

Chapter 5: Special Taxpayers

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

HOSPITALITY INDUSTRY TAXPAYERS

Taxpayers in the hospitality industry include employers operating restaurants, hotels, banquet halls, clubs, and many other types of organizations. Also included are the employees who work in this industry: the servers, hostesses, bartenders, bussers, and many others who are essential to the operation of the businesses in this category.

The widespread use of tip income as a means of compensation is a factor that is unique to this industry. It is also a form of compensation that has obtained substantial attention from the IRS, which has developed an equally unique set of rules and reporting requirements for tip income. These rules place obligations and penalties on both employees and employers in this industry. It is essential for the tax return preparer to have an understanding of these rules in order to comply with the necessary rules and reporting procedures.

Other tax rules exist specifically for employers in this industry. The smallwares deduction represents a rather recent change in rules by the IRS that may be helpful to taxpayers in this industry.

TAXATION OF TIP INCOME

In addition to the payment of payroll taxes on wages, employers in the hospitality industry are generally liable for the payment of payroll taxes on tips received by employees from customers.

The payment of payroll taxes on tips presents some unusual issues. Although hospitality industry employers are fully aware of the timing and amounts of wages paid to employees, the employer is frequently unaware of the amounts of tip income paid directly from customers to employees. Moreover, employers in the hospitality industry may have special rules for employees regarding how tips are distributed among all employees. Furthermore, tips are frequently received by employees in the form of cash. IRS rules address the reporting of tips and the associated payroll tax liability.

What Is a Tip?

IRS guidance makes a distinction between the following types of payments to employees.

- Amounts constituting a “tip,” which may or may not be subject to payroll taxes
- Amounts that are a “service charge,” which, if subsequently paid to the employee, are always treated as wage income and always subject to payroll taxes¹

The employer’s characterization of the payment is not determinative.²

A tip may be paid by the customer either directly to the employee or to the employer for subsequent payment to the employee. Tip income has the following fundamental characteristics.

- It is presented by the customer free of compulsion.
- The customer must have the unrestricted right to determine the amount paid.
- The amount paid is not determined by negotiation with the employer or dictated by employer policy.
- The customer has the right to determine who receives the payment.³

The absence of any one of the preceding factors creates serious doubt as to whether the amount received by the employee is a tip and is indicative that the amount is instead a service charge that the customer pays for use of the employer’s facilities or for other purposes.⁴ However, all of the surrounding facts and circumstances must be considered.⁵

The IRS has stated that when hotel customers are required to pay an additional charge of 10% to 15% of their total bill and this additional charge is distributed to the servers and other employees in accordance with a labor union agreement, the amount so distributed constitutes a service charge. It is treated as wage compensation for income tax and payroll tax withholding purposes.⁶

Note. Service charges are income to the employer and are part of the employer’s gross income. Service charges that the employer distributes to employees constitute wage income to those employees. This wage income is deductible by the employer.

¹ See Rev. Rul. 57-397, 1957-2 CB 628; and Rev. Rul. 59-252, 1959-2 CB 215.

² Rev. Rul. 2012-18, 2012-26 IRB 1032.

³ Rev. Rul. 59-252, 1959-2 CB 215.

⁴ Ibid.

⁵ Rev. Rul. 2012-18, 2012-26 IRB 1032.

⁶ Rev. Rul. 57-397, 1957-2 CB 628.

Example 1. Norman and Brenda have their wedding reception at Rockport Banquet Hall. After the reception, Norman and Brenda pay their final bill, which includes a 15% gratuity charge that is added to the total amount in accordance with the banquet hall's policy. After payment by the customer, the banquet hall's management pays the gratuity amount to its servers, bartenders, and bussers, indicating to these employees that the amount is a tip. However, the 15% gratuity is not a tip for payroll tax purposes but is instead considered to be a **service charge**. Norman and Brenda did not have the right to determine the amount paid or to determine which employees received specific amounts. Instead, the amount was charged in accordance with Rockport Banquet Hall's policy. The fact that the banquet hall calls the payment a "tip" when it distributes the amount to employees is not determinative of the character of these payments. Subsequent distribution of that amount to employees by the banquet hall constitutes a wage payment to each employee-recipient. These wage payments are subject to payroll taxes just like any other wage payment.

Example 2. Simon has lunch at the Freetown Café. On his bill, there is a blank line on which Simon can indicate the tip amount. A tip payment is not mandatory, but there are sample calculations for a 15%, 18%, and 20% tip from which Simon can choose. Simon chooses the 15% amount as the tip for the server. The amount Simon pays constitutes a tip. Simon chose to leave a tip free of compulsion. He had an unrestricted right to determine the amount paid and could have left any amount as a tip. Simon had the ability to direct the payment of the amount to his server. The amount of the tip was neither determined by negotiation with the café nor dictated by the café's policies.

