entire year.

Question 18E. May Brett and Melanie claim the \$1,000 child tax credit for Crystal on their 2005 joint return?

Answer 18E. No. Crystal is not a qualifying child under the new **uniform definition of a qualifying child** because she did **not** meet the **residency test** in 2005.

¹³ Child Citizenship Act of 2000, effective February 27, 2001

¹⁴ Treas. Reg. §1.152-2(a)

¹⁵ IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information*

2005 Workbook

For Example 18

| | | | | |
|--|---|---|---|--------------------------------|
| Form 8839 Department of the Treasury Internal Revenue Service | Qualified Adoption Expenses ▶ Attach to Form 1040 or 1040A. ▶ See separate instructions. | OMB No. 1545-1552 <div style="border: 1px solid black; padding: 5px; display: inline-block;"> 2005 Attachment Sequence No. 38 </div> | | |
| Name(s) shown on return Brett and Melanie Grant | | Your social security number 333 45 6789 | | |
| <p>Before you begin: You need to understand the following terms. See Definitions on page 1 of the instructions.</p> <p>• Eligible Child • Employer-Provided Adoption Benefits • Qualified Adoption Expenses</p> | | | | |
| <p>Part I Information About Your Eligible Child or Children—You must complete this part. See page 2 of the instructions for details, including what to do if you need more space.</p> | | | | |
| 1 | (a) Child's name First Last | (b) Child's year of birth | Check if child was— (c) born before 1988 and was disabled (d) a child with special needs (e) a foreign child | (f) Child's identifying number |
| Child 1 | Crystal Grant | 2003 | <input type="checkbox"/> <input type="checkbox"/> <input checked="" type="checkbox"/> | 111 11 1111 |
| Child 2 | | | <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> | |
| <p>Caution: If the child was a foreign child, see Special rules in the instructions for line 1, column (e), that begin on page 2, before you complete Part II or Part III. If you received employer-provided adoption benefits, complete Part III on the back next.</p> | | | | |
| <p>Part II Adoption Credit</p> <p>Before you begin: If you are filing Form 1040 and claiming the mortgage interest credit (see the instructions for Form 1040, line 54), complete Form 8396, Mortgage Interest Credit.</p> | | | | |
| | Child 1 | Child 2 | | |
| 2 Maximum credit per child | 2 | \$10,630 00 | \$10,630 00 | |
| 3 Did you file Form 8839 for a prior year? <input checked="" type="checkbox"/> No. Enter -0-. <input type="checkbox"/> Yes. See page 3 of the instructions for the amount to enter. | 3 | 0 | | |
| 4 Subtract line 3 from line 2 | 4 | 10,630 | | |
| 5 Qualified adoption expenses (see page 3 of the instructions) | 5 | 6,400 | | |
| Caution: Your qualified adoption expenses may not be equal to the adoption expenses you paid in 2005. | | | | |
| 6 Enter the smaller of line 4 or line 5 | 6 | 6,400 | | |
| 7 Add the amounts on line 6. If zero, skip lines 8 through 11 and enter -0- on line 12 | 7 | | | 6,400 |
| 8 Modified adjusted gross income (see page 4 of the instructions) | 8 | 121,300 | | |
| 9 Is line 8 more than \$159,450? <input checked="" type="checkbox"/> No. Skip lines 9 and 10, and enter -0- on line 11. <input type="checkbox"/> Yes. Subtract \$159,450 from line 8 | 9 | | | |
| 10 Divide line 9 by \$40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000" | 10 | | × | |
| 11 Multiply line 7 by line 10 | 11 | | 0 | |
| 12 Subtract line 11 from line 7 | 12 | | 6,400 | |
| 13 Credit carryforward from prior years (line 23 of your Credit Carryforward Worksheet on page 4 of the 2004 Form 8839 instructions) | 13 | | 0 | |
| 14 Add lines 12 and 13 | 14 | | 6,400 | |
| 15 Enter the amount from Form 1040, line 46, or Form 1040A, line 28 | 15 | 16,000 | | |
| 16 1040 filers: Enter the total of the amounts from Form 1040, lines 47 through 52, plus any mortgage interest credit from Form 8396, line 11. 1040A filers: Enter the total of the amounts from Form 1040A, lines 29 through 33. | 16 | 40 | | |
| 17 Subtract line 16 from line 15 | 17 | | | 15,960 |
| 18 Adoption credit. Enter the smaller of line 14 or line 17 here and on Form 1040, line 53, or Form 1040A, line 34. If line 17 is smaller than line 14, you may have a credit carryforward (see page 4 of the instructions) | 18 | | | 6,400 |

For Paperwork Reduction Act Notice, see page 5 of the instructions.

