Chapter 2: Credits

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

TAX CREDITS VERSUS DEDUCTIONS

Many taxpayers mistakenly use the terms "tax credits" and "tax deductions" interchangeably. Credits and deductions are both important ways that taxpayers can reduce their tax liability. In order to fully inform clients about potential options for lowering their taxes, tax professionals need to fully understand the differences between the two.

A **tax credit** reduces the amount of income tax that a taxpayer has to pay on a dollar-for-dollar basis. For example, a $500 residential energy credit (discussed later in this chapter) reduces the taxpayer's tax liability by $500.

There are three categories of tax credits that will be discussed in this chapter.

1. **Refundable credits** are not limited by the taxpayer's tax liability; when the refundable credit is more than the tax liability reported on the return, the excess is refunded.
2. **Partially refundable credits** are a hybrid of the other two categories. A portion of the tax credit is refundable, and the remainder is nonrefundable.
3. **Nonrefundable credits** are limited to the amount of tax shown on the taxpayer's return.

A **tax deduction** reduces the taxpayer's taxable income, which reduces their tax liability by a percentage, depending on the taxpayer's marginal tax bracket. For example, if a taxpayer is in the 15% tax bracket, a $500 deduction reduces the taxpayer's liability by $75 ($500 × 15%).

The various categories of individual tax credits are covered in this chapter. In addition, business credits that can be taken on Form 1040 are covered in the last section of this chapter. Tax deductions are covered in 2012 Volume C, Chapter 3: Schedule A.

Note. In this chapter, 2011 forms are frequently used rather than draft 2012 IRS forms because many of the draft forms were not available as of the date of publication.

REFUNDABLE CREDITS

EARNED INCOME CREDIT

Reference

IRC §32; Schedule EIC, *Earned Income Credit.*

Purpose

The earned income credit (EIC) provides a refundable tax credit to subsidize taxpayers with low to moderate earned income.

Eligibility Criteria

The rules for computing eligibility for the EIC are complex. Qualifications vary depending on whether the taxpayer has a qualifying child. However, all EIC recipients must satisfy the following seven rules.

1. The taxpayer's AGI must be less than the applicable threshold for the year. The 2012 thresholds are as follows.[1]
   - $45,060 ($50,270 if MFJ) with three or more qualifying children
   - $41,952 ($47,162 if MFJ) with two qualifying children
   - $36,920 ($42,130 if MFJ) with one qualifying child
   - $13,980 ($19,190 if MFJ) with no qualifying children
2. The taxpayer must have a valid social security number (SSN). If married, the taxpayer's spouse also must have a valid SSN.
3. The taxpayer's filing status cannot be MFS.
4. The taxpayer must be **one** of the following.
   - **a.** A U.S. citizen for the entire tax year
   - **b.** A resident alien for the entire tax year
   - **c.** A nonresident alien married to either a U.S. citizen or resident alien and filing a joint return
5. The taxpayer cannot file Form 2555, *Foreign Earned Income,* or Form 2555-EZ, *Foreign Earned Income Exclusion.*
6. The investment income on the taxpayer's return cannot be more than $3,200 in 2012.[2] (This limit is adjusted annually for inflation.)
7. The taxpayer must have earned income. If a taxpayer is filing a joint return, this rule is satisfied if at least one spouse has earned income.

Other tests apply, depending on whether the taxpayer has a qualifying child.

> **Note.** For a thorough discussion of the EIC rules, see pages 124–129 in the 2011 *University of Illinois Federal Tax Fundamentals* workbook.

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1. Rev. Proc. 2011-52, 2011-45 IRB 701.
2. Ibid.

Computation

The amount of a taxpayer's EIC is based on qualifying income and the number of qualifying children being claimed on the return.

Qualifying income is computed on the EIC worksheet included with the instructions for the relevant form in the 1040 series.

The maximum amount of EIC a taxpayer can receive in 2012 is as follows.[3]

- $5,891 with three or more qualifying children
- $5,236 with two qualifying children
- $3,169 with one qualifying child
- $475 with no qualifying children

Due Diligence Requirement

Eligibility requirements for the EIC are very complex and, as the above amounts indicate, the credit can be quite substantial. Combined with the myriad situations that taxpayers present with nontraditional living arrangements, computation of the EIC is replete with fraud and error. A 2008 Treasury Inspector General for Tax Administration (TIGTA) memorandum reports that the IRS annually pays **$10 to $12 billion in erroneous EIC payments.**[4] However, the majority of errors appear to be the unintentional result of the EIC's complexity.[5]

Accordingly, Congress enacted due diligence requirements for paid tax return preparers in order to reduce EIC errors. Most returns that claim the EIC are prepared by tax professionals.[6] Paid tax preparers must meet the following requirements.

1. For tax years ending on or after December 31, 2011, preparers must complete Form 8867, *Paid Preparer's Earned Income Credit Checklist,* (which follows) and submit it with every EIC tax return or claim for refund. The preparer must retain a copy of Form 8867 for three years from the latest of the following dates, as applicable. [7]
   - **a.** The unextended due date of the tax return
   - **b.** The date the return was electronically filed
   - **c.** The date the return was presented to the taxpayer for signature (for returns not filed electronically)
   - **d.** The date the EIC part of the return was submitted to the preparer who signed the return

> **Caution.** The 2012 version of Form 8867 may be substantially different from the 2011 version. As of the publication date of this workbook, the IRS draft Form 8867 expands Section IV of this form to require paid preparers to confirm that they asked the taxpayer(s) specific questions concerning eligibility for EIC. The IRS also includes questions that ask the paid preparers to indicate specific documents that were reviewed to:
>
> - Determine a child's residency
> - Determine a child's disability
> - Demonstrate the existence of a business reported on Schedule C

3. Ibid.

4. Treasury Inspector General for Tax Administration, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments,* Reference Number: 2009-40-024 (2008).

5. *Center on Budget and Policy Priorities.* Greenstein, Robert, and Wancheck, John. Apr. 19, 2011. Center on Budget and Policy Priorities. [www.cbpp.org/cms/?fa=view&id=3445] Accessed on Oct. 11, 2011.

6. IRS News Rel. IR-2011-98 (Oct. 6, 2011).

7. *Due Diligence FAQs.* [www.eitc.irs.gov/rptoolkit/faqs/duediligence] Accessed on Feb. 3, 2012.

Form **8867**

Department of the Treasury
Internal Revenue Service

Paid Preparer's Earned Income Credit Checklist

▶ To be completed by preparer and filed with Form 1040, 1040A, or 1040EZ.
▶ Information about Form 8867 and its separate instructions is at *www.irs.gov/form8867*.

OMB No. 1545-1629
2012
Attachment Sequence No. 177

Taxpayer name(s) shown on return	Taxpayer's social security number

For the definitions of the following terms, see **Pub. 596**.

- **Investment Income**
- **Qualifying Child**
- **Earned Income**
- **Full-time Student**

Part I All Taxpayers

1 Enter preparer's name and PTIN ▶ ----------

2 Is the taxpayer's filing status married filing separately? . . . . ☐ **Yes** ☐ **No**

▶ If you checked **"Yes"** on line 2, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

3 Does the taxpayer (and the taxpayer's spouse if filing jointly) have a social security number (SSN) that allows him or her to work or is valid for EIC purposes? See the instructions before answering ☐ **Yes** ☐ **No**

▶ If you checked **"No"** on line 3, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

4 Is the taxpayer filing Form 2555 or Form 2555-EZ (relating to the exclusion of foreign earned income)? . . . . ☐ **Yes** ☐ **No**

▶ If you checked **"Yes"** on line 4, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.

Form 8867 (2012) Page **2**

Part II Taxpayers With a Child

DRAFT AS OF August 23, 2012 DO NOT FILE

	Child 1	Child 2	Child 3
Caution. If there is more than one child, complete lines 8 through 14 for one child before going to the next column.			
8 Child's name			
9 Is the child the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them?	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**
10 Is either of the following true? • The child is unmarried, or • The child is married, can be claimed as the taxpayer's dependent, and is not filing a joint return (or is filing it only as a claim for refund).	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**
11 Did the child live with the taxpayer in the United States for over half of the year? See the instructions before answering	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**
12 Was the child (at the end of 2012)— • Under age 19 and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), • Under age 24, a full-time student, and younger than the taxpayer (or the taxpayer's spouse, if the taxpayer files jointly), or • Any age and permanently and totally disabled?	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**
▶ If you checked **"Yes"** on lines 9, 10, 11, **and** 12, the child is the taxpayer's qualifying child; go to line 13a. If you checked **"No"** on line 9, 10, 11, **or** 12, the child is not the taxpayer's qualifying child; see the instructions for line 12.			
13a Could any other person check **"Yes"** on lines 9, 10, 11, **and** 12 for the child?	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**	☐ **Yes** ☐ **No**
▶ If you checked **"No"** on line 13a, go to line 14. Otherwise, go to line 13b.			

Part III Taxpayers Without a Qualifying Child

16	Was the taxpayer's main home, and the main home of the taxpayer's spouse if filing jointly, in the United States for more than half the year? (Military personnel on extended active duty outside the United States are considered to be living in the United States during that duty period. See Pub. 596.)	☐ Yes ☐ No
	▶ If you checked **"No"** on line 16, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
17	Was the taxpayer, or the taxpayer's spouse if filing jointly, at least age 25 but under age 65 at the end of 2012? See the instructions before answering	☐ Yes ☐ No
	▶ If you checked **"No"** on line 17, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
18	Is the taxpayer, or the taxpayer's spouse if filing jointly, eligible to be claimed as a dependent on anyone else's federal income tax return for 2012? If the taxpayer's filing status is married filing jointly, check "No"	☐ Yes ☐ No
	▶ If you checked **"Yes"** on line 18, **stop;** the taxpayer **cannot** take the EIC. Otherwise, continue.	
19	Are the taxpayer's **earned income** and **adjusted gross income** each less than the limit that applies to the taxpayer for 2012? See Pub. 596 for the limit	☐ Yes ☐ No
	▶ If you checked **"No"** on line 19, **stop;** the taxpayer **cannot** take the EIC. If you checked **"Yes"** on line 19, the taxpayer can take the EIC. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to find out if **Form 8862** must be filed. Go to line 20.	

Part IV Due Diligence Requirements

20	Did you complete Form 8867 based on current information provided by the taxpayer or reasonably obtained by you?	☐ Yes ☐ No
21	Did you complete the EIC worksheet found in the Form 1040, 1040A, or 1040EZ instructions (or your own worksheet that provides the same information as the 1040, 1040A, or 1040EZ worksheet)? . .	☐ Yes ☐ No
22	If any qualifying child was not the taxpayer's son or daughter, did you ask why the parents were not claiming the child and document the answer?	☐ Yes ☐ No ☐ Does not apply
23	If the answer to question 13a is "Yes" (indicating that the child lived for more than half the year with someone else who could claim the child for the EIC), did you explain the tiebreaker rules and possible consequences of another person claiming your client's qualifying child?	☐ Yes ☐ No ☐ Does not apply
24	Did you ask this taxpayer any additional questions that are necessary to meet your knowledge requirement? See the instructions before answering	☐ Yes ☐ No ☐ Does not apply
	To comply with the EIC knowledge requirement, you must not know or have reason to know that any information used to determine the taxpayer's eligibility for, and the amount of, the EIC is incorrect. You may not ignore the implications of information furnished to or known by you, and you must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete. At the time you make these inquiries, you must document in your files the inquiries you made and the taxpayer's responses.	
25	Did you document the additional questions you asked and your client's answers?	☐ Yes ☐ No ☐ Does not apply

Form **8867** (2012)

26 Which documents below, if any, did you rely on to determine EIC eligibility for the qualifying child(ren) listed on Schedule EIC? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no qualifying child, check box a. If there is no disabled child, check box o.

