Chapter 2: Reporting Miscellaneous Income

Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

Most tax professionals are aware that taxpayers **must report all income from any source and any country** on their tax returns unless the income is explicitly exempt under the Code. However, it is sometimes a challenge to determine **where** to report certain types of income on Form 1040. This chapter describes the various types of income that should be reported on lines 7 and 21.

LINE 7 (WAGES, SALARIES, TIPS, ETC.)

The total of a taxpayer's wages, salaries, and tips should be reported on line 7 of Form 1040. For most people, the amount that is entered on this line is shown in box 1 of their Form(s) W-2, *Wage and Tax Statement.* However, certain other types of income should also be included in the total on line 7. Many of these items are discussed in the following section.

HOUSEHOLD EMPLOYEE WAGES

If an employer pays a household worker at least $1,800 in wages during 2013,[1] the employer must provide Form W-2 to the worker. If the worker does not receive a Form W-2 because they were paid wages that were less than the threshold amount, they should report the wages on line 7 of Form 1040. On the dotted line next to line 7, the notation "HSH" and the amount not reported on Form W-2 should be entered.

UNREPORTED TIP INCOME

A taxpayer who receives tip income that they did not report to their employer should include the tip income on line 7 of Form 1040. The amount entered on line 7 should include any allocated tips shown in box 8 of Form W-2 unless the individual can prove that their unreported tips are less than the amount in box 8. Allocated tips are not included as income in box 1 of Form W-2.

The taxpayer must report social security and Medicare taxes on the unreported tips as additional taxes on their tax return. The additional taxes are calculated on Form 4137, *Social Security and Medicare Tax on Unreported Tip Income.*

Although noncash tips are not reported to the employer, the taxpayer should also include their value in the amount entered on line 7. The taxpayer is not liable for social security and Medicare taxes on noncash tips.

> **Note.** For a detailed discussion of tip income, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers.

DEPENDENT CARE BENEFITS

The taxable portion of dependent care benefits must be included in the total reported on line 7 of Form 1040. Dependent care benefits include the following.

- Amounts an employer paid directly to either the taxpayer or the taxpayer's care provider for the care of qualifying persons
- The fair market value (FMV) of care in a daycare facility provided or sponsored by the employer
- Pretax contributions the taxpayer made under a dependent care flexible spending arrangement

A **qualifying person** is defined as:

- A dependent who is under age 13, or
- A disabled spouse or disabled dependent who resides with the taxpayer for more than six months of the tax year and is physically or mentally incapable of caring for himself or herself.[2]

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1. IRS Pub. 926, *Household Employer's Tax Guide.*
2. IRC §21(b)(1).

The taxpayer's salary may have been reduced to pay for dependent care benefits. If a taxpayer received any dependent care benefits as an employee, the benefits should be shown in box 10 of the taxpayer's Form W-2. The taxpayer must use Form 2441, *Child and Dependent Care Expenses,* to calculate the amount of benefits that they can exclude from the income reported on line 7 of Form 1040.

Example 1. Alexis, an unmarried taxpayer, received $2,000 in cash under her employer's dependent care plan for 2012. The $2,000 is shown on her Form W-2 in box 10. The Form W-2 also shows that Alexis earned wages of $43,000 in 2012, which was her only source of earned income. Alexis incurred only $900 of qualified expenses in 2012 for the care of her 4-year-old dependent daughter.

Part III of Alexis' Form 2441 follows. It shows that she had taxable dependent care benefits of $1,100.

Form 2441 (2012) Page **2**

Part III Dependent Care Benefits

12	Enter the total amount of **dependent care benefits** you received in 2012. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership			12	2,000
13	Enter the amount, if any, you carried over from 2011 and used in 2012 during the grace period. See instructions			13	
14	Enter the amount, if any, you forfeited or carried forward to 2013. See instructions			14	( )
15	Combine lines 12 through 14. See instructions			15	2,000
16	Enter the total amount of **qualified expenses** incurred in 2012 for the care of the **qualifying person(s)**	16	900		
17	Enter the **smaller** of line 15 or 16	17	900		
18	Enter your **earned income.** See instructions	18	43,000		
19	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see instructions. • All others, enter the amount from line 18.	19	43,000		
20	Enter the **smallest** of line 17, 18, or 19	20	900		
21	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 19)	21	5,000		
22	Is any amount on line 12 from your sole proprietorship or partnership? (Form 1040A filers go to line 25.) ☑ **No.** Enter -0-. ☐ **Yes.** Enter the amount here			22	0
23	Subtract line 22 from line 15	23	2,000		
24	**Deductible benefits.** Enter the **smallest** of line 20, 21, or 22. Also, include this amount on the appropriate line(s) of your return. See instructions			24	0
25	**Excluded benefits. Form 1040 and 1040NR filers:** If you checked "No" on line 22, enter the smaller of line 20 or 21. Otherwise, subtract line 24 from the smaller of line 20 or line 21. If zero or less, enter -0-. **Form 1040A filers:** Enter the **smaller** of line 20 or line 21			25	900
26	**Taxable benefits. Form 1040 and 1040NR filers:** Subtract line 25 from line 23. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7; or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7; or Form 1040NR, line 8, enter "DCB." **Form 1040A filers:** Subtract line 25 from line 15. Also, include this amount on Form 1040A, line 7. In the space to the left of line 7, enter "DCB"			26	1,100

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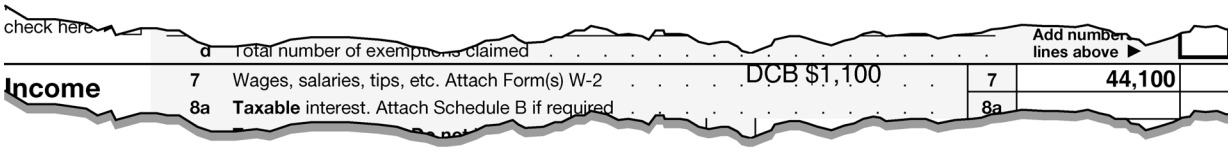
Alexis' Form 1040 shows a total of $44,100 on line 7 ($43,000 wages + $1,100 taxable dependent care benefits), as follows.



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

ADOPTION BENEFITS

The taxable portion of employer-provided adoption benefits should be included in the total reported on line 7 of Form 1040. In most cases, employer-provided adoption benefits are amounts an employer paid directly to an employee or a third party for qualified adoption expenses under a qualified adoption assistance program.

Qualified adoption expenses include the following.

- Adoption fees
- Attorney fees
- Court costs
- Travel expenses while away from home
- Re-adoption expenses relating to the adoption of a foreign child

Note. For more information about qualified adoption assistance programs, see IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*

Employer-provided adoption benefits should be shown in box 12 of the employee's Form W-2 with code "T." The employee's salary may have been reduced to pay these benefits. The taxpayer must use Form 8839, *Qualified Adoption Expenses,* to determine whether they can exclude part or all of the benefits from their income. The taxpayer may also be able to exclude amounts not shown in box 12 of Form W-2 if they adopted a child with special needs and the adoption became final during the tax year.

For the 2012 tax year, the maximum amount that can be excluded from an employee's gross income for qualified adoption expenses paid under a qualified adoption assistance program is $12,650.[3] For the 2013 tax year, the maximum exclusion amount is $12,970.[4]

Note. For information about the adoption credit, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 2, Credits.

Example 2. In 2012, Angelina paid $15,000 in qualified adoption expenses for the adoption of an eligible child. Under a qualified adoption assistance program, Angelina's employer reimbursed her for these expenses, which are shown in box 12 of her 2012 Form W-2. Her modified adjusted gross income for 2012 was $100,000.

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

4. Rev. Proc. 2013-15, 2013-5 IRB 444.

Angelina's taxable adoption benefits of $2,350 are calculated in Part III of Form 8839, which follows. She includes this amount in the total reported on line 7 of her Form 1040, with the notation "AB" entered on the dotted line next to line 7.

For Example 2

Form 8839 (2012) Page 2

Part III Employer-Provided Adoption Benefits

			Child 1		Child 2		Child 3			
13	Maximum exclusion per child	13	$12,650	00	$12,650	00	$12,650	00		
14	Did you receive employer-provided adoption benefits for a prior year for the same child? ☑ **No.** Enter -0-. ☐ **Yes.** See instructions for the amount to enter.	14								
15	Subtract line 14 from line 13	15	12,650							
16	Employer-provided adoption benefits you received in 2012. This amount should be shown in box 12 of your 2012 Form(s) W-2 with code **T**	16	15,000							
17	Add the amounts on line 16								17	15,000
18	Enter the **smaller** of line 15 or line 16. But if the child was a child with special needs and the adoption became final in 2012, enter the amount from line 15	18	12,650							
19	Enter modified adjusted gross income (from the worksheet in the instructions)	19	100,000							
20	Is line 19 more than $189,710? ☑ **No.** Skip lines 20 and 21, and enter -0- on line 22. ☐ **Yes.** Subtract $189,710 from line 19	20								
21	Divide line 20 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than 1.000						21 ×			
22	Multiply each amount on line 18 by line 21	22	0							
23	**Excluded benefits.** Subtract line 22 from line 18	23	12,650							
24	Add the amounts on line 23								24	12,650
25	**Taxable benefits.** Is line 24 more than line 17? ☑ **No.** Subtract line 24 from line 17. Also, include this amount, if more than zero, on line 7 of Form 1040 or line 8 of Form 1040NR. On the dotted line next to line 7 of Form 1040 or line 8 of Form 1040NR, enter "AB." ☐ **Yes.** Subtract line 17 from line 24. Enter the result as a negative number. Reduce the total you would enter on line 7 of Form 1040 or line 8 of Form 1040NR by the amount on Form 8839, line 25. Enter the result on line 7 of Form 1040 or line 8 of Form 1040NR. Enter "SNE" on the dotted line next to the entry line.								25	2,350

TIP

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

- You paid adoption expenses in 2011, those expenses were not fully reimbursed by your employer or otherwise, and the adoption was not final by the end of 2011.
- The total adoption expenses you paid in 2012 were not fully reimbursed by your employer or otherwise, and the adoption became final in 2012 or earlier.
- You adopted a child with special needs and the adoption became final in 2012.

Form 8839 (2012)

SCHOLARSHIP AND FELLOWSHIP GRANTS

Generally, the taxable portion of scholarship and fellowship grants must be included in the total reported on line 7 of Form 1040. However, a scholarship or fellowship may be excluded from income if **all** of the following conditions are satisfied.[5]

- The taxpayer is a candidate for a degree at an eligible educational institution.
- The taxpayer uses the scholarship or fellowship to pay qualified education expenses (i.e., tuition and fees and course-related expenses).
- The scholarship or fellowship does not represent payment for teaching, research, or other services required as a condition for receiving the scholarship.