Cat. No. 22843L

Form **8839** (2005)

For Example 18

Form 8839 (2005)

Page **2****Part III** Employer-Provided Adoption Benefits

| | Child 1 | | Child 2 | |
|---|-----------|-------------|-------------|--|
| 19 Maximum exclusion per child | 19 | \$10,630 00 | \$10,630 00 | |
| 20 Did you receive employer-provided adoption benefits for a prior year? <input checked="" type="checkbox"/> No. Enter -0-. <input type="checkbox"/> Yes. See page 4 of the instructions for the amount to enter. | 20 | 0 | | |
| 21 Subtract line 20 from line 19 | 21 | 10,630 | | |
| 22 Employer-provided adoption benefits you received in 2005. This amount should be shown in box 12 of your 2005 Form(s) W-2 with code T | 22 | 5,000 | | |
| 23 Add the amounts on line 22 | 23 | | 5,000 | |
| 24 Enter the smaller of line 21 or line 22. But if the child was a child with special needs and the adoption became final in 2005, enter the amount from line 21 | 24 | 5,000 | | |
| 25 Add the amounts on line 24. If zero, skip lines 26 through 29, enter -0- on line 30, and go to line 31 | 25 | | 5,000 | |
| 26 Modified adjusted gross income (from the worksheet on page 5 of the instructions) | 26 | 126,300 | | |
| 27 Is line 26 more than \$159,450? <input checked="" type="checkbox"/> No. Skip lines 27 and 28, and enter -0- on line 29. <input type="checkbox"/> Yes. Subtract \$159,450 from line 26 | 27 | | | |
| 28 Divide line 27 by \$40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000" | 28 | | × | |
| 29 Multiply line 25 by line 28 | 29 | | 0 | |
| 30 Excluded benefits. Subtract line 29 from line 25 | 30 | | 5,000 | |
| 31 Taxable benefits. Is line 30 more than line 23? <input checked="" type="checkbox"/> No. Subtract line 30 from line 23. Also, include this amount, if more than zero, on line 7 of Form 1040 or 1040A. On the line next to line 7, enter "AB." <input type="checkbox"/> Yes. Subtract line 23 from line 30. Enter the result as a negative number. Reduce the total you would enter on line 7 of Form 1040 or 1040A by the amount on Form 8839, line 31, and enter the result on line 7 of Form 1040 or 1040A. On the line next to line 7, enter "SNE." | 31 | | 0 | |



You may be able to claim the adoption credit in Part II on the front of this form if either of the following apply.

- The total adoption expenses you paid in 2005 were not fully reimbursed by your employer and the adoption became final in 2005 or earlier.
- You adopted a child with special needs and the adoption became final in 2005.

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Form **8839** (2005)

2005 Workbook

Observations for Brett and Melanie's Form 8839

- Line 5, qualified adoption expenses, does not include expenses paid or reimbursed by an employer.¹⁶
- Line 8, modified AGI for **credit** computation purposes, is **\$121,300**, which is equal to their actual AGI. Only foreign income modifies reported AGI for adoption credit purposes.
- Line 26, modified AGI for **exclusion** computation purposes, is **\$126,300**, consisting of:

| | |
|--|------------------|
| Line 8 amount (AGI) | \$121,300 |
| Plus: employer-provided benefits from line 23, Form 8839 | 5,000 |
| Line 26, modified AGI for exclusion computation | \$126,300 |

- The exclusion of \$5,000 plus the credit of \$6,400 exceeds the \$10,630 limit per child because **the limit is applied separately to each (exclusion and credit)** as explained in the excerpt shown below.
- If Brett and Melanie's credit exceeded their tax liability, they could carry the credit forward for up to five years.

Excerpt from IRS Pub. 968, *Tax Benefits for Adoption*

You may claim both a credit and an exclusion for expenses of adopting an eligible child. For example, you may be able to claim a credit of up to \$10,630 and also exclude up to \$10,630 from your income. However, you cannot claim both a credit and an exclusion for the same expense.