Residency of Qualifying Child(ren)

☐ **a** No qualifying child
☐ **b** School records or statement
☐ **c** Landlord or property management statement
☐ **d** Health care provider statement
☐ **e** Medical records
☐ **f** Child care provider records
☐ **g** Placement agency statement
☐ **h** Social service records or statement
☐ **i** Place of worship statement
☐ **j** Indian tribal official statement
☐ **k** Employer statement
☐ **l** Other (specify) ▼ ______
☐ **m** Did not rely on any documents, but made notes in file
☐ **n** Did not rely on any documents

Disability of Qualifying Child(ren)

☐ **o** No disabled child
☐ **p** Doctor statement
☐ **q** Other health care provider statement
☐ **r** Social services agency or program statement
☐ **s** Other (specify) ▼ ______
☐ **t** Did not rely on any documents, but made notes in file
☐ **u** Did not rely on any documents

27 If a Schedule C is included with this return, which documents or other information, if any, did you rely on to confirm the existence of the business and to figure the amount of Schedule C income and expenses reported on the return? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no Schedule C, check box a.

Documents or Other Information

☐ **a** No Schedule C
☐ **b** Business license
☐ **c** Forms 1099
☐ **d** Records of gross receipts provided by taxpayer
☐ **e** Taxpayer summary of income
☐ **f** Records of expenses provided by taxpayer
☐ **g** Taxpayer summary of expenses
☐ **h** Bank statements
☐ **i** Reconstruction of income and expenses
☐ **j** Other (specify) ▼ ______
☐ **k** Did not rely on any documents, but made notes in file
☐ **l** Did not rely on any documents

▶ You have complied with all the due diligence requirements if you:

1. Completed the actions described on lines 20 and 21 and checked **"Yes"** on those lines,
2. Completed the actions described on lines 22, 23, 24, and 25 (if they apply) and checked **"Yes"** (or **"Does not apply"**) on those lines,
3. Submit Form 8867 in the manner required, **and**
4. Keep all five of the following records for 3 years from the latest of the dates specified in the instructions under *Document Retention*:
   a. Form 8867, Paid Preparer's Earned Income Credit Checklist,
   b. The EIC worksheet(s) or your own worksheet(s),
   c. Copies of any taxpayer documents you relied on to determine eligibility for or amount of EIC,
   d. A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained, and
   e. A record of any additional questions you asked and your client's answers.

▶ If you checked **"No"** on line 20, 21, 22, 23, 24, or 25, you have not complied with all the due diligence requirements and may have to pay a $500 penalty for each failure to comply.

2. The preparer should accurately compute the credit.

3. The preparer must exhibit informed knowledge of the EIC eligibility criteria and expend reasonable efforts to ensure the accuracy of information obtained from the taxpayer. For example, a preparer should:

   a. Evaluate information received from clients;

   b. Apply a consistency and reasonableness standard to the information;

   c. Ask additional questions if the information appears incorrect, inconsistent, or incomplete; and

   d. Document and retain the record of inquiries made and client responses.

4. The preparer should retain records related to the taxpayer's eligibility, the computation of the credit, the identity of the person providing the information, and how and when the information was obtained. These records must be kept for three years after the later of the due date of the return or the date it was transferred in final form by the preparer to the next person in the filing process.[8]

For returns required to be filed after December 31, 2011, paid tax return preparers who fail to comply with the due diligence requirements are subject to a penalty of $500 per failure.[9]

HEALTH COVERAGE TAX CREDIT

Reference

IRC §35; Form 8885, *Health Coverage Tax Credit.*

Purpose

The health coverage tax credit (HCTC) offsets part of the amounts that eligible individuals who are negatively affected by free trade spend on certain kinds of health coverage for themselves and family members.

Eligibility Criteria

An eligible individual for purposes of the HCTC must meet all of the following conditions.[10]

- Is an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, reemployment TAA recipient, or Pension Benefit Guaranty Corporation pension payee who is at least 55 years old; or is a family member of an individual who was in one of the preceding categories at the time of Medicare enrollment, death, or divorce
- Is covered by a qualified health insurance plan for which the taxpayer paid more than 50% of the premiums
- Is not enrolled in Medicare Part A, B, or C, or is enrolled in Medicare but only claiming premiums for qualified family members
- Is not enrolled in Medicaid or the Children's Health Insurance Program
- Is not enrolled in the Federal Employees Health Benefits Program or eligible to receive benefits under the U.S. military health system
- Is not imprisoned
- Cannot be claimed as a dependent on someone else's tax return for the year

8. Ibid.

9. IRC §6695(g).

10. *HCTC Eligibility Guide.* [www.irs.gov/Individuals/HCTC:-Eligibility-Requirements---General-Requirements] Accessed on Sep. 5, 2012.

Computation

For eligible coverage months after April 2009, and before March 2011, the HCTC allows a credit for 80% of the premiums for qualified health insurance. The HCTC tax credit is 72.5% of premiums for payments made in March 2011 through December 2013.[11]

Eligible individuals who participate in a qualified health plan must determine whether they want to register for the monthly HCTC or claim the yearly HCTC.

The **monthly** HCTC helps pay the health insurance premiums as they become due each month. The procedures are as follows.[12]

1. The eligible individual must complete Form 13441-A, *Health Coverage Tax Credit (HCTC) Monthly Registration,* and continue paying the full health insurance premiums to the health plan administrator.
2. The form and supporting documents should be mailed to the following address:

   HCTC Processing Center
   P.O. Box 760189
   San Antonio, TX 78245
3. After the eligible individual receives a welcome letter and first invoice from the HCTC program, they send monthly payments for 27.5% of the health insurance premiums to the HCTC.
4. The HCTC program adds 72.5% to the payment and sends the total amount of the premium to the health plan.

With the **yearly** HCTC, the eligible individual pays health insurance premiums in full and then claims the credit on their federal income tax return. The steps are as follows.[13]

1. The eligible individual must confirm that they and affected family members meet the HCTC requirements.
2. The full amount of the monthly premiums must be paid to the qualified health plan. The eligible individual should keep copies of the insurance bills and records of all payments.
3. Form 8885, *Health Coverage Tax Credit,* and required supporting documents must be submitted with the tax return.
4. After the IRS processes the tax return, the eligible individual will receive 72.5% of the premium payments as either a tax credit or refund.

Note. For more information about the HCTC, see the instructions for Form 8885.

11. *HCTC: Latest News and Background.* [www.irs.gov/Individuals/HCTC:-Latest-News-and-Background] Accessed on Sep. 5, 2012.

12. *HCTC Eligibility Guide.* [www.irs.gov/Individuals/HCTC:-Eligibility-Requirements---General-Requirements] Accessed on Sep. 5, 2012.

13. Ibid.

PARTIALLY REFUNDABLE CREDITS

MINIMUM TAX CREDIT

Reference

IRC §53; Form 8801, *Credit for Prior Year Minimum Tax — Individuals, Estates, and Trusts.*

Purpose

Alternative minimum tax (AMT) is caused by two types of adjustment and preference items: deferral items and exclusion items. Deferral items generally are timing issues, such as depreciation or incentive stock options that are treated differently for regular tax and AMT purposes. In other words, the deferral item that generated the AMT is not a constant, as opposed to exclusion items such as the standard deduction, which are available to the taxpayer year after year.

The prior year minimum tax credit (MTC) prevents the double taxation of income arising from deferral items, which otherwise might be taxed first under AMT and later under regular tax.

Eligibility Criteria

To qualify for the MTC, the taxpayer must have a prior year AMT caused by deferral items. The credit is divided into two subparts: the refundable credit and the nonrefundable credit.

Nonrefundable Portion. A taxpayer may claim a nonrefundable credit for prior year minimum tax against their 2012 regular tax if the taxpayer:

- Had a 2011 AMT liability arising from deferral item adjustments or preferences, or
- Is carrying forward an MTC from 2011.

Refundable Portion. The refundable credit applies to any unused MTC carryforward from the third preceding tax return, reduced by any MTCs allowed in the prior two years. For 2012, MTC carryovers attributable to tax years before 2009 are eligible for refundable treatment.

The refundable MTC is the greater of:

- 50% of the unused MTC that is more than three years old, or
- The refundable MTC from the prior year's income tax return.

Computation

AMT is computed under an alternate, or parallel, set of tax rules. To calculate the prior year MTC, the AMT must be recomputed under yet another set of alternative rules — the AMT rules without regard to deferral items. The computation of this credit is beyond the scope of this chapter. For more information, refer to the instructions for Form 8801, *Credit for Prior Year Minimum Tax — Individuals, Estates, and Trusts.*

Note. For a detailed discussion of AMT, see Chapter 6 in the 2011 *University of Illinois Federal Tax Workbook.*

CHILD TAX CREDIT/ADDITIONAL CHILD TAX CREDIT

Reference

IRC §24; Form 8812, *Additional Child Tax Credit.*

Purpose

The nonrefundable child tax credit (CTC) helps offset the cost of childrearing for qualified families with children under the age of 17. The refundable additional child tax credit (ACTC) allows families with no income tax liability to receive an additional tax credit.

Eligibility Criteria

To qualify for both the CTC and the ACTC, a taxpayer must have a qualifying child that meets **all** of the following six conditions.

1. The child must be related to the taxpayer as a son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of these relatives.
2. The child must be under age 17 at the end of the calendar year.
3. The child cannot provide over half of their own support for the year.
4. The child must have lived with the taxpayer for more than half of the year. Certain exceptions apply.[14]
5. The taxpayer must claim the child as a dependent on their return.
6. The child must be a U.S. citizen, a U.S. national, or a resident of the United States.

Taxpayers must meet earned income requirements to qualify for the ACTC. For the 2012 tax year, this minimum earned income amount is $3,000.[15]

Computation

The CTC equals $1,000 per qualified child, limited to the taxpayer's tax liability. The 2011 credit is phased out for taxpayers with MAGI[16] in excess of the following amounts.

- Married filing jointly: $110,000
- Single, qualifying widow(er), or head of household: $75,000
- Married filing separately: $55,000

The ACTC applies to taxpayers with qualifying children who do not receive their full CTC because the amount of their CTC exceeds their tax liabilities. Taxpayers with three or more qualifying children can qualify for an increased ACTC to help offset some of their social security tax.

Note. On December 31, 2012, the ACTC is scheduled to expire and the CTC is scheduled to revert to $500 per qualified child.

Note. For more information on the child tax credit, see page 124 in the 2011 *University of Illinois Federal Tax Fundamentals* workbook.

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14. For exceptions to this residency rule, see the instructions for Form 8812, *Additional Child Tax Credit.*

15. Rev. Proc. 2011-52, 2011-45 IRB 701.

16. For purposes of the child tax credit, MAGI means AGI increased by any foreign income exclusions under IRC §§911, 931, and 933.