The following expenses are specifically **excluded** from qualified education expenses.[6]

- Room and board
- Travel
- Research
- Clerical help
- Equipment and other expenses not required for enrollment or attendance at an eligible educational institution

Example 3. Benjamin, a degree candidate, received an $8,000 scholarship. He used $5,000 for qualified tuition and used the remaining $3,000 for room and board. Benjamin can only exclude $5,000 from income. The $3,000 used for room and board must be included in income reported on line 7 of Benjamin's Form 1040.

Note. There are several additional rules and definitions associated with the proper tax treatment of scholarship and fellowship grants. For additional guidance, see IRC §117 and the underlying regulations associated with this Code section.

EXCESS SALARY DEFERRALS

Participants in certain types of retirement plans can choose to have part of their pretax compensation contributed to a retirement fund. The amount contributed, called an elective deferral, is not included in wages subject to income tax at the time it is contributed. Elective deferrals are subject to annual limits, which are shown in the following table.

	2012 Maximum Deferral		2013 Maximum Deferral	
Type of Plan	**Under Age 50**	**Age 50 or Over**	**Under Age 50**	**Age 50 or Over**
401(k) plan	$17,000	$22,500	$17,500	$23,000
Thrift Savings Plan for federal employees	17,000	22,500	17,500	23,000
SARSEP	17,000	22,500	17,500	23,000
SIMPLE plan	11,500	14,000	12,000	14,500
403(b) plan [a,b]	17,000	22,500	17,500	23,000
501(c)(18)(D) plan	7,000	7,000	7,000	7,000
457 plan [b,c]	17,000	22,500	17,500	23,000

[a] Higher limits are available for certain employees under the 15-year rule. For more information, see IRS Pub. 571, *Tax-Sheltered Annuity Plans (403(b) Plans).*

[b] If the organization offers both a §403(b) plan and a §457 plan, employees can contribute the maximum deferral amount to each plan.

[c] Participants within three years of normal retirement age may be allowed an increased limit. For more information, see IRS Pub. 525, *Taxable and Nontaxable Income.*

5. IRS Pub. 970, *Tax Benefits for Education*; IRC §117.

6. Ibid.

If a plan participant's salary deferrals exceed the applicable limit, they must notify the plan. If the plan permits, the excess amount is distributed to the participant. If the taxpayer participates in more than one plan, they can have the excess paid out of any of the plans that permit these distributions. The plan must pay the amount of the excess to the participant, along with any income earned on that amount, by April 15 of the following year. The participant should receive a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for the year in which the excess deferral is distributed. **The excess deferral must generally be added to the participant's wages reported on line 7 of Form 1040.**

Corrective Distribution[7]

If the taxpayer takes out the excess deferral amount after the year of the deferral and receives the corrective distribution by April 15 of the following year, the distribution is not included in income again in the year it is received**. However, if the taxpayer receives the corrective distribution after April 15, they must include it in the income reported on line 7 in both the year of the deferral and the year they receive it.** The taxpayer should receive Form 1099-R for the year in which the excess deferral is distributed. The corrective distribution shown on a 2012 Form 1099-R should be reported according to the following rules.

- If the distribution was for a 2012 excess deferral, the Form 1099-R should have code "8" in box 7. The taxpayer should add the excess deferral amount to their wages reported on line 7 of their 2012 Form 1040.
- If the distribution was for a 2012 excess deferral to a designated Roth account, the Form 1099-R should have code "B" in box 7. The taxpayer should **not** add this amount to line 7 on their 2012 Form 1040.
- If the distribution was for a 2011 excess deferral, the Form 1099-R should have code "P" in box 7. If the taxpayer did not add the excess deferral amount to their wages on their 2011 tax return, they must file an amended return. If the taxpayer did not receive the distribution by April 15, 2012, they must also add it to their wages reported on line 7 of their 2012 tax return.
- If the distribution was for the income earned on an excess deferral, the Form 1099-R should have code "8" in box 7. The taxpayer should add the income to the wages reported on line 7 of their 2012 Form 1040, regardless of when the excess deferral was made.

Excess Contributions[8]

If a taxpayer is a highly compensated employee, the total of their elective deferrals and other contributions made for them for any year under a §401(k) plan or SARSEP can be, as a percentage of pay, no more than 125% of the average deferral percentage (ADP) of all eligible non-highly compensated employees. A **highly compensated employee** is an individual who:

- Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person received, or
- Received compensation in the previous year of more than $115,000 (if the preceding year is 2012 or 2013). However, the employer can elect to limit the group considered highly compensated to the top 20% of employees when ranked by compensation.[9]

If the total contributed to the plan is more than the amount allowed under the ADP test, the excess contributions must be either distributed to the employee or recharacterized as after-tax employee contributions. The employee must include the excess contributions as wages on line 7 of Form 1040.

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7. IRS Pub. 525, *Taxable and Nontaxable Income.*
8. Ibid.
9. *Definitions.* [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Definitions] Accessed on Jan. 18, 2013.

If the highly compensated employee receives a corrective distribution of excess contributions (and allocable income), it is included in their income in the year it was distributed. The employee should receive a Form 1099-R for the year the excess contributions are distributed. The distribution should be added to the wages reported on line 7 of Form 1040 for that year.

DISABILITY PENSIONS

Taxpayers who receive disability pension payments from an employer-paid plan must generally include those payments in gross income. The employer should issue a Form 1099-R for the amount of the disability pension paid to the employee.

A taxpayer who has not reached minimum retirement age must report taxable disability payments as wages on line 7 of Form 1040. Minimum retirement age is generally the age at which the taxpayer can first receive a pension or annuity if they are not disabled. Beginning on the day after the taxpayer reaches minimum retirement age, payments they receive are taxable as a pension or annuity. These payments are reported on lines 16a and 16b of Form 1040.

> **Note.** Low-income taxpayers may be entitled to a tax credit if they were permanently and totally disabled when they retired. For more information, see IRS Pub. 524, *Credit for the Elderly or the Disabled.*

INSURANCE PREMIUMS FOR RETIRED PUBLIC SAFETY OFFICERS[10]

Eligible retired public safety officers (i.e., law enforcement officers, firefighters, chaplains, or members of a rescue squad or ambulance crew) can elect to exclude from income distributions made from their eligible retirement plan that are used to pay the premiums for accident or health insurance or long-term care insurance. **The distribution must be made directly from the plan to the insurance provider.** The taxpayer can exclude from income a maximum of $3,000 and can only make this election for amounts that would otherwise be included in income. The amount excluded cannot also be used as a medical expense deduction.

An **eligible retirement plan** is one of the following.

- Qualified trust
- §403(a) plan
- §403(b) annuity
- §457(b) plan

If the taxpayer is retired on disability and reporting their disability pension on line 7 of Form 1040, they should include only the taxable amount on that line. "PSO" and the amount excluded should be entered on the dotted line next to line 7.

WAGES FROM FORM 8919

A taxpayer uses Form 8919, *Uncollected Social Security and Medicare Tax on Wages,* to calculate and report their share of social security and Medicare tax due on compensation if they were an employee who was treated as an independent contractor by their employer. Total wages entered on line 6 of Form 8919 should be included in the total entered on line 7 of Form 1040.

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10. IRS Pub. 575, *Pension and Annuity Income.*

Example 4. Tara was employed by Small Business Supply Company from January through September 2012. Tara worked full-time as a bookkeeper and she also cleaned the office each Saturday. Tara's employer did not withhold any taxes from the pay she received for cleaning. In January 2013, she received a Form W-2 for the wages of $25,000 that she earned as a bookkeeper. She also received a Form 1099-MISC, *Miscellaneous Income,* for the $1,800 that she was paid for her cleaning services.

Tara completed Form 8919, which follows. She must include the $1,800 entered on line 6 of Form 8919 in the total reported on line 7 of her Form 1040. She must also enter the $102 of unreported social security and Medicare taxes from line 13 of Form 8919 on line 57 of her Form 1040.

Form **8919**

Department of the Treasury
Internal Revenue Service

Uncollected Social Security and Medicare Tax on Wages

► Information about Form 8919 and its instructions is at *www.irs.gov/form8919.*

► Attach to your tax return.

OMB No. 1545-0074

2012

Attachment Sequence No. **72**

Name of person who must file this form. If married, complete a separate Form 8919 for each spouse who must file this form.

Tara

Social security number

222-33-4444

Who must file. You must file Form 8919 if **all** of the following apply.

- You performed services for a firm.
- You believe your pay from the firm was not for services as an independent contractor.
- The firm did not withhold your share of social security and Medicare taxes from your pay.
- One of the reasons listed below under *Reason codes* applies to you.

Reason codes: For each firm listed below, enter in column (c) the applicable reason code for filing this form. If none of the reason codes apply to you, but you believe you should have been treated as an employee, enter reason code G, and **file Form SS-8 on or before the date you file your tax return**.

A I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.

C I received other correspondence from the IRS that states I am an employee.

G I filed Form SS-8 with the IRS and have not received a reply.

H I received a Form W-2 and a Form 1099-MISC from this firm for 2012. The amount on Form 1099-MISC should have been included as wages on Form W-2. **(Do not file Form SS-8 if you select reason code H.)**

	(a) Name of firm	(b) Firm's federal identification number (see instructions)	(c) Enter reason code from above	(d) Date of IRS determination or correspondence (MM/DD/YYYY) (see instructions)	(e) Check if Form 1099-MISC was received	(f) Total wages received with no social security or Medicare tax withholding and not reported on Form W-2
1	**Small Business Supply Company**	**99-1234567**	**H**		☑	**1,800**
2					☐	
3					☐	
4					☐	
5					☐	

6	**Total wages.** Combine lines 1 through 5 in column (f). Enter here and include on Form 1040, line 7; Form 1040NR, line 8; or Form 1040NR-EZ, line 3			6	**1,800**
7	Maximum amount of wages subject to social security tax	7	**110,100**		
8	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) or railroad retirement (tier 1) compensation, and unreported tips subject to social security tax from Form 4137, line 10	8	**25,000**		
9	Subtract line 8 from line 7. If line 8 is more than line 7, enter -0- here and on line 10			9	**85,100**
10	Wages subject to social security tax. Enter the smaller of line 6 or line 9			10	**1,800**
11	Multiply line 10 by .042 (social security tax rate for 2012)			11	**76**
12	Multiply line 6 by .0145 (Medicare tax rate)			12	**26**
13	Add lines 11 and 12. Enter here and on Form 1040, line 57; Form 1040NR, line 55; or Form 1040NR-EZ, line 16. (Form 1040-SS and Form 1040-PR filers, see instructions) ►			13	**102**

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37730B Form **8919** (2012)

ORDINARY INCOME FROM EMPLOYEE STOCK TRANSACTIONS[11]

A taxpayer generally has a capital gain or loss when they sell the stock that they bought by exercising a statutory stock option. However, in certain circumstances, the taxpayer has ordinary income that must be reported as wages on line 7 of Form 1040.

Statutory Stock Options

There are two types of statutory stock options.

1. Incentive stock options (ISO)
2. Options granted under employee stock purchase plans

For the transaction to qualify as a **statutory stock option,** both of the following conditions must be satisfied.