Limits on the credit or exclusion. *The credit and the exclusion for qualifying adoption expenses are each subject to a dollar limit and an income limit. These limits apply separately.*

Dollar limit. *The amount of your adoption credit or exclusion is limited to \$10,630 for each effort to adopt an eligible child. If you can take both a credit and an exclusion, the dollar limit applies separately to each.*

PROBLEM 8: FOREIGN INCOME EXCLUSION ON FORM 2555

BACKGROUND INFORMATION

With more U.S. citizens employed overseas by private employers, especially in Afghanistan and Iraq, the foreign income exclusion is becoming a more common tax issue. Two forms may be used to claim the exclusion from gross income:

- Form 2555, *Foreign Earned Income*, or
- Form 2555-EZ, *Foreign Earned Income Exclusion*

Form 2555 must be used by taxpayers who claim the separate foreign housing exclusion or deduction. **Example 19** (shown later) explains only the foreign income exclusion. It does not cover the separate foreign housing exclusion or deduction, which are claimed in Part VI of Form 2555.

U.S. citizens who reside in a foreign country are subject to the same U.S. income tax laws that apply to citizens living in the United States. If certain qualifications are met, a limited amount of foreign earned income may be excluded from gross income.

¹⁶ IRC §23(d)(1)(D)

WHO QUALIFIES

To claim the foreign income exclusion, taxpayers must meet two tests:

- The tax home test, and either
- The bona fide residence or physical presence test

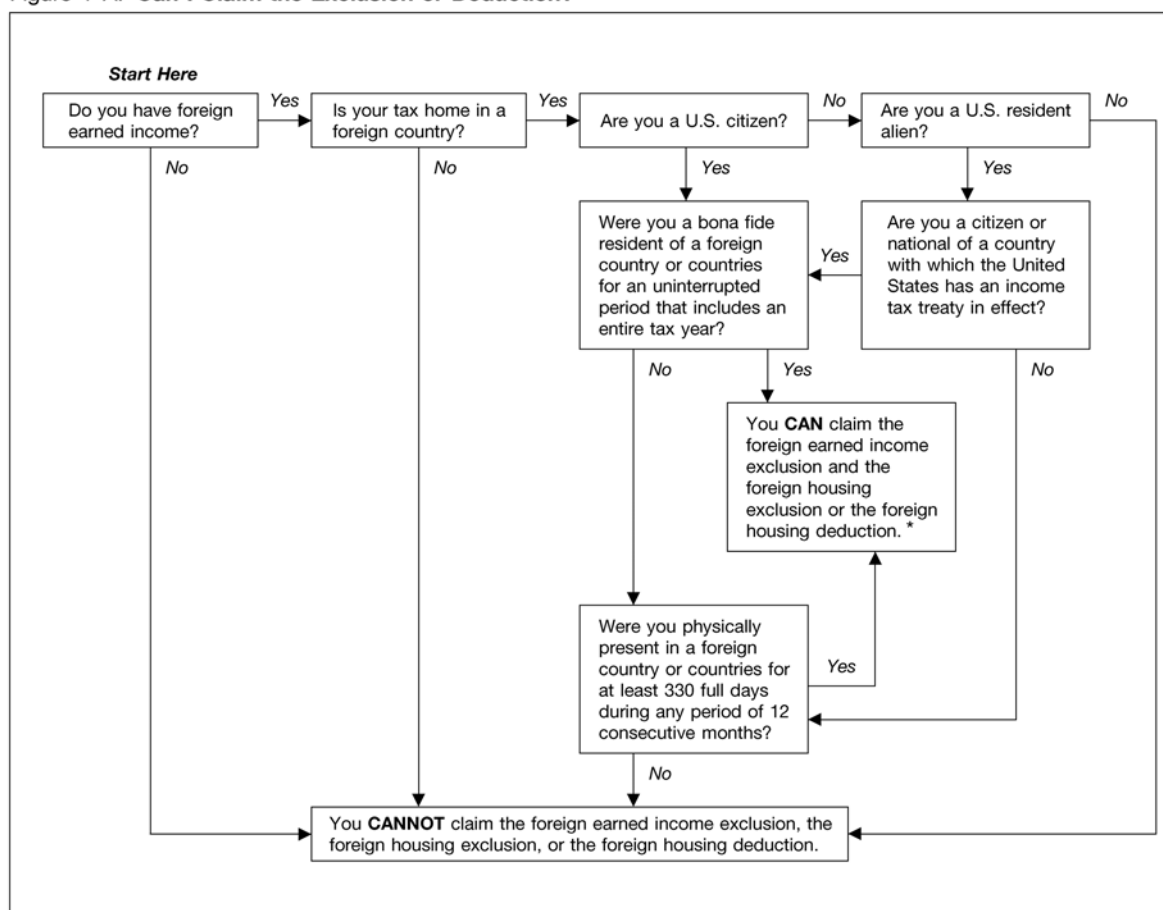
Tax Home Test. To meet this test, the taxpayer's tax home must be in a foreign country throughout the period of **either** bona fide residence **or** physical presence, whichever applies. A tax home is the taxpayer's regular or principal place of business, employment, or post of duty, regardless of where the taxpayer's family resides.