EDUCATION CREDITS

Reference

IRC §25A; Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits).*

Purpose

Education credits offset the cost of higher learning for taxpayers, their spouses, and dependents.

The American opportunity credit (AOC) applies to the first four years of undergraduate study and grants taxpayers a credit for 100% of the first $2,000 of qualified expenses and 25% of the next $2,000, for a maximum credit of $2,500. Qualified expenses include tuition; fees; and course-related books, supplies, and equipment.

Caution. The AOC is set to expire at the end of 2012. Unless Congress extends the AOC, payments made in 2012 for educational terms beginning after December 31, 2012 will **not** qualify for the AOC.

Payments made in 2012 for Spring 2013 terms may be eligible for the HOPE credit or Lifetime Learning credit.

The lifetime learning credit is allowed for all years of postsecondary education and is calculated as 20% of the first $10,000 of qualifying educational expenses, resulting in a maximum credit of $2,000 per year. Qualified expenses are generally the same as those allowed for the AOC.

The lifetime learning credit is nonrefundable. However, 40% of the AOC is refundable. The remaining 60% is nonrefundable.

Note. The education tax credits are phased out based on differing income levels. See Chapter 2, Education, in the 2011 *University of Illinois Federal Tax Fundamentals* workbook for a more extensive discussion.

INDIVIDUAL NONREFUNDABLE CREDITS

CHILD AND DEPENDENT CARE CREDIT

Reference

IRC §21; Form 2441, *Child and Dependent Care Expenses.*

Purpose

Certain parents and caregivers can claim the child and dependent care credit to offset some of the costs incurred in providing care for qualifying individuals while the parents or caregivers work or are looking for work.

Eligibility Criteria

To obtain this credit, a taxpayer must have paid qualifying expenses to care for a qualifying individual while working or looking for work. Married taxpayers generally must file a joint return to claim the child and dependent care credit. However, married taxpayers do not have to file jointly if legally separated under a decree of separate maintenance. Married taxpayers that qualify for the head-of-household (HoH) filing status may also claim the credit.

A **qualifying individual** is one of the following.

1. A qualifying child under the age of 13 who can be claimed as the taxpayer's dependent (see exception for divorced/separated parents)
2. A spouse who is mentally or physically incapable of self-care and who resided with the taxpayer for more than half the year
3. An individual who is mentally or physically incapable of self-care and who resided with the taxpayer for more than half the year, and who:
   a. Was the taxpayer's dependent, or
   b. Would have qualified as the taxpayer's dependent, except that:
      - The individual had 2012 gross income in excess of $3,800,
      - The individual filed a joint tax return, or
      - The taxpayer or the taxpayer's spouse was claimed as a dependent on another return.

Claiming the Credit

Taxpayers are required to provide identification numbers for all qualifying individuals. The identification number can be a social security number (SSN), an adoption taxpayer identification number (ATIN), or an individual taxpayer identification number (ITIN).

Additionally, the taxpayer must provide the provider's name, address, and taxpayer identification number (TIN). The words "tax exempt" can be used in place of the TIN for qualifying providers, such as churches or schools.

Taxpayers must exercise **due diligence** in providing the required information. Form W-10, *Dependent Care Provider's Identification and Certification*, can be used to gather the required information. If a provider refuses to comply with the request for information, the taxpayer should complete Form 2441, *Child and Dependent Care Expenses,* and enter "See Attached Statement" in the missing fields. The attached statement should detail the taxpayer's attempts to obtain the missing information.

Prepaid expenses are claimed in the year the service is provided. Expenses paid in a year following the year they were incurred are claimed in the year they were paid. The credit for these expenses is computed separately.[17]

Computation

The child and dependent care credit is based on a percentage of qualifying expenses, subject to certain limitations. An earned income limit and a dollar limit are based on the amount of qualifying expenses.

Earned Income Limitation. The child and dependent care credit cannot exceed the taxpayer's earned income. Married taxpayers must use the lower of the taxpayer's or the spouse's earned income to compute the credit.

Dollar Limitation. The credit is limited further by a cap on the dollar amount of qualifying expenses. The maximum amount of expenses on which the credit can be computed is $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals.

Taxpayers who elect to participate in an employer's dependent care benefits plan must reduce their dollar limit by the amount of the exclusion reported in box 10 of Form W-2.[18] Taxpayers cannot exclude more than $5,000 — or $2,500 if married filing separately (MFS).

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17. See IRS Pub. 503, *Child and Dependent Care Expenses*, for more details.

18. Taxpayers must complete Form 2441, *Child and Dependent Care Expenses,* Part III, to claim the dependent care benefit exclusion.

Percentage. Once the earned income and dollar limitations are applied, the credit is based on the amount of qualifying expenses multiplied by a sliding-scale percentage. This percentage ranges from 20% to 35%, depending on the adjusted gross income (AGI) shown on the return. The higher the income, the lower the percentage. Taxpayers with an AGI over $43,000 receive a credit of 20% of the qualifying expenses, whereas taxpayers with an AGI of $15,000 or less receive the maximum 35% credit, limited to their tax liability.

Note. For a detailed discussion about the child and dependent care credit, see pages 130–139 in the 2011 *University of Illinois Federal Tax Fundamentals* workbook.

RESIDENTIAL ENERGY CREDITS

Reference

IRC §§25C and 25D; Form 5695, *Residential Energy Credits.*

Purpose

Residential energy credits were composed of two different credits — the nonbusiness energy property credit and the residential energy efficient property credit. The **nonbusiness energy property credit** was available for improvements made to the taxpayer's principal residence before January 1, 2012 (unless extended). The **residential energy efficient property credit** generally applies to any dwelling unit used as a residence by the taxpayer.

Eligibility Criteria

To be eligible for the residential energy credits, taxpayers must make qualified energy-saving improvements to their homes, which must be located in the United States.

Caution. Parts of the following discussion relate to the nonbusiness energy property credit (as reported on page one of Form 5695), which expired as of December 31, 2011. This information is included as a reference. It is possible that Congress may extend this credit for 2012.

Nonbusiness Energy Property Credit. The nonbusiness energy property credit is only available for existing homes. Each taxpayer is limited to a total credit of $500 for all tax years after 2005. Further limits are imposed, as explained later in the "Claiming the Credit" section.

Nonbusiness energy property improvements are broken down into two subcategories: qualified energy efficiency improvements and residential energy property.

Qualified energy efficiency improvements consist of building envelope components that meet the following conditions.

- The component is installed on or in the taxpayer's principal residence, which is owned during the taxable year and located in the United States.
- The original use of the component begins with the taxpayer.
- The component is expected to remain in use at least five years.
- The component meets certain energy standards.[19]

19. The instructions for Form 5695 contain a list of current energy efficiency criteria. Although not all Energy Star certified products qualify for the credit, the Energy Star website (www.energystar.gov) also contains helpful information about the residential energy credits.

Taxpayers compute the credit on the cost of the following building envelope components, **without including** any costs for onsite preparation, assembly, or installation.

- Any insulation material or system that is specifically and primarily designed to reduce a home's heat loss or gain and meets the prescriptive criteria established by the International Energy Conservation Code
- Exterior windows and skylights that meet or exceed the Energy Star program requirements
- Exterior doors that meet or exceed the Energy Star program requirements
- Any metal roof with appropriate pigmented coatings or asphalt roof with appropriate cooling granules designed specifically and primarily to reduce heat gain and that meets or exceeds the Energy Star program requirements

Residential energy property costs consist of new qualified energy property that is installed on or in the taxpayer's principal residence, which is located in the United States and owned during the taxable year. Qualified energy property is any of the following and **includes** labor costs allocable to onsite preparation, assembly, or original installation.

- Certain electric heat pump water heaters; electric heat pumps; central air conditioners; natural gas, propane, or oil water heaters; and stoves that use biomass fuel
- Qualified natural gas, propane, or oil furnaces; and qualified natural gas, propane, or oil hot water boilers
- Certain advanced main air circulating fans used in natural gas, propane, or oil furnaces

Residential Energy Efficient Property Credit. This credit is available for both existing homes and homes under construction. The property must be placed in service on or before December 31, 2016. Taxpayers may take the credit for 30% of the costs of the following, including labor costs for onsite preparation, assembly, or original installation and for piping or wiring to interconnect the property to the home.

- Qualified solar electric property
- Solar water heating property
- Small wind energy property
- Geothermal heat pump property
- Fuel cell property (limited to $500 for each one-half kilowatt of capacity)

Of the above costs, **only fuel cell property must be installed on or in connection with the taxpayer's principal residence.**

Claiming the Credit

Nonbusiness Energy Property Credit. The **nonbusiness energy property credit** is claimed in Part I of Form 5695. The credit that may be claimed is the sum of the following.

- 10% of the amount paid or incurred for **qualified energy efficiency improvements** installed during the taxable year
- Any **residential energy property costs** paid or incurred during the taxable year

The amount of the credit is further limited as follows.

1. The total amount of the credit is limited to $500 for all tax years after 2005.

> **Note.** The nonbusiness energy property credit was not available in 2008 but was increased to an aggregate of $1,500 for the 2009 and 2010 tax years. If the taxpayer has taken total nonbusiness energy property credits in previous years (after 2005) that equal or exceed $500, no credit is available for 2011. As mentioned earlier, the credit expired on December 31, 2011.[20]

2. Only $200 can be applied to windows for all tax years after 2005.
3. The following limits apply to amounts paid during the taxable year.
   a. $50 for any advanced main air circulating fan
   b. $150 for any qualified natural gas, propane, or oil furnace or hot water boiler
   c. $300 for any item of energy efficient building property

Any unused credit **cannot** be carried forward.

Residential Energy Efficient Property Credit. This credit is claimed in Part II of Form 5695. The residential energy-efficient property credit equals 30% of the qualified costs. There is no maximum credit limit for residential energy-efficient property, with the exception of fuel cell property. The credit for qualified fuel cell property is limited to $500 for each one-half kilowatt of the property's capacity. These credits **can** be claimed for costs related to new construction and **can** be carried forward.

Example 1. Gus and Hazel remodeled their principal residence in 2011. They paid $5,000 for a natural gas furnace and $1,000 for an exterior door, both of which qualify for the nonbusiness energy property credit. In addition, they purchased an 8-kilowatt fuel cell power plant for $25,000, which qualifies for the residential energy efficient property credit. Gus and Hazel's tax liability before taking into account their energy credits is $16,000. Their Form 5695 follows.