1. The taxpayer must be an employee of the company granting the option (or a related company) during the period beginning on the date the option is granted and ending three months before the date the taxpayer exercises the option.[12]
2. The option must be nontransferable except at death.[13]

If either of the above conditions is not met, the option is a **nonstatutory** stock option.

Sale of the Stock

The taxpayer has taxable income or a deductible loss when they sell the stock that they bought by exercising the option. The income or loss is the difference between the amount the taxpayer paid for the stock (the option price) and the amount received when they sold it. This amount is generally treated as a capital gain or loss for the year of the sale. However, the taxpayer may have ordinary income for the year that the stock is sold (or otherwise disposed of) in either of the following situations.

- The taxpayer does not satisfy the **holding period requirement.**
- The **option was granted at a discount** under an employee stock purchase plan.

Holding Period Requirement. A taxpayer satisfies the holding period requirement if they do not sell the stock until the end of the **later** of:

1. The 1-year period after the stock was transferred to the taxpayer, or
2. The 2-year period after the option was granted.[14]

Incentive Stock Option. If a taxpayer sells stock acquired by exercising an ISO at a gain and does not satisfy the holding period requirement, **the gain is ordinary income up to the amount by which the stock's FMV when the option was exercised exceeded the option price.** Any excess gain is capital gain. If the taxpayer has a loss from the sale, it is a capital loss and the taxpayer does not have any ordinary income.

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11. IRS Pub. 525, *Taxable and Nontaxable Income.*
12. Treas. Reg. §1.421-7(h).
13. Treas. Reg. §1.421-7(b)(2).
14. Treas. Reg. §1.422-1(a)(1)(i)(A).

Example 5. Connor's employer, Macworks Corporation, granted him an ISO on March 11, 2011, to buy 100 shares of Macworks Corporation stock at $20 a share, which was its FMV at the time. Connor exercised the option on January 10, 2012, when the stock was selling for $25 a share. On January 25, 2013, Connor sold the stock for $27 a share.

Because less than two years had passed from the time the option was granted, Connor did not satisfy the holding period requirement. Consequently, Connor must report the difference between the option price ($20 per share) and the value of the stock when he exercised the option ($25 per share) as wages on line 7 of his 2013 Form 1040. The rest of the gain is capital gain, which is calculated as follows.

Selling price ($27 × 100 shares)	$2,700
Purchase price ($20 × 100 shares)	(2,000)
Gain	$ 700
Amount reported as wages on line 7 of Form 1040 (($25 × 100 shares) – $2,000)	$ 500
Amount reported as capital gain	200
Total	$ 700

If the taxpayer satisfies the holding period requirement for stock acquired by exercising an ISO, the entire gain or loss from the sale is capital gain or loss. The basis of the stock is the amount the taxpayer paid for the stock.

Employee Stock Purchase Plan. If the taxpayer does not satisfy the holding period requirement for stock acquired under an employee stock purchase plan, **the ordinary income is the amount by which the stock's FMV when the taxpayer exercised the option exceeded the option price.** The ordinary gain is not limited to the taxpayer's gain from the sale of the stock. The taxpayer must increase their basis in the stock by the amount of this ordinary income. The difference between the taxpayer's increased basis and the selling price of the stock is a capital gain or loss.

Example 6. Dawn's employer, Capital Iron Corporation, granted her an option under its employee stock purchase plan to buy 100 shares of its stock for $30 a share when the stock had a value of $32 per share. Dawn exercised the option eighteen months later, when the value of the stock was $33 per share. Six months after that, she sold her stock for $35 per share.

Because Dawn did not own the stock for at least one year, she did not satisfy the holding period requirement. Consequently, she must report the difference between the stock's FMV when she exercised the option ($33 per share) and the option price ($30 per share) as wages on line 7 of her Form 1040. The rest of the gain is capital gain, which is calculated as follows.

Selling price ($35 × 100 shares)	$3,500
Purchase price ($30 × 100 shares)	(3,000)
Gain	$ 500
Amount reported as wages on line 7 of Form 1040 (($33 × 100 shares) – $3,000)	$ 300
Amount reported as capital gain ($3,500 – ($3,000 + $300))	200
Total	$ 500

Option Granted at a Discount. Even if a taxpayer satisfies the holding period requirement for stock acquired under an employee stock purchase plan, they may still be required to recognize ordinary income if the option was granted at a discount. If the option price per share at the time the option was granted was less than 100% (but not less than 85%)[15] of the FMV of the share and the taxpayer disposes of the share after meeting the holding period requirement (or dies while owning the share), the taxpayer must include in income reported on line 7 the lesser of the following.

- The amount by which the share's FMV at the time the option was granted exceeds the option price
- The amount by which the share's FMV at the time of disposition or death exceeds the amount paid for the share under the option

Any excess gain is capital gain. If the taxpayer has a loss from the sale, it is a capital loss and they do not report any ordinary income.

Example 7. Assume the same facts as **Example 6,** except that Dawn sold the stock 14 months after she exercised the option. Therefore, she satisfied the holding period requirement. However, because the option price was between 85% and 100% of the share's FMV at the time the option was granted, Dawn must include in the income she reports on line 7 the lesser of the following.

- The FMV at the time the option was granted ($32 per share) less the option price ($30 per share), or $200 (($32 − $30) × 100 shares)
- The FMV at the time of disposition ($35 per share) less the option price ($30 per share), or $500 (($35 − $30) × 100 shares)

On line 7 of her Form 1040, Dawn must report $200, which is the lesser of the two preceding calculations. The rest of the gain is capital gain, which is calculated as follows.

Selling price ($35 × 100 shares)	$3,500
Purchase price ($30 × 100 shares)	(3,000)
Gain	$500
Amount reported as wages on line 7 of Form 1040 (($32 × 100 shares) – $3,000)	$ 200
Amount reported as capital gain	300
Total	$ 500

EXCESS MOVING EXPENSE REIMBURSEMENT

If a taxpayer receives a reimbursement for moving expenses under their employer's accountable plan for an amount that is greater than the deductible moving expenses incurred, the taxpayer generally must report any excess on line 7 of Form 1040.

> **Note.** Under the rules for accountable plans, an employer should require an employee to return any excess reimbursement within a reasonable period of time. Excess reimbursements that are not returned to the employer should be treated as paid under a nonaccountable plan and added to the employee's wages reported in box 1 of Form W-2.

15. A plan does not meet the requirements for an employee stock purchase plan if the option price is less than 85% of the FMV of the stock when the option was granted or exercised. See IRC §423(b)(6).

An employee reimbursement plan is an accountable plan if it meets specific requirements in the following three general areas.

1. **Business connection requirement.** The amounts paid to the employee must be for reimbursement of amounts the employee paid in connection with services rendered as an employee of the employer.
2. **Substantiation requirement**. The employee must submit receipts or other appropriate documentation to substantiate the time, amount, and business purpose of the expense for which reimbursement is sought.
3. **Requirement to return excess amounts**. The terms of the plan must require the employee to return reimbursement amounts paid by the employer that exceed the expense amounts substantiated by the employee.

> **Note.** Details on the requirements for employee reimbursement plans can be found in Treas. Reg. §1.62-2 and IRS Pub. 521, *Moving Expenses.*

Deductible Moving Expenses

Deductible moving expenses include the reasonable expenses of:

- Moving the taxpayer's household goods and personal effects, and
- Traveling to the taxpayer's new home. This includes lodging but not meals.

Who Can Deduct Moving Expenses

A taxpayer can deduct moving expenses if they meet all of the following requirements.

- The move is closely **related to the start of work.**
- The taxpayer meets the **distance test.**
- The taxpayer meets the **time test.**

Move Related to Start of Work. To qualify as a deductible moving expense, the taxpayer's move must be closely related, both in time and in place, to the start of work at a new job location.

Closely Related in Time. Normally, expenses incurred within one year from the commencement of work at the new location are considered a reasonable proximity in time. Expenses incurred after the 1-year period can qualify if it is shown that circumstances existed which prevented the employee from incurring the moving expenses at an earlier time.

Closely Related in Place. A taxpayer can generally consider their move closely related in place to the start of work if the distance from their new home to the new job location is not more than the distance from their former home to the new job location. If the taxpayer does not meet this requirement, they may still be able to deduct moving expenses if they can show that:

- They are required to live at their new home as a condition of employment, or
- They will spend less time or money commuting from their new home to their new job location.

A taxpayer's **home** is defined as their main home, which can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. It does not include a seasonal home or another home owned by the taxpayer or members of their family.

Distance Test. The taxpayer must meet certain minimum distance requirements to deduct moving expenses. These requirements differ depending on whether the taxpayer is a first-time employee without any prior principal work location or an individual who is presently in the work force and currently has a principal place of employment.

If the employee has no former place of employment or is returning to full-time work after a substantial period of unemployment or part-time work, the distance between the former residence and the new principal place of work must be at least 50 miles. If the employee had a former principal place of employment, the distance between the former residence and the new principal place of employment must be at least 50 miles greater than the distance between the former residence and the former principal place of employment.

Time Test for Employees. If the taxpayer is an employee, they must work full time for at least 39 weeks during the first 12 months after they arrive in the general area of their new job location. Full-time employment depends on what is usual for the taxpayer's type of work in their location.

For purposes of this test, the following rules apply.

- Only the taxpayer's full-time work as an employee counts, not any work performed as a self-employed person.
- The taxpayer does not have to work for the same employer for all 39 weeks.
- The taxpayer does not have to work 39 consecutive weeks.
- The taxpayer must work full time within the same general commuting area for all 39 weeks.
- The taxpayer is considered to have worked full time during any week they are temporarily absent from work because of illness, strikes, lockouts, layoffs, or similar events. They are also considered to have worked full time during any week they are absent from work for vacation or other leave provided for in their work agreement or contract.

> **Note.** The time test for self-employed persons differs from the rules for employees. For detailed information about all the tests for deductible moving expenses, see IRS Pub. 521, *Moving Expenses.*

Reimbursements

If moving expenses are paid to an employee through their employer's **accountable plan,** the amount of the reimbursement should be reported in box 12 of Form W-2, using Code "P." If the amount reported in box 12 exceeds the employee's deductible moving expenses, the excess must be included as compensation on line 7 of Form 1040. The taxpayer must also file Form 3903, *Moving Expenses,* showing all allowable moving expenses and reimbursements.

Example 8. Lori's new employer provided her with an advance of $1,000 for moving expenses under an accountable plan. Because of personnel turnover in the accounting department, her employer did not ask for documentation of her moving expenses within a reasonable period of time.

Lori's tax return preparer determined that her deductible moving expenses totaled only $900 for the year. Lori's $1,000 advance was reported in box 12 of her Form W-2, with a code "P."

Lori's Form 3903 follows. The excess reimbursement of $100 ($1,000 advance − $900 deductible moving expenses) is included on line 7 of her Form 1040.