Bona Fide Residence Test. To meet this test, the taxpayer must be a bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year (January 1 through December 31 for those who file on a calendar year basis).

Physical Presence Test. To meet this test, the taxpayer must be physically present in a foreign country for at least 330 full days during any period of 12 consecutive months. A full day means the 24-hour period that starts at midnight.

Note. Employees of the U.S. government who work overseas do not qualify for either the foreign income exclusion or the separate foreign housing exclusion or deduction.

Figure 4-A. **Can I Claim the Exclusion or Deduction? ****



* Foreign housing exclusion applies only to employees. Foreign housing deduction applies only to the self-employed.

** Flowchart found in 2004 IRS Pub. 54

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Example 19. Nancy, who is single, became a certified air traffic controller in 2004. For the first two months of 2005, she was employed as a secretary for a realty firm. Her 2005 Form W-2 from the real estate broker reports wages of \$5,210.

In March of 2005, she accepted a job as an air traffic controller with a private company, Central Air Traffic Control, Inc. (CATC). She was assigned to a job at the airport in Kabul, Afghanistan. The facts relating to that employment are shown below:

1. She arrived in Afghanistan in the afternoon of March 12, 2005, and stayed there through March 28, 2006. She left the country in the morning of March 29, 2006.
2. Her 2005 Form W-2 from CATC reports wages of \$108,417.
3. For security reasons, all of her housing in Kabul was furnished to her via an agreement between CATC and the U.S. military. She lived in a dormitory located on airport property which was leased by the U.S. military.

Note. The value of the furnished lodging is excludable under IRC §119 since it was furnished for the convenience of Nancy's employer. Therefore, the value of the furnished lodging is not included as wages on Nancy's 2005 Form W-2.

Question 19A. Does Nancy qualify for the foreign earned income exclusion in 2005?

Answer 19A. Yes. She meets both the tax home and the physical presence tests as explained below.

- **Nancy meets the tax home test.** Even though she owned a residence in Wichita, Kansas, she let her sister live there rent-free during her assignment to Kabul. She had an abode in Kabul, her provided dormitory room. Her assignment to Kabul was indefinite, not temporary. When she accepted the job, CATC informed her it would last at least 12 months.
- **Nancy also meets the 330 day physical presence test.** Her 12-consecutive-month period begins on March 13, 2005, her first full 24-hour day in Kabul. It ends on March 12, 2006.

Question 19B. What is the amount of Nancy's 2005 exclusion?

Answer 19B. \$64,400 as shown on line 43, Part VII, of Form 2555.