20. Instructions for Form 5695.

For Example 1

Form **5695**

Department of the Treasury
Internal Revenue Service

Residential Energy Credits

▶ See instructions.
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2011
Attachment Sequence No. **158**

Name(s) shown on return: **Gus and Hazel**
Your social security number: **444 55 3333**

Part I **Nonbusiness Energy Property Credit**

1a	Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions) . . . . ▶		**1a**	☑ Yes ☐ No
	Caution: *If you checked the "No" box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.*			
b	Print the complete address of the main home where you made the qualifying improvements. **Caution:** *You can only have one main home at a time.* 1000 BelAire Place (Number and street; Unit No.) Rolla, MO 65401 (City, State, and ZIP code)			
c	Were any of these improvements related to the construction of this main home? . . . . . . ▶		**1c**	☐ Yes ☑ No
	Caution: *If you checked the "Yes" box, you can only claim the nonbusiness energy property credit for qualifying improvements that were not related to the construction of the home. Do not include expenses related to the construction of your main home, even if the improvements were made after you moved into the home.*			
2	Lifetime limitation. Amounts claimed in 2006, 2007, 2009, and 2010.			
a	Amount, if any, from line 12 of your 2006 Form 5695	**2a**		
b	Amount, if any, from line 15 of your 2007 Form 5695	**2b**		
c	Amount, if any, from line 11 of your 2009 Form 5695	**2c**		
d	Amount, if any, from line 11 of your 2010 Form 5695	**2d**		
e	Add lines 2a through 2d. If $500 or more, **stop**; you cannot take the nonbusiness energy property credit		**2e**	
3	Qualified energy efficiency improvements (original use must begin with you and the component must reasonably be expected to last for at least 5 years; do not include labor costs) (see instructions).			
a	Insulation material or system specifically and primarily designed to reduce heat loss or gain of your home that meets the prescriptive criteria established by the 2009 IECC		**3a**	
b	Exterior doors that meet or exceed the Energy Star program requirements		**3b**	1,000
c	Metal or asphalt roof that meets or exceeds the Energy Star program requirements and has appropriate pigmented coatings or cooling granules which are specifically and primarily designed to reduce the heat gain of your home		**3c**	
d	Exterior windows and skylights that meet or exceed the Energy Star program requirements	**3d**		
e	Maximum amount of cost on which the credit can be figured	**3e**	$2,000	
f	If you claimed window expenses on your Form 5695 for 2006, 2007, 2009, or 2010, enter the amount from the Window Expense Worksheet (see instructions); otherwise enter -0-	**3f**		
g	Subtract line 3f from line 3e. If zero or less, enter -0-	**3g**		
h	Enter the smaller of line 3d or line 3g		**3h**	
4	Add lines 3a, 3b, 3c, and 3h		**4**	1,000
5	Multiply line 4 by 10% (.10)		**5**	100
6	Residential energy property costs (must be placed in service by you; include labor costs for onsite preparation, assembly, and original installation) (see instructions).			
a	Energy-efficient building property. Do not enter more than **$300**		**6a**	
b	Qualified natural gas, propane, or oil furnace or hot water boiler. Do not enter more than **$150** . .		**6b**	150
c	Advanced main air circulating fan used in a natural gas, propane, or oil furnace. Do not enter more than **$50** .		**6c**	
7	Add lines 6a through 6c		**7**	150
8	Add lines 5 and 7		**8**	250
9	Maximum credit amount. (If you jointly occupied the home, see instructions)		**9**	$500
10	Enter the amount, if any, from line 2e		**10**	
11	Subtract line 10 from line 9. If zero or less, **stop;** you cannot take the nonbusiness energy property credit. .		**11**	500
12	Enter the smaller of line 8 or line 11		**12**	250
13	Limitation based on tax liability. Enter the amount from the Credit Limit Worksheet (see instructions) .		**13**	16,000
14	**Nonbusiness energy property credit.** Enter the smaller of line 12 or line 13. Also include this amount on Form 1040, line 52, or Form 1040NR, line 49		**14**	250

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13540P Form **5695** (2011)

For Example 1

Form 5695 (2011) Page 2

Part II **Residential Energy Efficient Property Credit** (See instructions before completing this part.)

Note. *Skip lines 15 through 25 if you only have a* ***credit carryforward from 2010.***

15	Qualified solar electric property costs			15	
16	Qualified solar water heating property costs			16	
17	Qualified small wind energy property costs			17	
18	Qualified geothermal heat pump property costs			18	
19	Add lines 15 through 18			19	
20	Multiply line 19 by 30% (.30)			20	
21a	Qualified fuel cell property. Was qualified fuel cell property installed on or in connection with your main home located in the United States? (See instructions) ▶			21a	☑ Yes ☐ No
	Caution: *If you checked the "No" box, you cannot take a credit for qualified fuel cell property. Skip lines 21b through 25.*				
b	Print the complete address of the main home where you installed the fuel cell property. 1000 BelAire Place Number and street Unit No. Rolla, MO 65401 City, State, and ZIP code				
22	Qualified fuel cell property costs	22	25,000		
23	Multiply line 22 by 30% (.30)	23	7,500		
24	Kilowatt capacity of property on line 22 above ▶ 8 . x $1,000	24	8,000		
25	Enter the smaller of line 23 or line 24			25	7,500
26	Credit carryforward from 2010. Enter the amount, if any, from your 2010 Form 5695, line 28			26	
27	Add lines 20, 25, and 26			27	7,500
28	Enter the amount from Form 1040, line 46, or Form 1040NR, line 44	28	16,000		
29	**1040 filers:** Enter the total, if any, of your credits from Form 1040, lines 47 through 50; line 14 of this form; line 12 of the Line 11 Worksheet in Pub. 972 (see instructions); Form 8396, line 9; Form 8859, line 9; Form 8834, line 23; Form 8910, line 22; Form 8936, line 15; and Schedule R, line 22. **1040NR filers:** Enter the amount, if any, from Form 1040NR, lines 45 through 47; line 14 of this form; line 12 of the Line 11 Worksheet in Pub. 972 (see instructions); Form 8396, line 9; Form 8859, line 9; Form 8834, line 23; Form 8910, line 22; and Form 8936, line 15.	29	250		
30	Subtract line 29 from line 28. If zero or less, enter -0- here and on line 31			30	15,750
31	**Residential energy efficient property credit.** Enter the smaller of line 27 or line 30. Also include this amount on Form 1040, line 52, or Form 1040NR, line 49			31	7,500
32	Credit carryforward to 2012. If line 31 is less than line 27, subtract line 31 from line 27	32			

Form **5695** (2011)

FOREIGN TAX CREDIT

Reference

IRC §901; Form 1116, *Foreign Tax Credit*; and Form 8689, *Allocation of Individual Income Tax to the U.S. Virgin Islands.*

Purpose

The foreign tax credit reduces double taxation on foreign-source income by providing taxpayers with an income tax credit (subject to limitations) for taxes paid to a foreign country or U.S. possession on the same income taxed by the United States.

Eligibility Criteria

This credit is available to qualified taxpayers who pay or accrue eligible foreign taxes to qualified foreign countries or U.S. possessions.

Qualified Taxpayers. The foreign tax credit is available to U.S. citizens and resident aliens. Generally, nonresident aliens cannot claim the foreign tax credit. However, the following nonresident aliens are eligible for the credit.

- Full-year residents of Puerto Rico
- Nonresident aliens who pay or accrue tax on foreign-source income effectively connected to a U.S. trade or business, unless the tax due to the foreign country is based on income derived from U.S. sources

Eligible Foreign Taxes. The credit can be computed on income, war profits, and excess profits taxes paid to a qualified foreign country or U.S. possession. U.S. citizens living in certain treaty countries may also claim foreign income tax paid on certain items of U.S. income. Further details on the relationship between the foreign tax credit and tax treaty countries can be found in IRS Pub. 514, *Foreign Tax Credit for Individuals.*

The following taxes are **ineligible** for the foreign tax credit.[21]

1. Foreign taxes the taxpayer paid that were not legally owed, including taxes eligible to be refunded to the taxpayer
2. Foreign taxes paid to countries designated by the Secretary of State as repeated supporters of terrorism and countries that are either not recognized by the United States or with which the United States does not have diplomatic relations
3. Foreign taxes withheld from corporate dividends when the taxpayer has not held the stock for at least 16 days within the 31-day period beginning 15 days before the ex-dividend date[22]
4. Foreign taxes withheld on a dividend to the extent the taxpayer must make related payments on similar or related property (e.g., the taxpayer is obligated to pay someone else an amount equal to the dividends received)
5. Foreign taxes withheld on nondividend income or gain from property not held for at least 16 days within the 31-day period beginning 15 days before the right to receive the payment arises[23]
6. Foreign taxes withheld on nondividend income or gain from property to the extent the taxpayer must make related payments on positions in similar or related property
7. Payments of foreign tax that are returned to the taxpayer in the form of a subsidy

21. Instructions for Form 1116.

22. See IRC §901(k)(3) for holding requirement for preferred stocks.

23. IRC §901(l).

8. Taxes paid or accrued to a foreign entity in connection with the purchase or sale of oil or gas extracted in that country, if the taxpayer does not have an economic interest in the oil or gas, and the purchase price or sales price is different from the FMV of the oil or gas at the time of the purchase or sale

9. Foreign taxes paid or accrued on income for which the taxpayer is claiming an exclusion on Form 8873, *Extraterritorial Income Exclusion*[24]

Qualified Foreign Entities. Qualified foreign entities include foreign countries (unless otherwise prohibited) or U.S. possessions. This includes any political subdivision, agency, or instrumentality of the foreign country or possession.

Claiming the Credit

Taxpayers generally complete Form 1116, *Foreign Tax Credit*, to claim this credit. However, taxpayers seeking a credit for taxes paid to the U.S. Virgin Islands must use Form 8689, *Allocation of Individual Income Tax to the U.S. Virgin Islands*.

Election to Forgo Filing Form 1116. Taxpayers, other than estates or trusts, who received only passive foreign source income and who paid foreign tax of less than $300 for the year ($600 for MFJ), can elect to bypass Form 1116 and report the amount of foreign tax paid directly on Form 1040. To qualify for this election, the amount of foreign tax paid must be reported on a qualified payee statement, such as Form 1099-DIV, *Dividends and Distributions;* Form 1099-INT, *Interest Income;* or an appropriate Schedule K-1 from a pass-through entity.

In lieu of a credit, taxpayers may elect to claim any qualified foreign tax paid as an itemized deduction on Form 1040, Schedule A, *Itemized Deductions*. Generally, a taxpayer cannot claim both a credit and a deduction in the same year. Exceptions to this rule can be found in the instructions for Form 1116.

The foreign tax credit is nonrefundable. However, taxpayers filing Form 1116 may carry any unused credit back one year and forward for 10 years. This carryback/carryforward provision is not available to taxpayers who elect to claim the credit directly on Form 1040.

Computation

Computation of the foreign tax credit can be complex. For comprehensive information on computing this credit, refer to the Form 1116 instructions or IRS Pub. 514.

> **Note.** For a detailed discussion of international taxation, see Chapter 9 in the 2011 *University of Illinois Federal Tax Workbook*.

CREDIT FOR QUALIFIED RETIREMENT SAVINGS CONTRIBUTIONS

Reference

IRC §25B; Form 8880, *Credit for Qualified Retirement Savings Contributions.*

Purpose

The retirement savings contribution credit (also known as the **saver's credit**) is an income tax credit that rewards certain low- to moderate-income taxpayers for voluntarily contributing to their qualified retirement plans.

Eligibility Criteria

To be eligible for the retirement savings contribution credit, taxpayers must have voluntarily contributed to a qualified retirement plan and cannot have income in excess of designated AGI limitations. Dependents, full-time students, and taxpayers younger than age 18 cannot claim the credit.

24. See IRC §943(d) for exception for certain withholding taxes.

Qualified Retirement Plans. Only **elective** contributions made to the following types of retirement plans can be used to compute this credit.