Form **3903**

Department of the Treasury
Internal Revenue Service (99)

Moving Expenses

▶ Information about Form 3903 and its instructions is available at *www.irs.gov/form3903.*
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2012

Attachment Sequence No. 170

Name(s) shown on return: Lori

Your social security number: 454-54-5454

Before you begin: ✓ See the **Distance Test** and **Time Test** in the instructions to find out if you can deduct your moving expenses.
✓ See **Members of the Armed Forces** in the instructions, if applicable.

1	Transportation and storage of household goods and personal effects (see instructions) . . .	1	750	
2	Travel (including lodging) from your old home to your new home (see instructions). **Do not** include the cost of meals . . .	2	150	
3	Add lines 1 and 2 . . .	3	900	
4	Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is **not** included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code **P** . . .	4	1,000	
5	Is line 3 **more than** line 4?			
	☑ **No.** You **cannot** deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7, or Form 1040NR, line 8.			
	☐ **Yes.** Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26, or Form 1040NR, line 26. This is your **moving expense deduction** . . .	5		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 12490K Form **3903** (2012)

EXCESS PARSONAGE ALLOWANCE

An excess parsonage allowance may be included on line 7. For a detailed discussion about parsonage allowances , see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers.

LINE 21 (OTHER INCOME)

Line 21 is used to report any taxable income not reported elsewhere on Form 1040 or other schedules. The taxpayer must list the type and amount of income. If necessary, a statement can be attached showing the required information.

The following section provides information on many of the categories of taxable income reported on line 21.

PRIZES AND AWARDS

An individual who wins a prize in a drawing, quiz program, beauty contest, or other event should include it in their income reported on line 21. If the individual does not accept a prize that is offered to them, they should not include its value in their income. If the prize or award consists of goods or services, its FMV must be included in income.

Individuals who receive a prize in recognition of accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields must generally include the value of the prize in their income. However, the individual should not include the prize in income if **all** the following requirements are met.[16]

- The recipient was selected for the prize without any action on their part to enter the contest or proceeding.
- The recipient is not required to perform substantial future services as a condition for receiving the prize or award.
- The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization designated by the individual.

Scholarship Prizes

A scholarship prize won in a contest is not a scholarship or fellowship if the student is not required to use the prize for educational purposes. The taxpayer must include these amounts in the income reported on line 21, regardless of whether they use the amounts for educational purposes.

> **Example 9.** Lia won $1,000 in a scholarship essay contest, which was open to all history majors at Branson University. There are no restrictions on how she can use the prize money. Lia must include the scholarship prize in the total she reports on line 21 of her Form 1040.

GAMBLING INCOME

Taxpayers must include gambling winnings in the income reported on line 21 of Form 1040. If the taxpayer itemizes deductions on Schedule A, they can deduct gambling losses incurred during the year but only up to the amount of their gambling winnings. The gambling losses should be entered on line 28 of Schedule A (other miscellaneous deductions not subject to the 2%-of-AGI threshold). If the taxpayer does not itemize deductions, they must still report the **full** amount of gambling winnings on line 21.

> **Example 10.** Elliott is an occasional gambler. During 2012, his net daily gambling winnings totaled $350 and his net daily losses totaled $725. Because Elliott does not itemize, he cannot deduct his gambling losses but must report the winnings of $350 on line 21 of his 2012 Form 1040.

Form W-2G

The taxpayer may receive Form W-2G, *Certain Gambling Winnings,* showing the amount of their gambling winnings and any tax withheld on them. However, taxpayers who gamble should include all winnings in income, not just the occasional large wins evidenced by Forms W-2G. These total yearly winnings must be reported on line 21.

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16. IRC §74(b).

Example 11. Kelda is a regular visitor to a thoroughbred horse track. In 2012, she attended the track a minimum of three days a week for the five months it was open. During 2012, she won seven large trifectas and one large daily double wager for which she received Forms W-2G. The total amount reported to Kelda on the eight Forms W-2G was $10,400.

Kelda asked Marco, her accountant, to prepare her 2012 tax return. She gave him the Forms W-2G and a stack of wager tickets from the track, which she has separated and totaled for each day. Kelda also gave Marco a diary with meticulous details about her gambling activity and a spreadsheet that shows each day's winnings and losses. Kelda's records show that her gambling losses exceed her winnings as summarized below.

Total of daily winnings	$13,921
Total of daily losses	(25,623)
Net gambling loss for 2012	($11,702)

Marco finds Kelda's information credible; thus, he enters the following on her 2012 return.

Gambling winnings reported on line 21 of Form 1040	$13,921
Gambling losses (limited to the extent of winnings) reported on line 28 of Schedule A	13,921

Note. The taxpayer must keep an accurate diary or similar record, supplemented by verifiable documentation, as substantiation of their gambling winnings and losses. For further information, see Rev. Proc. 77-29.[17]

Casual Slot Machine Gambling Winnings and Losses

In 2008, the IRS issued advice concerning how a casual gambler determines wagering winnings and losses from **slot-machine** play.[18] Following are the conclusions of this advice.

1. Winnings or losses must be computed on a daily basis.
2. The days with net winnings are **not** combined with days of net losses to determine annual net winnings or net losses.
3. The two sources of authority for the conclusions reached in the advice are the following.
   a. A decision of the 9th Circuit Court regarding a compulsive gambler[19]
   b. Rev. Rul. 83-103[20]

Note. Chief Counsel Advice (CCA) guidance is the opinion of the IRS. It pertains to how a certain portion of the Code should be interpreted. This particular CCA was issued in response to "a recurring issue in litigation." CCAs are near the bottom of the hierarchy of sources that constitute substantial authority.

17. Rev. Proc. 77-29, 1977-2 CB 538.
18. Chief Counsel Advice AM 2008-011 (Dec. 12, 2008).
19. *U.S. v. William L. Scholl,* F.3d 964 (9th Cir. 1999), *aff'g* an unreported District Court decision.
20. Rev. Rul. 83-103, 1983-2 CB 148.

Example 12. Maureen, a methodical and frugal gambler, frequents the local casino seeking fame and fortune (mainly the latter) from playing slot machines. Because 20 is her lucky number, she visited the casino 10 days in 2012, on the 20th of each month except June and July. She is retired and on a fixed income, so she limits her daily gambling losses to $100.

On each of her 10 visits to the casino in 2012, she exchanged $100 of cash for $100 of slot-machine tokens. Following is a recap of each day's net winnings and losses.

1. On five of the days, she lost her entire $100 in tokens.
2. On the other five days, she redeemed her remaining tokens for the following amounts of cash.

20th Day of...	Amount of Cash Redeemed	Net Daily Losses	Net Daily Winnings
March	$ 20	($ 80)	N/A
May	70	(30)	N/A
August	150	N/A	$ 50
October	200	N/A	100
November	300	N/A	200
Net winnings or losses for these 5 days		**($110)**	**$350**
Losses for 5 days when she lost all $100		**(500)**	**N/A**
Net winnings or losses for the 10 days		**($610)**	**$350**

If Maureen combines her net daily winnings ($350) and her net daily losses ($610), her net slot machine gambling loss for 2012 is $260 ($610 of losses – $350 of winnings). She wants to know the correct way to report the slot machine winnings and losses on her 2012 Form 1040.

Correct Tax Result per the IRS Advice. If Maureen follows the IRS advice, she reports the following on her 2012 Form 1040.

- $350 of winnings on line 21 (other income) of her Form 1040.
- If she itemizes, she can deduct $350 of gambling losses as a miscellaneous itemized deduction on her Schedule A. This deduction is not subject to the 2% limitation.
- If she does not itemize, she **still** must report the $350 of winnings as gross income.[21]

Caution. If the winnings reported by the taxpayer on the return are less than the total of the Forms W-2G issued to the taxpayer, the IRS will issue a CP2000 notice and bill the taxpayer for additional taxes based on the Form W-2G amounts. Practitioners should be confident in the taxpayer's documentation and be prepared to defend the method used to calculate net winnings.

Lotteries and Raffles

The amount a taxpayer wins from lotteries and raffles is gambling income. In addition to cash winnings, the taxpayer must include the FMV of noncash prizes in income, such as cars, houses, trips, and bonds.

21. Rev. Rul. 54-339, 1954-2 CB 89.

Installment Payments

An individual who wins a state lottery prize that is payable in installments must generally include the annual payments in their gross income on line 21. Any amounts that are designated as interest should be reported as interest income on Schedule B. If the taxpayer sells future lottery payments for a lump sum, they must report the amount received from the sale as ordinary income included on line 21.

> **Observation.** When gambling winnings are included in AGI, there are additional ramifications. Examples include the following.
>
> - More social security benefits may become taxable.
> - The amount of the earned income credit could be altered.
> - The amounts allowed as IRA deductions could be limited.
> - A larger domestic production activities deduction may be allowed.
> - The saver's credit may be reduced.

State Tax Issues

As explained earlier, federal tax law requires most taxpayers to report gambling winnings on line 21 of Form 1040. Thus, these winnings are included in the taxpayer's AGI. Taxpayers who itemize can deduct gambling losses on Schedule A to the extent of their winnings. Besides the federal tax ramifications for taxpayers who do not itemize, the state tax issues arising from gambling income often surprise many taxpayers — and even many tax professionals.

Many states do not permit a deduction for gambling losses. These states include Connecticut, Illinois, Indiana, Massachusetts, and Michigan.

> **Example 13.** Assume the same facts as **Example 11.** Kelda is an Illinois resident. When Marco discusses Kelda's tax issues with her, he informs her that she is liable for $696 of Illinois state income tax on her gambling winnings ($13,921 winnings × 5% Illinois income tax rate), even though her winnings were more than offset by losses. Illinois does not permit the taxpayer's taxable income to be offset by any of the itemized deductions allowed on the federal return.

Professional Gamblers

IRC §165(d) provides that losses from wagering transactions are only allowed to the extent of the gains from such transactions. Although the Code does not distinguish professional gambling losses from casual gambling losses, the courts have held that professional gamblers are denied deductions for their net gambling losses.[22] Gambling expenses other than wagering losses are not subject to the restriction and are deductible if the taxpayer is a professional gambler.[23]

In *Comm'r v. Groetzinger,* the Supreme Court concluded that "if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business…"[24] In addition to the standard established in *Groetzinger,* the Tax Court often uses the nine factors found in Treas. Reg. §1.183-2(b) to determine whether a taxpayer had a profit motive. These factors are as follows.

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his or her advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. An expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. Elements of personal pleasure or recreation

> **Note.** For a detailed discussion of these nine factors, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Hobby Losses.