For Example 19

| | | | | | | | |
|---|--|--|---|---------------------------------|---------------------------|---|---|
| Form 2555 Department of the Treasury Internal Revenue Service (99) | Foreign Earned Income ▶ See separate instructions. ▶ Attach to Form 1040. | OMB No. 1545-0067 2005 Attachment Sequence No. 34 | | | | | |
| For Use by U.S. Citizens and Resident Aliens Only | | | | | | | |
| Name shown on Form 1040 Nancy | | Your social security number 333 : 33 : 3333 | | | | | |
| Part I General Information | | | | | | | |
| 1 Your foreign address (including country) 344 EOG/AFCAP, APO, AE 09354 | | 2 Your occupation Air Traffic Controller | | | | | |
| 3 Employer's name ▶ Central Air Traffic Control, Inc. | | | | | | | |
| 4a Employer's U.S. address ▶ 2010 Mayfair Ave. STE 110, Wichita, KS | | | | | | | |
| b Employer's foreign address ▶ 344 EOG/AFCAP, APO, AE 09354 | | | | | | | |
| 5 Employer is (check) a <input type="checkbox"/> A foreign entity b <input checked="" type="checkbox"/> A U.S. company c <input type="checkbox"/> Self any that apply: d <input type="checkbox"/> A foreign affiliate of a U.S. company e <input type="checkbox"/> Other (specify) ▶ | | | | | | | |
| 6a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. ▶ NA | | | | | | | |
| b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ <input checked="" type="checkbox"/> and go to line 7. | | | | | | | |
| c Have you ever revoked either of the exclusions? <input type="checkbox"/> Yes <input type="checkbox"/> 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? ▶ U.S.A. | | | | | | | |
| 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. <input type="checkbox"/> Yes <input checked="" type="checkbox"/> 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. ▶ USA from 1-1-05 through 3-11-05. Kabul, Afghanistan from 3-12-05 through 3-28-06 | | | | | | | |
| 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 <input type="checkbox"/> Purchased house b <input type="checkbox"/> Rented house or apartment c <input type="checkbox"/> Rented room d <input type="checkbox"/> Quarters furnished by employer | | | | | | | |
| 12a Did any of your family live with you abroad during any part of the tax year? <input type="checkbox"/> Yes <input type="checkbox"/> 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.) <input type="checkbox"/> Yes <input type="checkbox"/> No | | | | | | | |
| b Are you required to pay income tax to the country where you claim bona fide residence? (See instructions.) <input type="checkbox"/> Yes <input type="checkbox"/> 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 <input type="checkbox"/> Yes <input type="checkbox"/> No | | | | | | | |
| d Did you maintain a home in the United States while living abroad? <input type="checkbox"/> Yes <input type="checkbox"/> No | | | | | | | |
| e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶ | | | | | | | |
| For Paperwork Reduction Act Notice, see page 4 of separate instructions. | | | | Cat. No. 11900P | | Form 2555 (2005) | |

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For Example 19

Form 2555 (2005)

Page **2**

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 **03-13-05** through **03-12-06**
- 17** Enter your principal country of employment during your tax year. **Afghanistan**
- 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) |
|---|------------------|---------------|--|--|--|
| Physically present in foreign country or countries the entire 12 month period | | | | | |
| | | | | | |
| | | | | | |

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 2005 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 2005, no matter when you performed the service.

| 2005 Foreign Earned Income | | Amount (in U.S. dollars) | |
|---|------------|-----------------------------|----------------|
| 19 Total wages, salaries, bonuses, commissions, etc. | | 19 | 108,417 |
| 20 Allowable share of income for personal services performed (see instructions): | | 20a | |
| a In a business (including farming) or profession | | 20b | |
| b In a partnership. List partnership's name and address and type of income. ▶ | | | |
| 21 Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined): | | 21a | |
| a Home (lodging). | | 21b | |
| b Meals | | 21c | |
| c Car | | 21d | |
| d Other property or facilities. List type and amount. ▶ | | | |
| 22 Allowances, reimbursements, or expenses paid on your behalf for services you performed: | | | |
| a Cost of living and overseas differential | 22a | | |
| b Family | 22b | | |
| c Education | 22c | | |
| d Home leave | 22d | | |
| e Quarters | 22e | | |
| f For any other purpose. List type and amount. ▶ | 22f | | |
| g Add lines 22a through 22f | | 22g | |
| 23 Other foreign earned income. List type and amount. ▶ | | 23 | |
| 24 Add lines 19 through 21d, line 22g, and line 23 | | 24 | 108,417 |
| 25 Total amount of meals and lodging included on line 24 that is excludable (see instructions) | | 25 | NA |
| 26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your 2005 foreign earned income | | 26 | 108,417 |

Form **2555** (2005)

For Example 19

Form 2555 (2005)

Page 3

Part V All Taxpayers

| | | | |
|--|---|----|---------|
| 27 | Enter the amount from line 26 | 27 | 108,417 |
| Are you claiming the housing exclusion or housing deduction? | | | |
| <input type="checkbox"/> Yes. Complete Part VI. | | | |
| <input checked="" type="checkbox"/> No. Go to Part VII. | | | |

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

| | | | |
|----|--|----|------|
| 28 | Qualified housing expenses for the tax year (see instructions) | 28 | |
| 29 | Number of days in your qualifying period that fall within your 2005 tax year (see instructions) | 29 | days |
| 30 | Multiply \$32.59 by the number of days on line 29. If 365 is entered on line 29, enter \$11,894.00 here | 30 | |
| 31 | Subtract line 30 from line 28. If the result is zero or less, do not complete the rest of this part or any of Part IX | 31 | |
| 32 | Enter employer-provided amounts (see instructions) | 32 | |
| 33 | Divide line 32 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000" | 33 | × . |
| 34 | Housing exclusion. Multiply line 31 by line 33. Enter the result but do not enter more than the amount on line 32. Also, complete Part VIII | 34 | |