- Traditional or Roth IRAs
- IRC §401(k) plans
- IRC §403(b) plans
- IRC §457 plans
- SEP
- SIMPLE
- IRC §501(c)(18)(D)[25]
- Qualified retirement plans, such as the federal Thrift Savings Plan (voluntary employee contributions only)[26]

> **Note.** Qualified contributions generally can be found on Form W-2, *Wage and Tax Statement*, in box 12. Illinois Municipal Retirement Fund employee contributions are mandatory and, therefore, are not reported in box 12 of the Form W-2 and are not eligible for this credit.

Income Limits. Income limitations differ based on the taxpayer's filing status. Taxpayers with 2012 AGIs in **excess** of the following amounts cannot claim the retirement savings contribution credit.

- Married filing jointly (MFJ) — $57,500
- Head of household — $43,125
- All other filing statuses — $28,750

Claiming the Credit

Eligible taxpayers must reduce their current year qualified contributions by an amount equal to the aggregate distributions received from any qualified retirement plan during a "testing period," which includes the:

- Current taxable year,
- Two years preceding the current taxable year, and
- A period after the calendar end of the current taxable year and before the extended due date for filing the current taxable year's return.

Distributions received as a result of a plan loan or from transfers, rollovers, conversions, or excess contributions; dividends earned on certain employer securities; distributions returned before the due date of the return; and military pensions do not reduce current year qualified contributions.

Married taxpayers who file jointly also must reduce their qualified contributions by the aggregate amount of any distributions their spouses receive during the testing period. However, each spouse computes their qualified contribution amount separately and should only include the spouses' distributions from years during which they filed joint returns.

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25. IRC §501(c)(18) includes trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees.

26. Contributions designated under IRC §414(h)(2) are treated as employer contributions and do not qualify for the retirement savings contribution credit.

The qualified contribution amount eligible for the credit, after reductions for any "testing period" distributions, is limited to $2,000 per taxpayer (i.e., $2,000 each for married taxpayers).

Computation

The retirement savings contribution credit is computed on a sliding scale, which ranges from 10−50% of the taxpayer's (and, if married, the spouse's) qualified annual contribution(s). This percentage is based on the taxpayer's filing status and AGI.

The following percentage rates and income limits apply for tax year 2012.

Percentage	MFJ	HoH	Others
50%	Up to $34,500	Up to $25,875	Up to $17,250
20%	$34,501–$37,500	$25,876–$28,125	$17,251–$18,750
10%	37,501– 57,500	28,126– 43,125	18,751– 28,750

Example 2. Fred and Ginger are married, and have an AGI of $56,000 on their 2011 joint return. During 2011, Fred elected to defer $5,000 to his §401(k) plan, and Ginger contributed $3,000 to her traditional IRA. In 2009, Fred was single and withdrew $4,000 from his §403(b) plan. Fred and Ginger made no other withdrawals from qualified plans during the testing period.

Question 2A. How much is the 2011 retirement savings contribution credit for Fred and Ginger?

Answer 2A. Fred and Ginger's total credit is **$300.**

Fred's credit is $100, computed on his $5,000 §401(k) plan contribution, reduced by his $4,000 §403(b) distribution in 2009, and then multiplied by the 10% rate applicable for his MFJ filing status and $56,000 AGI.

Ginger's credit is $200, computed on the lesser of her 2011 contribution of $3,000 to her traditional IRA or $2,000 and then multiplied by the applicable 10% rate.

Fred and Ginger's Form 8880 follows.

For Example 2

Form **8880**

Department of the Treasury
Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

▶ **Attach to Form 1040, Form 1040A, or Form 1040NR.**
▶ **See instructions on back.**

OMB No. 1545-0074
2011
Attachment Sequence No. **54**

Name(s) shown on return	Your social security number
Fred and Ginger	123-45-6789

You **cannot** take this credit if **either** of the following applies.

CAUTION

- The amount on Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 37 is more than $28,250 ($42,375 if head of household; $56,500 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1994, **(b)** is claimed as a dependent on someone else's 2011 tax return, or **(c)** was a **student** (see instructions).

			(a) You		(b) Your spouse
1	Traditional and Roth IRA contributions for 2011. **Do not** include rollover contributions	1			3,000
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2011 (see instructions)	2	5,000		
3	Add lines 1 and 2	3	5,000		3,000
4	Certain distributions received **after** 2008 and **before** the due date (including extensions) of your 2011 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4	4,000		
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	1,000		3,000
6	In each column, enter the **smaller** of line 5 or $2,000	6	1,000		2,000
7	Add the amounts on line 6. If zero, **stop**; you cannot take this credit			7	3,000
8	Enter the amount from Form 1040, line 38*; Form 1040A, line 22; or Form 1040NR, line 37	8	56,000		
9	Enter the applicable decimal amount shown below:			9	X . 1

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
		Enter on line 9—		
---	$17,000	.5	.5	.5
$17,000	$18,250	.5	.5	.2
$18,250	$25,500	.5	.5	.1
$25,500	$27,375	.5	.2	.1
$27,375	$28,250	.5	.1	.1
$28,250	$34,000	.5	.1	.0
$34,000	$36,500	.2	.1	.0
$36,500	$42,375	.1	.1	.0
$42,375	$56,500	.1	.0	.0
$56,500	---	.0	.0	.0

Note: *If line 9 is zero, **stop**; you cannot take this credit.*

10	Multiply line 7 by line 9			10	300
11	Enter the amount from Form 1040, line 46; Form 1040A, line 28; or Form 1040NR, line 44	11	4,704		
12	**1040 filers:** Enter the total of your credits from lines 47 through 49, and Schedule R, line 22. **1040A filers:** Enter the total of your credits from lines 29 through 31. **1040NR filers:** Enter the total of your credits from lines 45 and 46.	12			
13	Subtract line 12 from line 11. If zero, **stop**; you cannot take this credit			13	4,704
14	**Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 50; Form 1040A, line 32; or Form 1040NR, line 47			14	300

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 33394D Form **8880** (2011)

Example 3. Use the same facts as **Example 2,** except Fred and Ginger were married and filed jointly in 2009.

Question 3A. How much is Fred and Ginger's 2011 retirement savings contribution credit?

Answer 3A. The credit is $100. Because Ginger is required to reduce her 2011 qualified plan contribution of $3,000 by the amount of Fred's 2009 distribution of $4,000, she is not eligible for a credit in 2011. Fred's credit is computed the same as in **Example 2.**

MORTGAGE INTEREST CREDIT

Reference

IRC §25; Form 8396, *Mortgage Interest Credit.*

Purpose

The mortgage interest credit provides added home ownership incentives to certain homebuyers by granting an income tax credit equal to a percentage of their annual qualified mortgage interest paid. The credit may be claimed **each** year for a portion of the home mortgage interest paid during the year.

Eligibility Criteria

To claim this credit, taxpayers must **hold a mortgage credit certificate (MCC)** issued under a program by a state or political subdivision authorized to issue qualified residential mortgage bonds. Certificates issued by the Federal Housing Administration, Department of Veterans Affairs, and the Farmers Home Administration **do not** qualify for this credit; nor do Homestead Staff Exemption Certificates.

The mortgage must be for the acquisition, rehabilitation, or improvement of the taxpayer's principal residence.[27] The home to which the MCC relates must meet the following tests.[28]

- It must be a single-family residence.
- It must be located in the jurisdiction of the governmental unit that issued the certificate.

If the interest on the mortgage was paid to a related person (as defined in IRC §§267 or 707(b)), the credit cannot be claimed.[29]

> **Note.** The Illinois Housing Development Authority (IHDA) administers the federally authorized MCC program for the state of Illinois. Other states have similar housing authorities. MCCs are issued by the IHDA on a first-come, first-served basis as funds become available for a particular community. For more information on the programs available, target areas, requirements, and income and price limits by Illinois county, see **www.ihda.org.**

27. IRC §25(c)(1)(b).
28. Temp. Treas. Reg. §1.25-3T(d).
29. IRC §25(e)(6).

Requirements for Obtaining an MCC. The following conditions apply to individuals seeking an MCC.[30]

1. The borrower (and spouse, if applicable) must be **first-time homebuyers.** A first-time homebuyer is defined as someone who has not owned a principal residence within the last three years.
2. The first-time homeowner requirement does not apply to the following.
   - Those who buy in any **targeted area** (as defined in Temp. Treas. Reg. §1.25-1T(b)(7))
   - Any qualified home improvement loan (as defined in Temp. Treas. Reg. §1.25-1T(b)(3))
   - Any qualified rehabilitation loan (as defined in Temp. Treas. Reg. §1.25-1T(b)(4))
3. The mortgage loan must be a new mortgage loan or a qualified refinancing.[31]
4. The household must meet certain income limits, and the home must meet purchase price limits. Those limits are determined by the county in which the homes are purchased.

A prospective qualified individual must secure the MCC **before** obtaining a mortgage. Participating lenders and community housing development organizations will assist the prospective buyer in obtaining the certificate.

Claiming the Credit

Certificate credit rates range from 10% to 50%. For certificate rates of 20% or less, the credit equals the amount of interest paid multiplied by the certificate rate. For certificate rates in excess of 20%, the credit equals the amount of interest paid multiplied by the certificate rate, limited to $2,000.

The amount of the credit must be subtracted from mortgage interest paid to determine the amount of mortgage interest that qualifies as an itemized deduction on Schedule A, line 10.[32]

A credit in excess of the taxpayer's liability may be carried forward three years.[33] This credit is subject to recapture if the taxpayer sells their qualified home within nine years. The recapture amount is computed on Form 8828, *Recapture of Federal Mortgage Subsidy.*

30. Temp. Treas. Reg. §1.25-3T(e).
31. Treas. Reg. §1.125-3(p).
32. IRC §163(g).
33. IRC §25(e)(1)(A).

Example 4. Teena has rented an apartment for the last four years in Brown County, Indiana. Her 2011 income of $52,000 is below the income limit of $79,200 for 1-member households as set by the Indiana Housing and Community Development Authority (IHCDA) for Brown County.[34] Teena buys a single-family residence in the county seat of Nashville, Indiana, on March 1, 2011, for $190,000. This is well below the purchase price limit set by the IHCDA for Brown County.

Teena's mortgage broker helped her obtain a mortgage credit certificate. The MCC specified:

- A certificate credit rate of 20%, and
- A certified loan amount of $180,000. (Teena made a down payment of $10,000.)

The lender's interest rate for Teena's 30-year mortgage is 4.5%. Her 2011 Form 1098, *Mortgage Interest Statement,* reports $6,050 of interest paid. Her 2011 Form 1040, page 2; Schedule A; and Form 8396 are shown below.

Form 1040 (2011) Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)			38	52,000
	39a	Check if: ☐ **You** were born before January 2, 1947, ☐ Blind. ☐ **Spouse** was born before January 2, 1947, ☐ Blind. **Total boxes checked ▶ 39a** ☐				
Standard Deduction for— • People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $5,800 Married filing jointly or Qualifying widow(er), $11,600 Head of household, $8,500	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐				
	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	9,065
	41	Subtract line 40 from line 38			41	42,935
	42	**Exemptions.** Multiply $3,700 by the number on line 6d			42	3,700
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	39,235
	44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election			44	5,988
	45	**Alternative minimum tax** (see instructions). Attach Form 6251			45	
	46	Add lines 44 and 45 ▶			46	5,988
	47	Foreign tax credit. Attach Form 1116 if required	47			
	48	Credit for child and dependent care expenses. Attach Form 2441	48			
	49	Education credits from Form 8863, line 23	49			
	50	Retirement savings contributions credit. Attach Form 8880	50			
	51	Child tax credit (see instructions)	51			
	52	Residential energy credits. Attach Form 5695	52			
	53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☑ 8396	53	1,210		
	54	Add lines 47 through 53. These are your **total credits**			54	1,210
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55	4,778
	56	Self-employment tax. Attach Schedule SE				

[34] [www.in.gov/ihcda/files/2011-12_Income_limits_FOR_LENDERS.pdf] Accessed on Feb. 3, 2012.