If the taxpayer's gambling activity is conducted in a sufficiently business-like fashion that they can rightfully claim professional gambler status, they should report their gross winnings as income on Schedule C rather than on line 21 of Form 1040. Losses **(to the extent of winnings)** and allowable expenses such as transportation, lodging, and meals (subject to the 50% limitation) can be deducted as business expenses on Schedule C. It is important to recognize that a professional gambler's allowable expenses can be deducted in full on Schedule C, regardless of the amount of their winnings.[25] **It is only the wagering losses that are limited.**

JURY DUTY PAY

A taxpayer must include jury duty pay in their income reported on line 21. If an employee is required to give the jury duty pay to their employer because the employer continued to pay the employee's salary while they served on the jury, the employee can deduct the amount turned over to the employer as an adjustment to income. The amount repaid to the employer should be entered on line 36, and "jury duty" and the amount should be entered on the line next to line 36.

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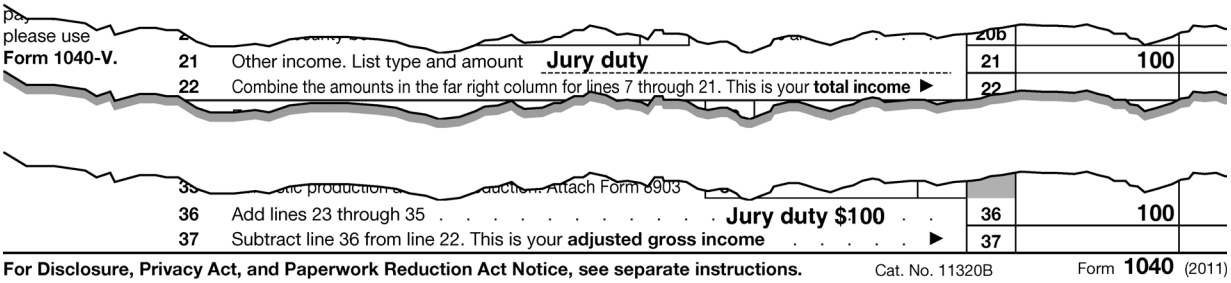
22. See e.g., *Valenti v. Comm'r,* TC Memo 1994-483 (Oct. 4, 1994).
23. IRC §162(a).
24. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).
25. *Mayo v. Comm'r,* 136 TC 81 (Jan. 25, 2011).

Example 14. Michele received $100 for jury duty pay in 2012. Michele received her usual salary during the time she served on the jury but company policy required her to turn over the amount she received for jury duty pay to the company.

Michele's tax return preparer reports the jury duty pay and the amount returned to her employer on lines 21 and 36 of Form 1040, respectively, as shown below.


please use
Form 1040-V.

21	Other income. List type and amount Jury duty	21	100
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	
36	Add lines 23 through 35 . . . . . Jury duty $100	36	100
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2011)

TAXABLE DISTRIBUTIONS FROM COVERDELL ESA

Taxable distributions from a Coverdell education savings account (ESA) are reported on line 21. Distributions from these accounts may be taxable if they are more than the amount of **adjusted qualified education expenses** (AQEE) of the designated beneficiary during the tax year. **AQEE is calculated by reducing qualified education expenses by any tax-free educational assistance.**

For purposes of Coverdell ESAs, **qualified education expenses** include qualified higher education expenses as well as qualified elementary and secondary education expenses. Qualified education expenses also include any contributions to a qualified tuition program[26] on behalf of the designated beneficiary.[27]

> **Note.** A provision in the American Taxpayer Relief Act of 2012 permanently extended the feature that allows distributions from Coverdell ESAs to be applied to elementary and secondary education expenses as well as higher education expenses.

Qualified higher education expenses relate to enrollment or attendance at an eligible postsecondary school. These include the following.

1. Tuition, fees, books, supplies, and equipment if required by the eligible institution for enrollment or attendance of a designated beneficiary
2. Expenses for special needs services incurred in connection with enrollment or attendance at an eligible school
3. Expenses for room and board for students attending at least half time, if the amount does not exceed the greater of the following two amounts
   a. The room and board allowance used by the educational institution in calculating the cost of attendance for federal financial aid purposes
   b. The actual amount charged if the student resides in housing owned or operated by the school

26. Qualified tuition programs are defined in IRC §529(b).

27. IRC §530(b)(2)(B).

Qualified elementary and secondary education expenses include the following.[28]

1. Expenses for tuition and fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious school
2. Expenses for room and board, uniforms, transportation, and supplementary items and services that are required or provided by a public, private, or religious school in connection with enrollment or attendance
3. Expenses for the purchase of computer technology, equipment, or Internet access and related services if used by the beneficiary and the beneficiary's family during the years of schooling (not including software designed for sports, games, or hobbies unless the software is predominantly educational in nature)

Qualified education expenses **must be reduced** by all the following tax-free benefits to arrive at AQEE.

- Tax-free scholarships and fellowships
- Veterans' educational assistance benefits
- Pell grants
- Employer-provided educational assistance
- Any other nontaxable payments received as educational assistance

Computation of Taxable Distributions

The taxable portion of a distribution is the earnings portion of any distribution not spent on qualified education expenses. This amount is computed as follows.[29]

Step 1. Multiply the total distribution by a fraction. The numerator of the fraction is the basis (contributions not previously distributed) at the end of the previous year plus total contributions for the current year. The denominator of the fraction is the total account balance at the end of the current year plus the amount distributed during the year.

Step 2. Subtract the amount calculated in Step 1 from the total current year distribution. The result is the amount of earnings included in the total distribution.

Step 3. Multiply the total earnings from Step 2 by a fraction. The numerator of the fraction is the AQEE paid during the year. The denominator of the fraction is the total amount distributed during the year.

Step 4. Subtract the amount calculated in Step 3 from the amount of earnings calculated in Step 2. The result is the amount the beneficiary must include in the income reported on line 21 of Form 1040.

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28. IRC §530(b)(3)(A).
29. IRS Pub. 970, *Tax Benefits for Education.*

Example 15. Giselle received an $850 distribution from her Coverdell ESA in 2012. There were no contributions to her Coverdell ESA account in 2012, but $1,500 had been contributed before 2012. This is her first distribution from the account, so her basis in the account on December 31, 2011, was $1,500. The balance of her account on December 31, 2012, is $950. Giselle had $700 of AQEE for 2012. She calculates the taxable portion of her distribution as follows.

Step	Calculation		
1	$850 distribution $\times \left(\frac{\$1{,}500 \text{ basis} + \$0 \text{ contribution}}{\$950 \text{ balance} + \$850 \text{ distribution}}\right)$	$708	(basis)
2	$850 distribution – $708 basis	142	(earnings)
3	$142 earnings $\times \frac{\$700 \text{ AQEE}}{\$850 \text{ distribution}}$	117	(tax-free earnings)
4	$142 earnings – $117 tax-free earnings	25	(taxable earnings)

On her 2012 tax return, Giselle includes $25 in income as distributed earnings that were not used for qualified education expenses. She reports this amount as other income on Form 1040, line 21, listing the type and amount of income on the dotted line.

Note. The earnings portion of a Coverdell ESA distribution that is not spent on qualified educational expenses is subject to a 10% additional tax, with certain exceptions. For a detailed discussion of Coverdell ESAs, see 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 2: Education.

TAXABLE DISTRIBUTION FROM QUALIFIED TUITION PROGRAM

Taxable distributions from a qualified tuition program (QTP)[30] are reported on line 21. As is the case with Coverdell ESAs, distributions from QTPs may be taxable if they are more than the amount of **adjusted qualified education expenses** (AQEE) of the designated beneficiary during the tax year. AQEE is calculated in the same manner for QTPs as it is for Coverdell ESAs except that elementary and secondary educational expenses are not qualified expenses for QTP purposes.

Computation of Taxable Distributions

The taxable portion of a QTP distribution is calculated as follows.

Step 1. Multiply the total earnings distributed from the QTP by a fraction. The numerator is the AQEE paid during the year and the denominator is the total amount distributed during the year.

Step 2. Subtract the amount calculated in Step 1 from the total distributed earnings. The result is the amount the beneficiary must include in the income reported on line 21 of Form 1040.

30. Qualified tuition programs are also called §529 plans.

Example 16. In 2012, Wesley received a $6,000 scholarship after a distribution of $11,000 was made from his QTP. The distribution included a $9,000 return of contributions and $2,000 of earnings. Wesley's qualified education expenses for the year total $11,000. Because he received a scholarship of $6,000, his AQEE is $5,000 ($11,000 − $6,000).

The taxable portion of Wesley's QTP distribution is calculated as follows.

Step	Calculation		
1	$2,000 earnings × $\frac{\$5{,}000 \text{ AQEE}}{\$11{,}000 \text{ distribution}}$	$ 909	(tax-free earnings)
2	$2,000 earnings – $909 tax-free earnings	1,091	(taxable earnings)

Wesley must include $1,091 as taxable income on his 2012 Form 1040, line 21. If Wesley's father, who is the account owner, received the $6,000 excess distribution, the $1,091 of taxable earnings would be reported on the father's Form 1040.

Note. Nonqualified QTP distributions are subject to a 10% penalty on the earnings portion of the distribution, unless an exception applies. In **Example 16,** the 10% penalty does not apply because the distribution in excess of Wesley's AQEE was attributable to the scholarship that he received. For a detailed discussion of QTPs, see 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 2: Education.

TAXABLE DISTRIBUTION FROM HSA OR ARCHER MSA

Taxable distributions from a health savings account (HSA) or an Archer medical savings account (MSA) are reported on line 21 of Form 1040. Distributions from these accounts may be taxable if they are more than the unreimbursed qualified medical expenses of the account beneficiary or account holder in the tax year. **Qualified medical expenses** are those expenses that generally qualify for the medical and dental expenses deduction on Schedule A.[31]

Distributions from an HSA

Distributions from an HSA in excess of the taxpayer's qualified medical expenses are subject to income tax[32] and may be subject to an additional 20% tax. The taxpayer uses Form 8889, *Health Savings Accounts (HSAs),* to calculate the amounts they must include in income and any additional tax due.

The taxpayer must include the taxable portion of the HSA distribution on line 21 of Form 1040 and report the additional tax in the total on Form 1040, line 60. "HSA" and the amount should be entered on the dotted lines next to lines 21 and 60.[33]

Distributions from an Archer MSA

Distributions from an Archer MSA in excess of the taxpayer's qualified medical expenses are subject to income tax and may be subject to an additional 20% tax. The taxpayer uses Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts,* to calculate the taxable distributions they must include in income and any additional tax due.

The taxpayer must include the taxable portion of the Archer MSA distribution on line 21 of Form 1040 and report the additional 20% tax on line 60. "MSA" and the amount should be entered on the dotted lines next to lines 21 and 60.

Note. There is no additional 20% tax due on HSA or Archer MSA distributions made after the date the taxpayer becomes disabled, reaches age 65, or dies.[34]

31. For more information, see IRS Pub. 502, *Medical and Dental Expenses.*

32. IRC §223(f)(2).

33. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

34. IRC §223(f)(4).

EXCESS CONTRIBUTIONS TO HSA OR ARCHER MSA

Eligible persons can claim a tax deduction for contributions to an HSA or Archer MSA, up to certain limits. Contributions that exceed the annual limits are not deductible. Excess contributions must be reported as other income on line 21 and are subject to an excise tax.