Application of Income and Payroll Taxes

IRC §3121(a) indicates that "wages" for payroll tax purposes includes all remuneration from employment. Generally, cash tips are included in the definition of wages from employment and are therefore subject to payroll taxes. However, the following amounts are **not** included as wages for payroll tax purposes.

- Noncash tips
- Cash tips totaling less than \$20 received in any calendar month in the course of employment with an employer

If an employee works for several different employers, the \$20 monthly cash tip exemption applies separately to each employer. For tips totaling over \$20 for the month received in the course of employment with an employer, the entire amount of the tip is subject to payroll taxes without subtracting the \$20 tip exemption amount. The \$20 tip exemption amount only applies if the total amount of tip income for the month from a particular employer is under \$20.

Although the preceding exceptions serve to exempt some tips from payroll taxes, **all tip amounts (cash and noncash) are subject to income tax.**

Example 3. Graziana works as a server at Gargonzola's PizzaWorks. For the month of February 2013, she receives a total of \$18 in tip income. Although she must still report this amount on her Form 1040 for the 2013 tax year for income tax purposes, the \$18 tip amount for February is not subject to payroll taxes.

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Example 4. Assume the same facts as **Example 3**, except Graziana also works as a server for two other employers. She receives the following amounts of tip income for the month of February from each employer.

Employer	Tip Income Received in February 2013
Gargonzola PizzaWorks	\$18
Freddie's Sandwich Shoppe	57
Joe's Fish 'n Chips	14
Total tips received	\$89

For the month of February, Graziana's tips received in the course of her employment with Gargonzola PizzaWorks and Joe's Fish 'n Chips are exempt from payroll taxes because the amounts received in connection with each employer are under \$20. However, because the tip income received from Freddie's Sandwich Shoppe is more than \$20, it is subject to payroll taxes. For income tax purposes, Graziana is obligated to include the total amount of \$89 in her gross income for the year. The \$20 exemption only applies to payroll taxes, **not income tax**.

Example 5. Billy is a bartender at the L'il Leprechaun Irish Pub. A generous customer decides to leave Billy a tip but, instead of a cash tip, the customer gives Billy two tickets to a major league baseball game. The fair market value (FMV) of the tickets is \$200. Billy must include the FMV of the tickets in his gross income for tax purposes as wages. The \$200 value is **not** subject to payroll taxes.

The following table summarizes the application of income tax and payroll taxes in connection with cash tips, noncash tips, and service charges that are distributed to employees.

	Cash Tips	Noncash Tips	Service Charges Distributed to the Employee
Subject to income tax	Yes	Yes (FMV included in wages)	Yes
Subject to payroll taxes	Yes	No	Yes

Payroll Tax Rates

The following table summarizes the payroll tax rates for 2013. These rates apply to employment compensation, including cash tip income.

	Social Security	Medicare
Employee portion	6.2% (up to a maximum taxable earnings amount of \$113,700)	1.45% (applies to all earnings without an upper limit)
Employer portion	6.2% (up to a maximum taxable earnings amount of \$113,700)	1.45% (applies to all earnings without an upper limit)

Note. Taxpayers with wages over \$200,000 (\$250,000 for joint filers) may be liable for an additional 0.9% Medicare tax on the amount of wages over the threshold. For employees with compensation in excess of \$200,000, the employer must withhold the additional 0.9%.

EMPLOYEE REPORTING OF TIP AMOUNTS

It is the responsibility of the employee to report to the employer the amount of cash tips received.⁷ To report tips, the employee provides the employer with a written statement.⁸ Form 4070A, *Employee's Daily Record of Tips*, may be used by the employee to record cash tips received. Form 4070, *Employee's Report of Tips to Employer*, can be used as the required written statement to the employer to report cash tips.⁹ Both Forms 4070A and 4070 are in IRS Pub. 1244, *Employee's Daily Record of Tips and Report to Employer*. Although these forms are made available by the IRS, their use is not mandatory. Any written statement created by the employee or employer will suffice.¹⁰

Tips to Include

Only cash tips that meet the definition of “wages” must be reported by the employee for payroll tax purposes.¹¹ Noncash tips do not need to be reported because they are not subject to payroll taxes. If the total amount of cash tips received for employment with an employer is less than \$20 for the month, the employee is not required to report those tips to that employer.¹² Cash tips include those paid by customers through credit and debit cards as well as tips that are received from other employees in a tip-sharing arrangement.¹³

Reporting Period

The employer may require the employee to submit a written report of tips received on a weekly, biweekly, or other basis. However, the maximum time period that the written report can cover is one calendar month.¹⁴ A calendar-month report must be submitted to the employer by the 10th day of the following month. If the 10th day of the following month is a Saturday, Sunday, or legal holiday, the written report is due on the next regular business weekday.¹⁵

Employee Recordkeeping Requirement

The employee is required to maintain records that serve as sufficient proof of the amount of tip income received throughout the year. A daily record of tips, including a daily record entered on Form 4070A, suffices as proof of tip income. If applicable, a daily record of tip income should include a record of tips paid to other employees in a tip-sharing arrangement, including the names of the other employees.¹⁶

Written Report Requirements

The written tip report must include the following information.