For Example 4

SCHEDULE A (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074
2011
Attachment Sequence No. 07

Name(s) shown on Form 1040: Teena
Your social security number: 222-33-4444

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions)	1			
	2	Enter amount from Form 1040, line 38 [2]				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid	5	State and local **(check only one box):** a ☑ Income taxes, **or** b ☐ General sales taxes	5	1,700		
	6	Real estate taxes (see instructions)	6	2,000		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	3,700
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	4,840		
Note. Your mortgage interest deduction may be limited (see instructions).	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11			
	12	Points not reported to you on Form 1098. See instructions for special rules	12			
	13	Mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instructions.)	14			
	15	Add lines 10 through 14			15	4,840
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	525		
If you made a gift and got a benefit for it, see instructions.	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	525
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20	
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶	21			
	22	Tax preparation fees	22			
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23			
	24	Add lines 21 through 23	24			
	25	Enter amount from Form 1040, line 38 [25]				
	26	Multiply line 25 by 2% (.02)	26			
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ▶			28	
Total Itemized Deductions	29	Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40			29	9,065
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐				

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 17145C **Schedule A (Form 1040) 2011**

For Example 4

Form **8396** — Department of the Treasury, Internal Revenue Service (99)

Mortgage Interest Credit

(For Holders of Qualified Mortgage Credit Certificates Issued by State or Local Governmental Units or Agencies)

▶ Attach to Form 1040 or 1040NR. ▶ See instructions on back.

OMB No. 1545-0074 — 2011 — Attachment Sequence No. 138

Name(s) shown on your tax return	Your social security number
Teena	222-33-4444

Enter the address of your main home to which the qualified mortgage certificate relates if it is different from the address shown on your tax return.

101 Autumn Lane

Name of Issuer of Mortgage Credit Certificate	Mortgage Credit Certificate Number	Issue Date
First County Bank	9146002394	03/01/2011

Before you begin Part I, figure the amounts of any of the following credits you are claiming: Credit for the elderly or the disabled, alternative motor vehicle credit, qualified plug-in electric vehicle credit, and qualified plug-in electric drive motor vehicle credit.

Part I Current Year Mortgage Interest Credit

1	Interest paid on the certified indebtedness amount. If someone else (other than your spouse if filing jointly) also held an interest in the home, enter only your share of the interest paid	1	6,050
2	Enter the certificate credit rate shown on your **mortgage credit certificate. Do not** enter the interest rate on your home mortgage	2	20 %
3	If line 2 is 20% or less, multiply line 1 by line 2. If line 2 is more than 20%, or you refinanced your mortgage and received a reissued certificate, see the instructions for the amount to enter. **You must reduce your deduction for home mortgage interest on Schedule A (Form 1040) by the amount on line 3.**	3	1,210
4	Enter any 2008 credit carryforward from line 16 of your 2010 Form 8396	4	
5	Enter any 2009 credit carryforward from line 14 of your 2010 Form 8396	5	
6	Enter any 2010 credit carryforward from line 17 of your 2010 Form 8396	6	
7	Add lines 3 through 6	7	1,210
8	Limitation based on tax liability. Enter the amount from the Credit Limit Worksheet (see instructions)	8	5,988
9	**Current year mortgage interest credit.** Enter the **smaller** of line 7 or line 8. Also include this amount in the total on Form 1040, line 53, or Form 1040NR, line 50. Check box **c** on that line and enter "8396" in the space next to that box	9	1,210

Part II Mortgage Interest Credit Carryforward to 2012. (Complete **only** if line 9 is less than line 7.)

10	Add lines 3 and 4	10	
11	Enter the amount from line 7	11	
12	Enter the **larger** of line 9 or line 10	12	
13	Subtract line 12 from line 11	13	
14	**2010 credit carryforward to 2012.** Enter the **smaller** of line 6 or line 13	14	
15	Subtract line 14 from line 13	15	
16	**2009 credit carryforward to 2012.** Enter the **smaller** of line 5 or line 15	16	
17	**2011 credit carryforward to 2012.** Subtract line 9 from line 3. If zero or less, enter -0-	17	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 62502X Form **8396** (2011)

Example 4 Observations

1. Because Teena itemized her deductions, her allowable mortgage interest deduction on Schedule A is reduced by the amount of the credit claimed on Form 8396 ($6,050 mortgage interest paid less the $1,210 credit from line 9 of Form 8396 = $4,840 mortgage interest deduction).

2. If Teena's 2011 tax were zero, she could carry over the unused $1,210 credit to the next three tax years (2012, 2013, and 2014) or until used, whichever comes first. The current year credit is used first and then the prior year credits, beginning with the earliest period.[35]

3. If the certificate credit rate exceeds 20%, line 3 of Form 8396 cannot exceed $2,000.[36] The limit does not apply if the rate is 20% or less.

4. If Teena sells the home within nine years after the closing date in 2011, she **may** be subject to the recapture rules if the sale results in a gain.[37] This is true even if the gain is eligible for the $250,000 exclusion provided under IRC §121.[38]

5. If Teena did not have the MCC, her income tax would be $5,688. This is calculated as follows.

AGI	$52,000
Itemized deductions ($9,065 + $1,210)	(10,275)
Exemption	(3,700)
Taxable income	$38,025
Income tax	$ 5,688

Therefore, the mortgage interest credit saved Teena $910 in taxes ($5,688 − $4,778).

ADOPTION CREDIT

Reference

IRC §23; Form 8839, *Qualified Adoption Expenses.*

Purpose

The adoption credit subsidizes the expenses of adoptive parents and encourages the adoption of special-needs individuals. It is separate and distinct from the employer-provided adoption assistance exclusion, although both the credit and the exclusion are computed on the same form.

Eligibility Criteria

To be eligible for this credit, a taxpayer must have paid reasonable and necessary expenses to adopt an eligible individual. **Eligible individuals** include children under the age of 18 or individuals physically or mentally incapable of self-care.

Qualified expenses include adoption fees, court costs, attorney fees, travel expenses (including meals and lodging), and re-adoption expenses for foreign children. However, expenses that violate state or federal laws do not qualify for the credit. Additional **ineligible expenses** include surrogate costs; costs associated with adopting a spouse's child; costs covered under any federal, state, or local program; costs allowed as a credit or deduction under any other federal income tax rule; and costs reimbursed under an employee plan or paid by any other person or organization.

35. Temp. Treas. Reg. §1.25-2T(d)(2).

36. IRC §25(a)(2).

37. IRC §§25(i) and 143(m).

38. The IRC §121 exclusion is $500,000 for MFJ taxpayers and $250,000 for all other taxpayers.

Income Limit. The 2012 credit begins phasing out for taxpayers with modified adjusted gross income (MAGI) over \$189,710 and phases out completely at \$229,710.[39] Income must be modified by adding back any foreign-earnings exclusion. Income limitations are adjusted annually for inflation.

Computation

The 2012 adoption credit provides up to \$12,650 of tax relief per qualified adoption.[40] The credit is the dollar amount of qualified expenses paid, up to the annual limit, except for special-needs individuals (see below).

The timing of the credit depends on whether the adoptee is considered a foreign child. A **foreign child** is one who was not a citizen or resident of the United States or its possessions at the time adoption proceedings were initiated. A credit cannot be claimed for foreign adoptions **unless and until the adoption becomes final.** All expenses paid in prior years are treated as paid in the year the adoption is finalized. All expenses paid in years **after** the adoption becomes final are taken as a credit in the **year of payment.**

For **domestic adoptions,** expenses paid prior to the year that the adoption becomes final are taken as a credit in the year **following** the year that they are paid. Expenses paid in the year that the adoption becomes final or in any subsequent year are taken as a credit in the year that they are paid.

A taxpayer who adopts a **special-needs individual** qualifies for the maximum credit amount regardless of whether the taxpayer incurred any expenses for the adoption. A special-needs individual must meet **all** the following conditions.

1. The individual must be a citizen or a resident of the United States or its possessions at the time the adoption effort begins.
2. A state or District of Columbia agency must determine that the individual cannot be returned to the parents' home.
3. The state has determined that it is reasonable to assume the individual will not be adopted without assistance. Factors to be considered include the following.
   - **a.** Age
   - **b.** Ethnic background
   - **c.** Membership in a sibling group
   - **d.** Medical condition
   - **e.** Physical, mental, or emotional handicaps

> **Note.** The Patient Protection and Affordable Care Act of 2010 provided a **temporary** refundable adoption credit and increased the maximum amount of the credit for taxable years beginning after December 31, 2009, and before January 1, 2012. For taxable years beginning after December 31, 2011, these temporary changes no longer apply.[41]

39. Rev. Proc. 2011-52, 2011-45 IRB 701.
40. Ibid.
41. Ibid.

QUALIFIED PLUG-IN ELECTRIC DRIVE MOTOR VEHICLE CREDIT

Reference

IRC §30D; Form 8936, *Qualified Plug-In Electric Drive Motor Vehicle Credit.*

Eligibility Criteria

The qualified plug-in electric drive motor vehicle credit is available for vehicles acquired on or after January 1, 2010.

To qualify for the credit, a vehicle must meet all of the following criteria.

- Is new when purchased by the taxpayer
- Is acquired for use by the taxpayer and not for resale
- Has four or more wheels
- Is manufactured primarily for use on public streets, roads, and highways
- Has a gross vehicle weight less than 14,000 pounds
- Has a battery with at least four kilowatt hours that can be recharged from an external source of electricity

Computation

The qualified plug-in electric vehicle credit equals the sum of the following.

- $2,500
- $417 for a vehicle that is propelled by a battery with at least five kilowatt hours of capacity
- An additional $417 for each kilowatt hour of battery capacity in excess of five kilowatt hours

The portion of the credit determined by battery capacity cannot exceed $5,000, which limits the total allowable credit to $7,500 per qualified vehicle.

This credit phases out for a specific vehicle after the manufacturer has sold at least 200,000 vehicles.[42] This credit is subject to recapture if the vehicle ceases to be eligible for the credit.

CREDIT FOR THE ELDERLY OR THE DISABLED

Reference

IRC §22; Form 1040, Schedule R, *Credit for the Elderly or the Disabled.*

Purpose

The elderly or disabled credit is applied against the income tax liability of low-income seniors and disabled individuals.

42. See IRS Notice 2009-89, 2009-48 IRB 714, for details on manufacturers' certifications and phaseout reductions.

Eligibility Criteria

The credit is based on the taxpayer's filing status, age, and income. If the taxpayer is MFJ, it is also based on the spouse's age and income. To qualify for the credit, one of the following must apply.[43]

1. The taxpayer is age 65 or older at the end of the year, or
2. All of the following conditions are met.
   a. The taxpayer was permanently and totally disabled on the date they retired.
   b. The taxpayer received taxable disability income for the year.
   c. The taxpayer had not reached mandatory retirement age at the beginning of the tax year. (**Mandatory retirement age** is defined as the age when the employer's retirement program requires the taxpayer to retire.)