Annual HSA Contribution Limit

HSA accounts may be established by eligible individuals who are covered under a high-deductible health plan (HDHP). The amount that can be contributed to an individual's HSA depends on the type of HDHP coverage they have, their age, the date they become an eligible individual, and the date they cease to be an eligible individual. For 2011–2013, the following limits apply.

Type of HDHP	Maximum 2011 HSA Contribution	Maximum 2012 HSA Contribution [35]	Maximum 2013 HSA Contribution [36]
Self-only HDHP	$3,050	$3,100	$3,250
Family HDHP	6,150	6,250	6,450

Eligible individuals who are age 55 or older at the end of the tax year may contribute an additional $1,000 to their HSA. For married couples, if both spouses are age 55 or older and not enrolled in Medicare, each spouse's HSA contribution limit is increased by $1,000; thus, the maximum family contribution for 2013 is $8,450 ($6,450 family coverage + $2,000 additional contribution for both spouses). Although $6,450 may be contributed to either spouse's HSA for 2013, each spouse must make the additional contribution to their separately owned HSA.

Beginning with the first month that an individual is enrolled in Medicare, no HSA contribution is allowed.

Maximum HSA contributions may be limited if the participant does not participate in an HDHP for the entire year. The adjusted limit is the **higher** of:

1. The maximum annual HSA contribution prorated for the number of full months the HDHP was in place, or
2. The maximum annual HSA contribution based on the type of HDHP (self-only or family) in place on the first day of the last month of the taxpayer's tax year **(last-month rule,** which is discussed later in this section).

Excess Contributions. IRC §4973 imposes a 6% excise tax on HSA contributions in excess of the maximum contribution limit for the year. Excess contributions made by the taxpayer are not deductible. Excess contributions made by the individual's employer are included in the employee's gross income. If the excess contribution is not included in box 1 of Form W-2, *Wage and Tax Statement,* the individual must report the excess on line 21 of Form 1040.

The 6% excise tax on excess contributions is calculated on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. However, if the excess contributions for the year and the net income attributable to the excess contributions are withdrawn from the HSA before the tax return due date (including extensions), the amount is not subject to excise tax for that year. The income earned on the withdrawn contribution should be included on line 21 of Form 1040 for the year the taxpayer withdrew the contributions and earnings.[37]

35. Rev. Proc. 2011-32, 2011-22 IRB 835.

36. Rev. Proc. 2012-26, 2012-20 IRB 933.

37. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

Example 17. George, age 45, enrolls in family HDHP coverage on January 1, 2012, and contributes $6,250 to an HSA on that date. He ceases to be covered by an HDHP on August 1, 2012. George ceases to be an eligible individual on August 1, 2012. The last-month rule does not apply to him because he is not an eligible individual on December 1, 2012.

On December 15, 2012, George withdraws $2,604 ($6,250 maximum 2012 HSA contribution – ($6,250 × 7/12 proration for the seven months HDHP was in place)) from his HSA. He also withdraws $46, which is the amount of earnings attributable to the $2,604 excess contribution.

The $2,604 is an excess contribution for purposes of IRC §4973, but it is not subject to the 6% excise tax because George withdrew the excess contribution and earnings before the extended due date for filing his 2012 tax return. He reports the $46 earnings on line 21 of his 2012 return.

Last-Month Rule. Under the last-month rule, if the taxpayer is an eligible individual on the first day of the last month of their tax year (December 1 for most taxpayers), they are considered an eligible individual for the entire year. They are treated as having the same HDHP coverage for the entire year as they had on the first day of that last month.[38] However, if contributions are made to the taxpayer's HSA based on the amount allowable under the last-month rule, the taxpayer must remain an eligible individual during the **testing period,** which begins with the last month of the tax year and ends on the last day of the 12th month following that month (e.g., December 1, 2012, through December 31, 2013).

Example 18. Julia, age 51, becomes eligible for an HSA on December 1, 2011. She has family HDHP coverage on that date. Under the last-month rule, she contributes $6,150 to her HSA.

If the taxpayer fails to remain an eligible individual during the testing period (other than because of death or disability) they must include in income the total contributions made to their HSA that would not have been made except for the last-month rule. The taxpayer includes this amount in income in the year in which they fail to be an eligible individual. This amount is also subject to a 10% additional tax. Both the income and additional tax are reported on Part III of Form 8889. The taxable income is then included on line 21 of Form 1040 and the 10% additional tax is included on line 60 of Form 1040.

Note. The amount included in gross income because an individual failed to remain an eligible individual during the testing period is not considered an excess contribution and §4973 does not apply. Therefore, the amount cannot be withdrawn under the excess contribution rules.[39]

Example 19. Assume the same facts as **Example 18.** Julia fails to be an eligible individual in June 2012. Because she did not remain an eligible individual throughout the testing period (December 1, 2011, through December 31, 2012), Julia must include in her 2012 income the contributions made in 2011 that would not have been made except for the last-month rule.

Julia's 2011 HSA limit is $513 ($6,150 family-coverage limit × 1/12 proration for the one month the HDHP was in place). Therefore, Julia must include $5,637 ($6,150 − $513) in her 2012 income. A 10% additional tax also applies to this amount.

Relevant portions of Julia's Forms 8889 and 1040 follow.

38. IRC §223(b)(8)(A).

39. IRS Notice 2008-52, 2008-25 IRB 1166.

For Example 19

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Part III **Income and Additional Tax for Failure To Maintain HDHP Coverage.** See the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part III for each spouse.

18	Last-month rule	18	5,637
19	Qualified HSA funding distribution	19	
20	**Total income.** Add lines 18 and 19. Include this amount on Form 1040, line 21, or Form 1040NR, line 21. On the dotted line next to Form 1040, line 21, or Form 1040NR, line 21, enter "HSA" and the amount	20	5,637
21	**Additional tax.** Multiply line 20 by 10% (.10). Include this amount in the total on Form 1040, line 60, or Form 1040NR, line 59. On the dotted line next to Form 1040, line 60, or Form 1040NR, line 59, enter "HDHP" and the amount	21	564

Form **8889** (2012)

21	Other income. List type and amount HSA $5,637	21	5,637
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	

Other Taxes

57	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	57	
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
59a	Household employment taxes from Schedule H	59a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
60	Other taxes. Enter code(s) from instructions HDHP $564	60	564
61	Add lines 55 through 60. This is your **total tax** ▶	61	

Note. For more information about the rules pertaining to HSA contributions, see 2011 *University of Illinois Federal Tax Workbook,* Chapter 7: Individual Taxpayer Topics.

Annual Archer MSA Contribution Limit

An Archer MSA may be established for eligible individuals who are covered under an HDHP. There are two limits on the amount the taxpayer or their employer can contribute to an Archer MSA.

- **The annual deductible limit.** The taxpayer (or their employer) can contribute up to 75% of the HDHP's annual deductible amount to an Archer MSA. The limit is 65% of the annual deductible amount for taxpayers with a self-only plan. The maximum annual Archer MSA contribution is prorated for the number of full months the HDHP is in place.

Example 20. Jared has an HDHP for his family for the months of July through December 2012. The annual deductible is $5,000. Jared can contribute up to $1,875 ($5,000 × 75% annual deductible limit × $^{6}/_{12}$ proration for six months) to his Archer MSA for 2012.

- **The income limit.** A taxpayer cannot contribute more than they earned for the year from the employer through which the taxpayer has the HDHP. Self-employed taxpayers cannot contribute more than their net self-employment (SE) income.

Example 21. Assume the same facts as **Example 20.** Jared earned $35,000 from AJ Welders in 2012. AJ maintains Jared's family HDHP. Jared can contribute $1,875 (the prorated annual deductible limit) because he earned more than that amount at AJ.

Excess Contributions. A taxpayer has excess contributions if the amount contributed to their Archer MSA for the year is greater than the previously described limits. Excess contributions made by the taxpayer are not deductible. Excess contributions made by the individual's employer are included in the employee's gross income. If the excess contribution is not included in box 1 of Form W-2, *Wage and Tax Statement,* the individual must report the excess on line 21 of Form 1040.

A 6% excise tax is generally imposed on excess contributions. Form 5329 is used to calculate the excise tax. However, if excess contributions for the year and the net income attributable to the excess contributions are withdrawn from the Archer MSA before the tax return due date (including extensions), the amount is not subject to excise tax for that year. The income earned on the withdrawn contribution should be included on line 21 of Form 1040 for the year the taxpayer withdrew the contributions and earnings.

LOSS ON CORRECTIVE DISTRIBUTIONS OF EXCESS DEFERRALS

As discussed earlier in this chapter, excess salary deferrals may be returned to the plan participant. A plan participant should report **a loss on a corrective distribution of an excess deferral** in the year the excess amount (reduced by the loss) is received. **The loss is reported as a negative amount on Form 1040, line 21, and identified as "loss on excess deferral distribution."**

RECOVERIES OF ITEMS DEDUCTED IN PREVIOUS YEARS

A recovery is a return of an amount the taxpayer deducted or took as a credit in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of itemized deductions. Taxable recoveries are generally reported on line 21 of Form 1040. The type and amount of the recovery should be listed on the dotted line next to line 21. Any interest the taxpayer receives on the recovery must be reported as interest income in the year it is received.

Under the tax benefit rule of IRC §111, a taxpayer must include a recovery in income in the year they received it up to the amount by which the deduction or credit for the recovered amount reduced the amount of tax in the earlier year.

Itemized Deduction Recoveries

Total Recovery Included in Income. If a taxpayer recovers any itemized deduction that they claimed in an earlier year, they generally must include the full amount of the recovery in income in the year it is received. This rule applies if **all** of the following statements are true for the year in which the deduction was taken.

1. The taxpayer's itemized deductions exceeded the standard deduction by at least the amount of the recovery.
2. The taxpayer had taxable income.
3. The deduction for the item recovered equals or exceeds the amount recovered.
4. The taxpayer's itemized deductions were not subject to the limit on itemized deductions.
5. The taxpayer had no unused tax credits.
6. The taxpayer was not subject to alternative minimum tax (AMT).

> **Note.** Taxable refunds of state or local income taxes are reported on line 10 of Form 1040. For information about calculating the amount to include in income, see the Form 1040 instructions for line 10.

Example 22. In 2011, Martha and Grant filed a joint federal tax return. Their taxable income was $65,000 and they were not entitled to any tax credits. Their itemized deductions totaled $13,000, which exceeded the standard deduction by $1,400 ($13,000 itemized deductions − $11,600 standard deduction for 2011).

In 2012, Martha and Grant received the following recoveries for amounts deducted on their 2011 return.

Mortgage interest refund	$400
Personal property tax refund	350
Total recoveries	$750

Neither of the refunds was more than the deductions Martha and Grant took for 2011. Because their total recoveries are less than the amount by which their itemized deductions exceeded the standard deduction, they must include the total recoveries of $750 in their 2012 income reported on line 21 of Form 1040.