- The employee's name, address, and social security number
- The employer's name and address
- The date that the statement was submitted to the employer
- The period that the statement covers and the amount of tips received in that period¹⁷

⁷ IRC §6053(a); Treas. Reg. §31.6053-1(a).

⁸ Rev. Rul. 95-7, 1995-1 CB 185.

⁹ Ibid.

¹⁰ IRS Pub. 1244, *Employee's Daily Record of Tips and Report to Employer*.

¹¹ IRC §6053(a).

¹² Rev. Rul. 2012-18, 2012-26 IRB 1032.

¹³ Ibid.

¹⁴ Treas. Reg. §31.6053-1(c)(1).

¹⁵ IRS Pub. 1244, *Employee's Daily Record of Tips and Report to Employer*.

¹⁶ Ibid.

¹⁷ Treas. Reg. §31.6053-1(b)(1).

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An electronic reporting system may be used to meet the written report requirement as long as it contains all of these required items of information.¹⁸ However, the electronic system must also:

- Ensure that the information received is the same information transmitted by the employee;
- Document all instances that the employee accesses the system to transmit tip information; and
- Be designed to make it reasonably certain that the employee accessing the system to transmit information is, in fact, the employee named in the electronic statement submitted.¹⁹

EMPLOYER PAYROLL TAX LIABILITY

The employer is required to withhold and remit payroll taxes on the cash tip amounts received by employees.²⁰ The employee's share of payroll taxes is withheld from other funds that are paid to the employee by the employer, such as an hourly wage amount.²¹ The employer withholds the employee's share of payroll taxes and pays both the employee and employer amounts in the same way that payroll taxes are paid on other wage amounts.²²

Reported Tips

If an employee timely provides the employer with the required written report, the employer is deemed to have paid the employee the tip remuneration shown on the report on the date the report is furnished.²³ This deemed payment date determines the period in which the employer is required to withhold and pay the payroll taxes and include the deemed payment amount on Form 941, *Employer's Quarterly Federal Tax Return*.

Example 6. Jetties Beach Tavern had its grand opening on September 1, 2013. Jetties remains open for the months of September and October 2013, closing for the season at the end of October. Jetties has two employees: Lonnie, the server, and Rhonda, the bartender. For the months of September and October, Lonnie and Rhonda earn the following wage amounts from Jetties and receive the following tip amounts from customers. Both Lonnie and Rhonda completed Form W-4, *Employee's Withholding Allowance Certificate*. The appropriate income tax withholding rate for each of them is 10%.

	Sep. Wages	Sep. Tips	Sep. Total	Oct. Wages	Oct. Tips	Oct. Total
Lonnie	\$415	\$1,986	\$2,401	\$ 545	\$2,242	\$2,787
Rhonda	550	2,054	2,604	610	2,356	2,966
Total	\$965	\$4,040	\$5,005	\$1,155	\$4,598	\$5,753

Lonnie and Rhonda report their September and October tip income to Jetties using Form 4070 as their required written report. They furnish these reports to Jetties on the 10th day of the following month. These reports for the month of September follow.

¹⁸ Treas. Reg. §31.6053-1(d)(2).

¹⁹ Treas. Reg. §31.6053-1(d)(1).

²⁰ IRC §3121(q).

²¹ Rev.Rul. 2012-18, 2012-26 IRB 1032.

²² Rev. Rul. 95-7, 1995-1 CB 185.

²³ IRC §3121(q).

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For Example 6

Form 4070 (Rev. August 2005) Department of the Treasury Internal Revenue Service	Employee's Report of Tips to Employer	OMB No. 1545-0074
Employee's name and address Lonnie B. Catania, 61 Emily St., Siasconset, MA 02564	Social security number 987: 65 :4321	
Employer's name and address (include establishment name, if different) Jetties Beach Tavern, LLC 4 North Beach St. Nantucket, MA 02554	1 Cash tips received 942	
	2 Credit and debit card tips received 1044	
	3 Tips paid out 0	
Month or shorter period in which tips were received from September 1, 2013 to September 30, 2013	4 Net tips (lines 1 + 2 - 3) 1986	
Signature <i>Lonnie B. Catania</i>	Date 10/10/2013	
For Paperwork Reduction Act Notice, see the instructions on the back of this form. Cat. No. 41320P Form 4070 (Rev. 8-2005)		