Filing Status. If the taxpayer's filing status is MFS and they lived with their spouse at any time during the tax year, they cannot take the credit.

If the taxpayer is a nonresident alien during the tax year, the credit is available only if the taxpayer's filing status is MFJ.

Income Limits. The following income limits apply to the credit for 2011.[44]

	THEN you generally cannot take the credit if:	
IF you are . . .	**The amount on Form 1040A, line 22, or Form 1040, line 38, is . . .**	**Or you received . . .**
Single, head of household, or qualifying widow(er) with dependent child	$17,500 or more	$5,000 or more of nontaxable social security and other nontaxable pensions, annuities, or disability income
Married filing jointly and only one spouse is eligible for the credit	$20,000 or more	$5,000 or more of nontaxable social security and other nontaxable pensions, annuities, or disability income
Married filing jointly and both spouses are eligible for the credit	$25,000 or more	$7,500 or more of nontaxable social security and other nontaxable pensions, annuities, or disability income
Married filing separately and you lived apart from your spouse for all of 2011	$12,500 or more	$3,750 or more of nontaxable social security and other nontaxable pensions, annuities, or disability income

Note. Although the purpose of this credit seems noble, in reality the credit seldom applies. Because the income limitations of this credit are so low and the standard deduction and exemption amounts are now relatively high, eligible taxpayers seldom have a tax against which to apply this nonrefundable credit.

43. 2011 Instructions for Schedule R.

44. Ibid.

CREDIT TO HOLDERS OF TAX CREDIT BONDS

Reference

IRC §54A; Form 8912, *Credit to Holders of Tax Credit Bonds.*

Purpose

Holders of tax credit bonds generally do not receive interest payments from the bond issuers. Instead, these bondholders claim an annual income tax credit in lieu of periodic interest payments via Form 8912, *Credit to Holders of Tax Credit Bonds*.

Eligibility Criteria

Taxpayers who hold the following bonds are eligible to claim a tax credit equal to a deemed amount of interest reported for each bond.

- Clean renewable energy bond
- Midwestern tax credit bond
- Qualified forestry conservation bond
- New clean renewable energy bond
- Qualified energy conservation bond
- Qualified zone academy bond
- Qualified school construction bond
- Build America bond

Build America bond holders receive **both** taxable interest payments and a corresponding tax credit.

BUSINESS CREDITS

This section lists the general business credits allowed on Form 1040, followed by a brief synopsis of a few key credits.

Form 3800, *General Business Credit*

The general business credit for the year consists of the taxpayer's carryforward of business credits from prior years plus the total of their current year business credits.

In order to claim a general business credit derived solely from a pass-through entity, the taxpayer generally may report the corresponding credit directly on Form 3800, *General Business Credit*.[45] In all other cases, the taxpayer must file Form 3800 as well as the relevant forms from the following list.

- Form 8931, *Agricultural Chemicals Security Credit*
- Form 6478, *Alcohol and Cellulosic Biofuel Fuels Credit*
- Form 8911, *Alternative Fuel Vehicle Refueling Property Credit*
- Form 8910, *Alternative Motor Vehicle Credit*
- Form 8864, *Biodiesel and Renewable Diesel Fuels Credit*

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45. For the exceptions to the general rule, see the instructions for Form 3800.

- Form 8933, *Carbon Dioxide Sequestration Credit*
- Form 8932, *Credit for Employer Differential Wage Payments*
- Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*
- Form 8882, *Credit for Employer-Provided Childcare Facilities and Services*
- Form 6765, *Credit for Increasing Research Activities*
- Form 8941, *Credit for Small Employer Health Insurance Premiums*
- Form 8881, *Credit for Small Employer Pension Plan Startup Costs*
- Form 8826, *Disabled Access Credit*
- Form 8906, *Distilled Spirits Credit*
- Form 8844, *Empowerment Zone and Renewal Community Employment Credit*
- Form 8909, *Energy Efficient Appliance Credit*
- Form 8908, *Energy Efficient Home Credit*
- Form 8845, *Indian Employment Credit*
- From 3468, *Investment Credit*
- Form 8586, *Low-Income Housing Credit*
- Form 8896, *Low Sulfur Diesel Fuel Production Credit*
- Form 8923, *Mine Rescue Team Training Credit*
- Form 5884-B, *New Hire Retention Credit*
- Form 8874, *New Markets Credit*
- Form 8907, *Nonconventional Source Fuel Credit*
- Form 8820, *Orphan Drug Credit*
- Form 8936, *Qualified Plug-In Electric Drive Motor Vehicle Credit*
- Form 8834, *Qualified Plug-In Electric and Electric Vehicle Credit*
- Form 8900, *Qualified Railroad Track Maintenance Credit*
- Form 8835, *Renewable Electricity, Refined Coal, and Indian Coal Production Credit*
- Form 5884, *Work Opportunity Credit*

Note. Unused general business credits can typically be carried back one year and carried forward 20 years.

CREDIT FOR EMPLOYER SOCIAL SECURITY AND MEDICARE TAXES PAID ON CERTAIN EMPLOYEE TIPS

Reference

IRC §45B; Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.*

Summary

Qualified employers in the food and beverage industry may claim a credit for social security and Medicare taxes paid or incurred on certain employees' tips. Employers qualify for this credit if they meet both of the following conditions.

- The employer had employees who received tips from customers for providing, delivering, or serving food or beverages for consumption if tipping of employees for delivering or serving food or beverages is customary.
- The employer paid or incurred employer social security and Medicare taxes on those tips during the tax year.

The credit equals the amount the employer paid or incurred for the employer's share of social security and Medicare taxes on tips received by the employee. However, the amount of tips used to compute the credit for any month must be reduced by an amount equal to the employee's hours worked during the month times $5.15 per hour[46] minus the actual wages (excluding tips) paid to the employee during that month.

Example 5. Heather worked 100 hours at O'Fallon's Restaurant and received $450 in tips for March 2012. O'Fallon's paid Heather $375 in wages (excluding tips) at the rate of $3.75 per hour. If Heather had been paid $5.15 per hour, she would have received wages of $515. For purposes of the credit taken on Form 8846, the $450 in tips is reduced by $140 ($515 − $375); therefore, $310 of Heather's tips for March 2012 is taken into account. O'Fallon's can claim a credit of $24 (310 × 7.65%) for Heather's March 2012 tips.

This credit is claimed on Form 8846 filed with an original or amended return any time within three years of the due date of the employer's return.

DISABLED ACCESS CREDIT

Reference

IRC §44; Form 8826, *Disabled Access Credit.*

Summary

The disabled access credit provides a nonrefundable credit for small businesses that incur expenses in providing access to persons with disabilities. An eligible small business is one that had gross receipts in the preceding year of $1 million or less, or had no more than 30 full-time employees in the previous year.

Eligible access expenditures include reasonable and necessary amounts paid or incurred to:

1. Remove barriers preventing a business from being accessible to or usable by disabled individuals (does not include amounts paid or incurred in connection with a facility that is first placed in service after November 5, 1990);
2. Provide qualified interpreters or other methods of making audio materials available to hearing-impaired people;
3. Provide qualified readers, taped texts, and other methods of making visual materials available to visually-impaired people; and
4. Acquire or modify equipment or devices for disabled individuals.

The credit is equal to 50% of the eligible access expenditures for the taxable year that exceed $250 but do not exceed $10,250. The maximum credit is $5,000 per year.

46. This amount represents the federal minimum wage as of January 1, 2007, and has not been increased for purposes of the Form 8846 tax credit computation.

NEW HIRE RETENTION CREDIT

Reference

IRC §3111(d); Form 5884-B, *New Hire Retention Credit.*

Summary

The Hiring Incentives to Restore Employment Act (HIRE Act) provides a credit to employers that hire certain previously unemployed workers after February 3, 2010, and before January 1, 2011, and retain them for at least 52 consecutive weeks. Employers are eligible to claim the new hire retention credit in the tax year during which the 52-week retention period is satisfied.

> **Note.** The latest possible 52-week retention period for this credit ended on December 31, 2011. This section is provided for tax professionals who need information on the credit in order to prepare either an amended return or a fiscal-year return for the applicable period.

The credit is calculated for each eligible employee on Form 5884-B. The form requires reporting each employee's wage totals for both the first and second 26 consecutive weeks of employment because the wages in the second half of the year must be at least 80% of the wages paid in the first half of the year.

The new hire retention credit is part of the general business credit claimed on Form 3800. **It may be carried forward** but may not be carried back to any tax year beginning before March 18, 2010.

Qualified employees must meet all of the following criteria to be eligible for the new hire retention credit.

1. The employee begins employment with the employer after February 3, 2010, and before January 1, 2011.
2. The employee was unemployed or employed 40 hours or less during the 60-day period ending on the date such employment begins. The employee must certify that they meet this requirement by signing an affidavit (Form W-11, *Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit,* or similar document).
3. The employee is not employed by the employer to replace another employee unless the other employee separated from employment voluntarily or for cause (including downsizing).
4. The employee is not related to the employer in one of the following ways.
   - **a.** Child or descendent of a child
   - **b.** Sibling or stepsibling
   - **c.** Parent or ancestor of a parent
   - **d.** Stepparent
   - **e.** Niece or nephew
   - **f.** Aunt or uncle
   - **g.** Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
   - **h.** A relative of anyone who owns more than 50% of the employer's outstanding stock or capital and profits interest or is a dependent of the employer or a dependent of anyone who owns more than 50% of the employer's stock or capital and profits interest

The amount of credit for each employee is the lesser of:

- 6.2% of the employee's wages during the 52-week consecutive period, or
- $1,000.

SMALL BUSINESS HEALTH INSURANCE TAX CREDIT

Reference

IRC §45R; Form 8941, *Credit for Small Employer Health Insurance Premiums.*

Summary

The small business health insurance tax credit is designed to encourage small employers to offer health insurance for the first time or maintain coverage they already have.

A tax credit is provided for a qualified small employer for nonelective contributions to purchase health insurance for its employees. The tax credit is available initially for any taxable year beginning in 2010–2013. **An eligible small employer** is one that meets all the following criteria.

- The employer has no more than 25 full-time equivalent (FTE) employees for the taxable year.
- The average annual wages of the employees do not exceed $50,000 (indexed for inflation in years after 2013).
- The employer has a qualifying contribution arrangement under which it must pay **at least 50%** of the premium cost of the qualified health insurance plan for each enrolled employee.

The following steps must be followed to determine whether an employer is eligible for the credit.[47]

1. Determine the employees taken into account for purposes of the credit.
2. Determine the number of hours of service performed by the employees.
3. Calculate the number of FTEs.
4. Determine the average annual wages paid per FTE.
5. Determine the premiums paid by the employer that are taken into account for purposes of the credit.

Determining Number of Employees. The following persons are not counted in the determination of FTEs and average annual wages.