Total Recovery Not Included in Income. A taxpayer may be able to exclude part or all of the recovery from their income if at least one of the six statements listed in the preceding discussion **is not true.**

Standard Deduction Limit. Generally, only the portion of a taxpayer's itemized deductions that exceed their standard deduction are subject to the recovery rule (except for taxpayers who are required to itemize). If the taxpayer's total deductions on the earlier year return were not more than their income for that year, the amount they should include in income is the lesser of the following.

- The total amount of the taxpayer's recoveries
- The amount by which their itemized deductions exceeded the standard deduction

Example 23. In 2011, Branford and Sylvia filed a joint federal tax return. Their taxable income was $45,000 and they were not entitled to any tax credits. Their itemized deductions totaled $11,800, which exceeded the standard deduction by $200 ($11,800 itemized deductions − $11,600 standard deduction for 2011).

In 2012, Branford and Sylvia recovered $1,500 of their 2011 itemized deductions. None of the recoveries were more than the actual deductions taken on their 2011 return. Branford and Sylvia must include $200 in the income reported on line 21 of their 2012 return. This is the lesser of their recoveries ($1,500) or the amount by which their itemized deductions exceeded their standard deduction ($200).

Negative Taxable Income. If the taxpayer's taxable income **for the prior year** was a negative amount, the recovery they must include in income is reduced by that amount. A taxpayer has negative taxable income if their exemption amount is more than their income after deductions (line 41 on the 2012 Form 1040).

Example 24. Assume the same facts as **Example 23,** except Branford and Sylvia's exemptions on their 2011 Form 1040 exceed their income after deductions by $90, giving them negative taxable income of $90. Branford and Sylvia must include $110 ($200 – $90) in their 2012 income reported on line 21 rather than $200.

Recovery Limited to Deduction. The taxpayer should not include in their income any amount by which their recovery exceeds the amount they deducted in the earlier year. The amount included in income is limited to the lesser of the following.

- The amount deducted
- The amount recovered

Example 25. In 2011, Tamara paid $2,500 for medical expenses. After subtracting 7.5% of her adjusted gross income (AGI) from this amount, her actual medical expense deduction was $500. In 2012, Tamara received a $750 insurance reimbursement for her 2011 medical expenses. Tamara is only required to include $500 of the reimbursement in her income reported on line 21 of her 2012 return, because that is the amount she actually deducted.

Itemized Deductions Limited. For tax years prior to 2010, taxpayers were subject to a limit on their itemized deductions if their AGI exceeded a threshold amount. For the 2010–2012 tax years, there was no limit on itemized deductions. For tax years after 2012, the itemized deduction limitation is reinstated for higher-income taxpayers under a provision contained in the American Taxpayer Relief Act of 2012.

If the taxpayer recovered an amount that was deducted in a year in which their itemized deductions were limited, a portion of the recovery must be included in income reported on line 21. To determine the part of the recovery that must be included in income, see the "Itemized Deduction Recoveries" section in IRS Pub. 525, *Taxable and Nontaxable Income.*

> **Note.** For more information about the provisions contained in the American Taxpayer Relief Act of 2012, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation.

Unused Tax Credits. If a taxpayer recovers an item deducted in an earlier year in which they had unused tax credits, they must recalculate the earlier year's tax to determine whether they must include the recovery in their income. This is done by adding the amount of the recovery to the taxable income for the earlier year and determining the tax and the credits on the recalculated amount. If the recalculated tax, after applying the credits, is more than the actual tax in the earlier year, the taxpayer must include the recovery in their income up to the amount of the deduction that reduced the tax in the earlier year. If the tax, after applying the credits, does not change, the taxpayer did not have a tax benefit from the deduction. Therefore, the recovery is not included in income.[40]

Example 26. In 2011, Marlee filed as head of household and itemized her deductions. Her taxable income was $5,900 and her tax before credits was $593. Marlee claimed a child care credit of $900, which reduced her tax to zero. She had an unused tax credit of $307 ($900 − $593).

In 2012, Marlee recovered $200 of her itemized deductions. She reduced her 2011 itemized deductions by $200 and recalculated her 2011 tax on taxable income of $6,100 ($5,900 + $200). Her revised tax amount for 2011 is $613. Because Marlee's child care credit still exceeds the recalculated tax, her 2011 tax liability is not changed by reducing her deductions by the recovery amount. Consequently, Marlee did not have a tax benefit from the recovered deduction and does not include any of the recovery in her 2012 income.

Subject to AMT. If the taxpayer was subject to AMT in the year the deduction was taken, they must recalculate the tax for the earlier year to determine whether the recovery must be included in their income. This requires a recalculation of their regular tax and their AMT. If inclusion of the recovery does not change the taxpayer's total tax, they do not include the recovery in income. However, if the taxpayer's total tax increases, they received a tax benefit from the deduction and must include the recovery in their income reported on line 21 up to the amount of the deduction that reduced their tax in the earlier year.

Other Recoveries

Total Recovery Included in Income. If a taxpayer recovers an amount that was previously deducted as an adjustment to income when calculating AGI, they generally must include the full amount of the recovery in their income in the year received.

Example 27. In August 2011, Alberto paid $4,000 tuition and fees to the local college for the fall semester. Alberto withdrew from some of his classes but did not receive a refund prior to the time he filed his 2011 tax return. Alberto claimed a $4,000 tuition and fees deduction on his 2011 return, which reduced his AGI by $4,000.

In May 2012, Alberto received a refund of $1,000 from the college. He must report this amount as other income on line 21 of his 2012 tax return.

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

Total Recovery not Included in Income. If any part of the deduction the taxpayer took for the recovered amount did not reduce their tax, they may be able to exclude part of the recovery from their income. The taxpayer must increase their income in the year of recovery by the refunded amount only to the extent that the deduction reduced their tax in the year the deduction was taken.

Example 28. Assume the same facts as **Example 27,** except Alberto paid $5,000 tuition and fees in August 2011. However, the maximum tuition and fees deduction for 2011 was $4,000 based upon Alberto's modified adjusted gross income (MAGI). Thus, Alberto claimed a tuition and fees deduction for $4,000 on his 2011 tax return.

After Alberto received the $1,000 refund in May 2012, his tax return preparer calculated the taxable recovery amount by reducing Alberto's qualified expenses on which the original tuition and fees deduction was computed by the refund, and then recomputing the deduction using the redetermined qualified expenses.

Qualified tuition and fees expenses as originally determined	$5,000
Refund	(1,000)
Recalculated expenses	$4,000

Based on Alberto's MAGI, his 2011 tuition and fees deduction remains unchanged at $4,000. Therefore, Alberto does not include the recovery in his 2012 income because he derived no tax benefit from the recovered amount.

Note. For more information on the tuition and fees deduction, see 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 2: Education.

INCOME FROM PERSONAL PROPERTY RENTAL

The manner in which a taxpayer reports income and expenses from the rental of personal property is generally determined by the following.[41]

- Whether the rental activity is a business
- Whether the rental activity is conducted for profit

If the taxpayer's primary purpose is income or profit and they are engaged in the rental activity with continuity and regularity, the rental activity is a business. A sole proprietor who is in the business of renting personal property should report their income and expenses on Schedule C, *Profit or Loss From Business.*

Income from the rental of personal property should be entered on line 21 of Form 1040 if the taxpayer engaged in the rental for profit but was **not in the business of renting such property.** The type and amount of the income should be listed on the dotted line next to line 21. The associated rental expenses should be entered on Form 1040, line 36, with the amount and "PPR" listed on the dotted line next to line 36.

Note. For a thorough discussion of the factors used to determine whether an activity is conducted for profit, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Hobby Losses.

41. IRS Pub. 17, *Your Federal Income Tax.*

NOT-FOR-PROFIT ACTIVITIES

A taxpayer must report income from an activity from which they do not expect to make a profit, such as a hobby or a farm that is operated mostly for recreation and pleasure. Income from such activities is entered on line 21 of Form 1040. Deductions for expenses related to the activity may be limited.

> **Note.** For a thorough discussion of not-for-profit activities, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Hobby Losses.

DIVIDENDS ON INSURANCE POLICIES

Dividends paid on life insurance policies the insured person uses to pay their premiums are not taxable. When dividends on an insurance contract (other than a modified endowment contract) are **distributed** to the insured, they are a partial return of the premiums paid. These distributed dividends are not included in the insured taxpayer's income unless they exceed the total of all net premiums paid for the contract. A taxable distribution on an insurance policy is reported on line 21 of Form 1040.

UNEMPLOYMENT BENEFIT PAYMENTS BY A UNION

Benefits paid to an unemployed member of a union from regular union dues are included in the union member's income reported on line 21 of Form 1040. However, if the union member made nondeductible contributions to a special union fund, the unemployment benefits they receive from the fund are includible in income only to the extent that they are more than the contributions.

UNEMPLOYMENT BENEFIT PAYMENTS TO STATE EMPLOYEES

Payments similar to unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. The payments are fully taxable, but they should not be reported as unemployment compensation. Instead, these payments should be reported on line 21 of Form 1040.

CREDIT CARD INSURANCE

Generally, if a taxpayer receives benefits under a credit card disability or unemployment insurance plan, the benefits are taxable. These insurance plans make the minimum monthly payment on the credit card account if the insured individual cannot make the payment due to injury, illness, disability, or unemployment. The insured reports the benefit payments on line 21 of Form 1040 if the amount of benefits received during the year is more than the amount of premiums paid during the year.[42]

RECAPTURE OF CHARITABLE CONTRIBUTION

In certain circumstances, a taxpayer must recapture charitable contribution deductions. The recapture is reported on line 21 of Form 1040.

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42. IRS Pub. 17, *Your Federal Income Tax.*

Charitable Organization Disposes of Property within Three Years

Part of a taxpayer's charitable contribution deduction must be recaptured if **all** of the following statements are true.

1. The taxpayer claims a charitable deduction of more than $5,000 for a donation of an item or group of similar items of **tangible personal property.**
2. The deduction is more than the taxpayer's basis in the property.
3. The organization sells, trades, or otherwise disposes of the property after the year it was contributed but within three years of the contribution.
4. The organization does **not** provide a written statement (such as on Part IV of Form 8282, *Donee Information Return*) signed by an officer of the organization under penalty of perjury, that either:
   a. Certifies its use of the property was substantial and related to the organization's purpose, or
   b. Certifies its intended use of the property became impossible.

If all the preceding statements apply, the taxpayer recaptures the difference between the deduction claimed and the taxpayer's basis in the property at the time of contribution. This recapture is reported on line 21 of Form 1040 in the year the organization sells or otherwise disposes of the property.[43]

Fractional Interest in Tangible Personal Property

A fractional interest in property is an undivided portion of the entire interest in the property. A taxpayer can deduct a charitable contribution of a fractional interest in tangible personal property only if all interests in the property are held immediately before the contribution by:

- The taxpayer, or
- The taxpayer and the qualifying organization receiving the contribution.[44]

This type of donation is most often associated with the right to possess works of art and valuable collectibles. For example, a taxpayer who owns a painting may donate a fractional interest by giving an art museum the right to possess the painting for three months of each year.