Note: The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

| | | | | |
|----|---|----|----------|-----|
| 35 | Maximum foreign earned income exclusion | 35 | \$80,000 | 00 |
| 36 | <ul style="list-style-type: none"> If you completed Part VI, enter the number from line 29. All others, enter the number of days in your qualifying period that fall within your 2005 tax year (see the instructions for line 29). | 36 | 294 days | |
| 37 | <ul style="list-style-type: none"> If line 36 and the number of days in your 2005 tax year (usually 365) are the same, enter "1.000." Otherwise, divide line 36 by the number of days in your 2005 tax year and enter the result as a decimal (rounded to at least three places). | 37 | × . | 805 |
| 38 | Multiply line 35 by line 37 | 38 | 64,400 | |
| 39 | Subtract line 34 from line 27 | 39 | 108,417 | |
| 40 | Foreign earned income exclusion. Enter the smaller of line 38 or line 39. Also, complete Part VIII | 40 | 64,400 | |

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

| | | | |
|----|---|----|--------|
| 41 | Add lines 34 and 40 | 41 | 64,400 |
| 42 | Deductions allowed in figuring your adjusted gross income (Form 1040, line 36) that are allocable to the excluded income. See instructions and attach computation | 42 | N/A |
| 43 | Subtract line 42 from line 41. Enter the result here and in parentheses on Form 1040, line 21. Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 | 43 | 64,400 |

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if (a) line 31 is more than line 34 and (b) line 27 is more than line 41.

| | | | |
|--|--|----|--|
| 44 | Subtract line 34 from line 31 | 44 | |
| 45 | Subtract line 41 from line 27 | 45 | |
| 46 | Enter the smaller of line 44 or line 45 | 46 | |
| Note: If line 45 is more than line 46 and you could not deduct all of your 2004 housing deduction because of the 2004 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 47. Otherwise, go to line 48. | | | |
| 47 | Housing deduction carryover from 2004 (from worksheet on page 4 of the instructions) | 47 | |
| 48 | Housing deduction. Add lines 46 and 47. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line | 48 | |

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Form 2555 (2005)

2005 Workbook

For Example 19

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return 2005** (99) IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

For the year Jan. 1–Dec. 31, 2005, or other tax year beginning , 2005, ending , 20

Label
(See instructions on page 16.)
Use the IRS label.
Otherwise, please print or type.

Presidential
Campaign

Label HERE

Your first name and initial
Nancy

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 16.

Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.

Your social security number
333 33 3333

Spouse's social security number

You must enter your SSN(s) above.

Checking a box below will not change your tax or refund.

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

| | | | |
|-----|---|-----|-------------------------|
| 7 | Wages, salaries, tips, etc. Attach Form(s) W-2 | 7 | 113,627 |
| 8a | Taxable interest. Attach Schedule B if required | 8a | 100 |
| b | Tax-exempt interest. Do not include on line 8a | 8b | |
| 9a | Ordinary dividends. Attach Schedule B if required | 9a | |
| b | Qualified dividends (see page 20) | 9b | |
| 10 | Taxable refunds, credits, or offsets of state and local income taxes (see page 20) | 10 | |
| 11 | Alimony received | 11 | |
| 12 | Business income or (loss). Attach Schedule C or C-EZ | 12 | |
| 13 | Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/> | 13 | |
| 14 | Other gains or (losses). Attach Form 4797 | 14 | |
| 15a | IRA distributions | 15a | |
| b | Taxable amount (see page 22) | 15b | |
| 16a | Pensions and annuities | 16a | |
| b | Taxable amount (see page 22) | 16b | |
| 17 | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E | 17 | |
| 18 | Farm income or (loss). Attach Schedule F | 18 | |
| 19 | Unemployment compensation | 19 | |
| 20a | Social security benefits | 20a | |
| b | Taxable amount (see page 24) | 20b | |
| 21 | Other income. List type and amount (see page 24) | 21 | < 64,400 > |
| 22 | Add the amounts in the far right column for lines 7 through 21. This is your total income | 22 | 49,327 |
| 23 | Educator expenses (see page 23) | 23 | |

Observation for Nancy's Form 2555

- Line 25 is N/A because the value of Nancy's furnished lodging is not included as wages on her 2005 Form W-2 from CATC. For the same reason, she does not qualify for the housing exclusion and/or deduction in Part VI of Form 2555.
- Line 36 is 294 days. It includes March 13, 2005 through December 31, 2005.