1. Seasonal workers (unless the seasonal worker works for the employer for more than 120 days during the tax year)
2. Sole proprietors
3. Partners in a partnership
4. Shareholders owning more than 2% of an S corporation
5. Any owner of more than 5% of a business
6. Family members (i.e., lineal descendant, sibling or step-sibling, parent or parent's ancestor, step-parent, niece or nephew, aunt or uncle, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law) of any person described in items 2–5 above

Premiums paid on behalf of these persons are not counted in determining the amount of the credit.

Determining Number of Hours of Service Performed. An employee's hours of service for a year include:

- Each hour for which the employee is paid for the performance of duties for the employer, and
- Each hour for which the employee is paid or entitled to payment for vacation, holiday, illness, incapacity, layoff, jury duty, military duty, or leave of absence. However, no more than 160 hours of service are required to be counted for an employee for any single continuous period during which the employee performs no duties.

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47. IRS Notice 2010-44, 2010-22 IRB 717.

An employer can use any of the following methods to calculate the total number of hours of service that must be taken into account for an employee for the year.

Method 1. **Actual paid hours of service worked**

Method 2. **Days-worked equivalency.** This method credits the employee with eight hours of service for each actual workday in which the employee is credited with at least one hour of service. Workdays include vacation days, holidays, etc.

Method 3. **Weeks-worked equivalency.** This method credits the employee with 40 hours of weekly service for each week in which the employee is credited with at least one hour of service.

Employers do not have to use the same method for all employees. Instead, the employer may apply different methods for different classifications of employees, if the classifications are reasonable and consistently applied. For example, an employer may use Method 1 for all hourly employees and Method 3 for all salaried employees. Employers are permitted to change the method for calculating employees' hours of service for each taxable year.[48]

No more than 2,080 hours can be taken into account for any employee.

Example 6. Natural Bisquet Company is a small business that produces upscale organic doggie treats. In 2012, it has four employees. The company's accountant has decided to use Method 1 to calculate hours of service for hourly employees and Method 3 to calculate hours of service for salaried employees.

			Hours of Service			
Employee	**Classification**	**Wages**	**Actual Hours**	**Weeks Worked**	**Based on Actual Hours**	**Based on Weeks Worked**
Mandy	Hourly	$17,000	1,700	52	1,700	
Sandy	Hourly	18,140	1,814	50	1,814	
Randy	Salaried	52,000	2,102	52		2,080
Candy	Salaried	45,000	1,800	52		2,080
Totals		$132,140			3,514	4,160

The number of hours of service performed for purposes of the health insurance credit is calculated as follows.

Employee	**Hours Used to Compute FTE**
Mandy	1,700
Sandy	1,814
Randy	2,080
Candy	2,080
Total hours of service	7,674

Calculate the Number of FTEs. The number of FTEs for an employer is calculated by dividing the total hours of service (explained in the preceding section) by 2,080. If the result is not a whole number, it is rounded down to the next whole number.

Example 7. Use the same facts as **Example 6.** National Bisquet's FTEs for purposes of the small business health care credit is 3 (7,674 hours ÷ 2,080 = 3.69, rounded down to 3).

48. *Small Business Health Care Tax Credit: Frequently Asked Questions.* [www.irs.gov/uac/Small-Business-Health-Care-Tax-Credit:-Questions-and-Answers] Accessed on Sep. 5, 2012.

Determine the Average Annual Wages. Average annual wages are calculated by dividing the total wages[49] paid by the employer to qualified employees by the number of the employer's FTEs for the year. If the result is not a multiple of $1,000, it is rounded down to the nearest $1,000.

> **Example 8.** Use the same facts as **Example 7.** National Bisquet's average annual wages are $44,000 ($132,140 total wages ÷ 3 FTEs = $44,047, rounded to $44,000).

Determine the Amount of Premiums Paid. Only the portion of health insurance premiums paid under a qualifying arrangement by the employer is counted in calculating the credit. A **qualifying arrangement** is one in which the employer pays at least 50% of the cost of premiums for each employee enrolled in coverage. Any payment made in accordance with a salary reduction arrangement under a §125 cafeteria plan is not treated as paid by the employer.

For years prior to 2014, health insurance coverage for purposes of the credit means benefits consisting of medical care under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer.[50] Health insurance coverage for purposes of the credit also includes the following.

- Limited scope dental or vision
- Long-term care, nursing-home care, home-health care, community-based care, or any combination of these
- Coverage only for a specified disease or illness
- Hospital indemnity or other fixed-indemnity insurance
- Medicare supplemental health insurance, certain other supplemental coverage, and similar supplemental coverage provided to coverage under a group health plan[51]

Computation

The credit is equal to the **lesser** of the following two amounts multiplied by an applicable tax credit percentage.

1. The amount of contributions the employer made on behalf of the employees during the taxable year for the qualifying health coverage
2. The amount of contributions that the employer would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium (The benchmark premium is the average total premium cost in the small-group market for employer-sponsored coverage in the employer's state. The benchmark premium varies based on the type of coverage provided to the employee — single, adult with child, two adults, or family.)

The benchmark premium is multiplied by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. As mentioned earlier, this tax credit is only available if this uniform percentage is at least 50%.

> **Example 9.** Use the same facts as **Example 8.** National Bisquet Co. pays 100% of the health insurance premiums for its two salaried employees, Randy and Candy, who are both single. In 2012, it pays $11,500 for their coverage. However, the benchmark premium for single employees in the state is $5,198. Therefore, the amount of health insurance premiums that can be taken into account for purposes of the credit is limited to $10,396 ($5,198 × 2 employees).

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49. "Wages" for this purpose means wages as defined under IRC §3121(a), without regard to the wage base limitation under §3121(a)(1).

50. IRC §9832(b)(1).

51. IRS Notice 2010-44, 2010-22 IRB.

For the first phase of the credit (any taxable year beginning in 2010–2013), **the maximum applicable tax credit percentage is 35% for an employer that is not tax-exempt.** For the second phase of the credit (taxable years beginning in years after 2013), the applicable tax credit percentage is 50%. The second phase of the credit is only available to a qualified small employer that purchases health insurance coverage through a state exchange and can be claimed for only two additional consecutive years.

Credit Reduction. The credit is reduced for employers with average wages per employee between $25,000 and $50,000. The amount of this reduction is equal to the amount of the credit (determined before any reduction) multiplied by a fraction, the numerator of which is the average annual wages of the employer in excess of $25,000 and the denominator of which is $25,000. In effect, the credit amount is reduced by 4% for each $1,000 of average annual wages in excess of $25,000.

Example 10. Use the same facts as **Example 9.** National Bisquet's health care tax credit is calculated as follows.

Initial credit amount determined before any reduction:	
$10,396 health insurance premiums × 35%	$3,639
Credit reduction for average annual wages in excess of $25,000:	
$\$3{,}639 \times \left(\frac{\$44{,}000 \text{ average wages} - \$25{,}000}{\$25{,}000}\right)$	(2,766)
Total 2011 health insurance credit	$ 873

The credit is also reduced for any employer that has more than 10 but not more than 25 FTEs. For an employer with more than 10 FTEs, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15. In effect, the credit is reduced by 6.667% for each FTE in excess of 10.

For an employer with both more than 10 FTEs and average annual wages in excess of $25,000, the total reduction is the sum of the two reduction amounts.[52]

Example 11. In 2011, Joe DaMan, a sole proprietor doing business as DaMan Co., is a qualified employer for purposes of the small business health insurance credit. DaMan Co. has 12 FTEs and average annual wages of $30,000. DaMan pays $96,000 in health insurance premiums for its employees (which does not exceed the average premium for the small-group market in its state) and otherwise meets the requirements for the credit.

DaMan's credit is calculated as follows.

Initial credit amount determined before any reduction:	
$96,000 × 35%	$33,600
Credit reduction for FTEs in excess of 10:	
$\$33{,}600 \times \frac{2}{15}$	(4,480)
Credit reduction for average annual wages in excess of $25,000:	
$\$33{,}600 \times \frac{\$5{,}000}{\$25{,}000}$	(6,720)
Total 2011 health insurance credit	$22,400

52. Joint Committee on Taxation report JCX-18-10, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act."*

Claiming the Credit

For an employer that is not tax-exempt, the credit is claimed on the employer's annual income tax return. The credit for a year offsets only an employer's actual income tax liability (or AMT liability) for the year. However, as a general business credit, an unused credit amount can generally be carried back one year and carried forward 20 years.

For partnerships and S corporations, this credit is calculated at the entity level and allocated to the partners or shareholders for inclusion on their individual returns.

Both small businesses and tax-exempt organizations use Form 8941, *Credit for Small Employer Health Insurance Premiums,* to calculate the credit.

DaMan's 2011 Form 8941 from **Example 11** follows.

Form **8941** — **Credit for Small Employer Health Insurance Premiums** — OMB No. 1545-2198 — **2011**

Department of the Treasury
Internal Revenue Service

▶ Information about Form 8941 and its instructions is available at *www.irs.gov/form8941*.
▶ Attach to your tax return.

Attachment Sequence No. **63**

Name(s) shown on return	Identifying number
DaMan Co.	99-1234567

1	Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (see instructions)	1	15
2	Enter the number of full-time equivalent employees you had for the tax year (see instructions). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12	2	12
3	Average annual wages you paid for the tax year (see instructions). If you entered $50,000 or more, skip lines 4 through 11 and enter -0- on line 12	3	30,000
4	Premiums you paid during the tax year for employees included on line 1 for health insurance coverage under a qualifying arrangement (see instructions)	4	96,000
5	Premiums you would have entered on line 4 if the total premium for each employee equaled the average premium for the small group market in which you offered health insurance coverage (see instructions)	5	100,000
6	Enter the **smaller** of line 4 or line 5	6	96,000
7	Multiply line 6 by the applicable percentage: • Tax-exempt small employers, multiply line 6 by 25% (.25) • All other small employers, multiply line 6 by 35% (.35)	7	33,600
8	If line 2 is 10 or less, enter the amount from line 7. Otherwise, see instructions	8	29,120
9	If line 3 is $25,000 or less, enter the amount from line 8. Otherwise, see instructions	9	22,400
10	Enter the total amount of any state premium subsidies paid and any state tax credits available to you for premiums included on line 4 (see instructions)	10	0
11	Subtract line 10 from line 4. If zero or less, enter -0-	11	96,000
12	Enter the **smaller** of line 9 or line 11	12	22,400
13	If line 12 is zero, skip lines 13 and 14 and go to line 15. Otherwise, enter the number of employees included on line 1 for whom you paid premiums during the tax year for health insurance coverage under a qualifying arrangement (see instructions)	13	12
14	Enter the number of full-time equivalent employees you would have entered on line 2 if you only included employees included on line 13	14	12
15	Credit for small employer health insurance premiums from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)	15	0
16	Add lines 12 and 15. Cooperatives, estates, and trusts, go to line 17. Tax-exempt small employers, skip lines 17 and 18 and go to line 19. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, stop here and report this amount on Form 3800, line 4h	16	22,400
17	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	17	
18	Cooperatives, estates, and trusts, subtract line 17 from line 16. Stop here and report this amount on Form 3800, line 4h	18	
19	Enter the amount you paid in 2011 for taxes considered payroll taxes for purposes of this credit (see instructions)	19	
20	Tax-exempt small employers, enter the **smaller** of line 16 or line 19 here and on Form 990-T, line 44f	20	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37757S Form **8941** (2011)