The charitable deduction of a fractional interest in tangible personal property must be recaptured if both of the following statements are true.[45]

- The taxpayer contributed a fractional interest in tangible personal property after August 17, 2006.
- The taxpayer did not contribute the rest of their interests in the property to a qualified organization on or before the earlier of:
  - The date that is 10 years after the date of the initial contribution, or
  - The date of the taxpayer's death.

43. IRS Pub. 526, *Charitable Contributions.*
44. Ibid.
45. Ibid.

Recapture is also required in any situation in which the qualified organization has not taken substantial physical possession of the property and used it in a way related to its purpose during the period beginning on the date of the initial fractional contribution and ending on the earlier of:

- The date that is 10 years after the date of the initial contribution, or
- The date of the taxpayer's death.

The recapture of the charitable contribution deduction is reported as other income on line 21 of Form 1040. The recapture is also subject to interest charges and a 10% additional tax, which is reported on line 60 of Form 1040 and identified as "FITPP."[46]

CANCELED DEBTS

In most situations, when a debt the taxpayer owes is canceled or forgiven (other than as a gift or bequest), the taxpayer must include the canceled amount in their income. If the debt is a nonbusiness debt, the taxpayer reports the canceled amount on line 21 of Form 1040. Canceled or forgiven business debts are reported on Schedule C if the taxpayer is a sole proprietor or Schedule F if the taxpayer is a farmer and the debt is farm debt.

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

A canceled debt is not included in a taxpayer's gross income in the following situations.

- The debt is canceled in a bankruptcy proceeding.
- The debt is canceled when the taxpayer is insolvent. However, the taxpayer cannot exclude any amount of canceled debt that exceeds the amount by which they are insolvent.
- The debt is qualified farm debt and is canceled by a qualified person.
- The debt is qualified real property business debt.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness.
- Payment of the debt would be deductible.
- The price is reduced after purchase. The debt reduction is treated as a purchase price adjustment and reduces the taxpayer's basis in the property.
- The debt is a student loan canceled as a result of working for a certain length of time in certain professions for any of a broad class of employers.

Note. More information about student loans that qualify for the exception can be found in IRS Pub. 525, *Taxable and Nontaxable Income.* A detailed discussion of various issues associated with debt cancellation can be found in the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Individual Taxpayer Topics.

46. Form 1040 Instructions.

DISASTER RELIEF PAYMENTS

The taxable portion of disaster relief payments is included in income reported on line 21 of Form 1040. If any part of the disaster relief payment is taxable, the taxpayer should attach a statement to the tax return showing the total payment received and how the taxable part was calculated.

A taxpayer can exclude from income any amount they receive that is a qualified disaster relief payment. A **qualified disaster relief payment** is an amount paid to an individual for one of the following reasons.[47]

- To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses that result from a qualified disaster
- To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of the taxpayer's home or repair or replacement of its contents as a result of a qualified disaster

The payment must have been made by one of the following.

- A person engaged in the furnishing or sale of transportation as a common carrier because of death or personal physical injuries incurred as a result of a qualified disaster
- A federal, state, or local government or agency or instrumentality in connection with a qualified disaster in order to promote the general welfare

Qualified disaster relief payments do **not** include the following.

- Payments for expenses paid by insurance or other reimbursements
- Income replacement payments or unemployment compensation

A **qualified disaster** is:[48]

- A disaster that results from a terrorist or military action,
- A federally declared disaster,
- A disaster that results from an accident involving a common carrier, or
- Any other event that is determined to be catastrophic by the Secretary of the Treasury.

> **Note.** For more information about the special rules that apply to federally declared disaster area losses, see IRS Pub. 547, *Casualties, Disasters, and Thefts.*

INSURANCE REIMBURSEMENT AFTER CASUALTY LOSS

Some insurance policies reimburse policyholders for living expenses incurred after a casualty loss. If these insurance payments are more than the insured taxpayer's temporary increase in living expenses, the taxpayer must include the excess in their income reported on line 21 of Form 1040. However, if the casualty occurs in a federally declared disaster area, none of the insurance proceeds are taxable.

47. IRC §139(b).

48. IRC §139(c).

A temporary increase in living expenses is the difference between the taxpayer's actual living expenses incurred during the period they could not use their home and the taxpayer's normal living expenses for that period. **Actual living expenses** are the reasonable and necessary expenses incurred because of the loss of the taxpayer's main home. These expenses generally include amounts paid for the following.[49]

- Rent for suitable housing
- Transportation
- Food
- Utilities
- Miscellaneous services

The taxpayer's **normal living expenses** consist of these same expenses that they would have incurred if the casualty (or threat of one) had not occurred.

Example 29. Mitchell's apartment was damaged by a fire in October 2012. As a result, he vacated the apartment and moved to a motel for a month. Mitchell's actual living expenses that he incurred while he lived in the motel and the normal living expenses that he would have incurred if the fire had not occurred are shown in the following table.

	Normal Living Expenses	Actual Living Expenses
Apartment rent	$ 900	$ 0
Motel rent	0	1,800
Food	300	600
Utilities	100	0
Total	$1,300	$2,400

Mitchell received $1,800 from his insurance company to cover his living expenses. His tax return preparer determines the payment Mitchell must include in income as follows.

Insurance payments for living expenses		$1,800
Actual living expenses incurred	$2,400	
Normal living expenses	(1,300)	
Temporary increase in living expenses	$1,100	(1,100)
Amount of payment reported on line 21		$ 700

The taxpayer reports the taxable part of the insurance payment in income for the year they regain the use of their main home or the year they receive the taxable part of the insurance payment, if later.

Example 30. Assume the same facts as **Example 29.** Mitchell regained the use of his apartment in November 2012. He received the insurance reimbursement in January 2013. Mitchell must report the taxable insurance payment of $700 on his 2013 tax return.

FEES FOR SERVICES

All fees for a person's services must be reported as income. Some of these fees are reported on line 21 of Form 1040 and others are reported elsewhere on the tax return.

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49. IRS Pub. 547, *Casualties, Disasters, and Thefts.*

Personal Representatives

All personal representatives must include fees paid to them from an estate in their gross income. If the taxpayer is not in the trade or business of being an executor (e.g., they are the executor of a friend's or relative's estate), they report these fees on line 21. If the taxpayer is in the trade or business of being an executor, the fees are reported as SE income on Schedule C.

Manager for Bankruptcy Estate

A taxpayer must include in income all payments received from their bankruptcy estate for managing or operating a trade or business that the taxpayer operated before they filed for bankruptcy. This income is reported on line 21 of Form 1040.

Other Fees

The following table shows where other types of fees are reported on the tax return.

Type of Fee	Where Reported	Notes
Notary public	Schedule C	Not subject to SE tax
Election precinct official	Line 7 of Form 1040	Should receive Form W-2
Corporate director	Schedule C	Subject to SE tax
Nonemployee compensation	Schedule C	Subject to SE tax

Observation. Other types of income reported on line 21 may also be subject to SE tax.

FREE TOURS

If a taxpayer receives a free tour from a travel agency for organizing a group of tourists, the tour's value must be included in the taxpayer's income. If the taxpayer is not in the trade or business of organizing tours, they should report the FMV of the tour on line 21 of Form 1040. If the taxpayer organizes tours as a trade or business, the tour's value is reported on Schedule C.

ILLEGAL ACTIVITIES

Income from illegal activities, such as money from dealing illegal drugs, must be included in income reported on line 21 of Form 1040 or on Schedule C, if the income is from the taxpayer's SE activity.

KICKBACKS

A taxpayer must include kickbacks, side commissions, push money, or similar payments in the income reported on line 21 of Form 1040 or on Schedule C, if the income is from the taxpayer's SE activity.

MANUFACTURER INCENTIVE PAYMENTS

A taxpayer must include incentive payments from a manufacturer that they receive as a salesperson in the income reported on line 21 of Form 1040 or on Schedule C, if the taxpayer is self-employed.

Example 31. Anderson sells cars for an automobile dealer. He receives incentive payments from the automobile manufacturer every time he sells a particular car model. Anderson reports the incentive payments on line 21 of Form 1040.

ALTERNATIVE TRADE ADJUSTMENT ASSISTANCE PAYMENTS

Payments a taxpayer receives under the Demonstration Project for Alternative Trade Adjustment Assistance for Older Workers (ATAA) must be included in income. The state should send the taxpayer Form 1099-G, *Certain Government Payments,* advising them of the amount that must be included in income. This amount should be reported on line 21 of Form 1040.

OPTION TO BUY HOME

If a taxpayer grants an option to buy their home and the option is exercised, the taxpayer should add the amount received for the option to the selling price of the home. If the option is not exercised, the taxpayer must report the amount as ordinary income in the year the option expires. This amount is reported on line 21 of Form 1040.

CHILD'S INTEREST AND DIVIDEND INCOME

Qualifying parents use Form 8814, *Parents' Election To Report Child's Interest and Dividends,* to elect to report their child's income on the parents' return. If the election is made, the child does not have to file a return. For 2013, only the amount of interest and dividend income that exceeds $2,000 is taxable.[50] The amount from line 12 of Form 8814 is entered on line 21 of Form 1040. The tax return preparer should enter "Form 8814" on the dotted line next to line 21.

> **Note.** For more detailed information about Form 8814, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers.

COURT AWARDS AND DAMAGES

Any amounts a taxpayer receives as compensatory damages for personal **physical injury or physical sickness** are not included in income except to the extent the amounts are attributable to medical expenses that were previously deducted.[51] However, related punitive damages and certain payments for emotional distress **are** included in income.

> **Note.** For more information about damages received for personal injuries, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Schedule A.

Punitive Damages

Generally, punitive damages are reported as ordinary income on line 21. However, in certain cases in which a state statute in effect on September 13, 1995, provides only for punitive damages in wrongful death claims, IRC §104(c) allows the punitive damages to be excluded from taxable income.

Payments for Emotional Distress

Emotional distress is not treated as a physical injury or physical sickness.[52] However, damages received for emotional distress **due to a physical** injury or sickness are treated as received for the physical injury or sickness. The taxpayer should not include such payments in income.

If the emotional distress is due to a personal injury that is **not** attributable to a physical injury or sickness, the taxpayer should include the damages in income reported on line 21 of Form 1040.

NET OPERATING LOSS DEDUCTION

A taxpayer should include any net operating loss (NOL) deduction from an earlier year on line 21. The NOL deduction is subtracted from any income included on line 21. If the result is a negative amount, it should be entered in parentheses. On the dotted line next to line 21, the tax return preparer should enter "NOL" and show the amount of the deduction in parentheses.

> **Note.** For more information about calculating and claiming NOLs, see IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.*

50. Rev. Proc. 2012-41, 2012-45 IRB 539.

51. IRC §104(a).

52. IRC §104(a)(5).