Form 4070 (Rev. August 2005) Department of the Treasury Internal Revenue Service	Employee's Report of Tips to Employer	OMB No. 1545-0074
Employee's name and address Rhonda C. Schroeder, 9 King St., Siasconset, MA 02564	Social security number 789: 56 :1234	
Employer's name and address (include establishment name, if different) Jetties Beach Tavern, LLC 4 North Beach St. Nantucket, MA 02554	1 Cash tips received 1,297	
	2 Credit and debit card tips received 757	
	3 Tips paid out 0	
Month or shorter period in which tips were received from September 1, 2013 to September 30, 2013	4 Net tips (lines 1 + 2 - 3) 2,054	
Signature <i>Rhonda C. Schroeder</i>	Date 10/10/2013	
For Paperwork Reduction Act Notice, see the instructions on the back of this form. Cat. No. 41320P Form 4070 (Rev. 8-2005)		

Jetties must complete a Form 941, *Employer's Quarterly Federal Tax Return*, for the third quarter (July, August, and September) of 2013, which is completed in connection with all September employee compensation. The third quarter Form 941 is completed to show only the September wages for Lonnie and Rhonda. **It does not show the tip income because Jetties is deemed to have paid the tip income on the date Lonnie and Rhonda furnished their Forms 4070, which was on October 10, 2013.** This tip income is therefore reported on the fourth quarter Form 941 (covering October, November, and December) along with other fourth quarter employee compensation.

Jetties' third quarter Form 941 is shown on the following page.

The fourth quarter Form 941 covers the following compensation amounts for Lonnie and Rhonda.

Sep. tip income (deemed paid on Oct. 10)	\$4,040
Oct. tip income (deemed paid on Nov. 10)	4,598
Fourth quarter tip income	<u>\$8,638</u>
Total Oct. wage payments	<u>1,155</u>
Total wages and tips for fourth quarter	\$9,793

Jetties' fourth quarter Form 941 is completed in connection with the above compensation and is shown on subsequent pages.

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For Example 6

Form **941 for 2013: Employer's QUARTERLY Federal Tax Return**
 (Rev. January 2013) Department of the Treasury — Internal Revenue Service

950113
 OMB No. 1545-0029

Employer identification number (EIN) 3 7 - 1 2 3 4 5 6 7	
Name (not your trade name) Jetties Beach Tavern, LLC	
Trade name (if any) <input type="text"/>	
Address 4 North Beach Street	
Number Nantucket City	Suite or room number 02554 State MA ZIP code

Report for this Quarter of 2013
(Check one.)

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Instructions and prior year forms are available at www.irs.gov/form941.

Read the separate instructions before you complete Form 941. Type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: <i>Mar. 12</i> (Quarter 1), <i>June 12</i> (Quarter 2), <i>Sept. 12</i> (Quarter 3), or <i>Dec. 12</i> (Quarter 4)	1	<input style="width: 80%;" type="text" value="2"/>																				
2 Wages, tips, and other compensation	2	<input style="width: 80%;" type="text" value="965 . 00"/>																				
3 Income tax withheld from wages, tips, and other compensation	3	<input style="width: 80%;" type="text" value="96 . 50"/>																				
4 If no wages, tips, and other compensation are subject to social security or Medicare tax		<input type="checkbox"/> Check and go to line 6.																				
<table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 30%;"></th> <th style="width: 20%; text-align: center;">Column 1</th> <th style="width: 10%;"></th> <th style="width: 20%; text-align: center;">Column 2</th> </tr> </thead> <tbody> <tr> <td>5a Taxable social security wages</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value="965 . 00"/></td> <td style="text-align: center;">× .124 =</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value="119 . 66"/></td> </tr> <tr> <td>5b Taxable social security tips</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value=" ."/></td> <td style="text-align: center;">× .124 =</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value=" ."/></td> </tr> <tr> <td>5c Taxable Medicare wages & tips</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value="965 . 00"/></td> <td style="text-align: center;">× .029 =</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value="27 . 99"/></td> </tr> <tr> <td>5d Taxable wages & tips subject to Additional Medicare Tax withholding</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value=" ."/></td> <td style="text-align: center;">× .009 =</td> <td style="text-align: center;"><input style="width: 80%;" type="text" value=" ."/></td> </tr> </tbody> </table>				Column 1		Column 2	5a Taxable social security wages	<input style="width: 80%;" type="text" value="965 . 00"/>	× .124 =	<input style="width: 80%;" type="text" value="119 . 66"/>	5b Taxable social security tips	<input style="width: 80%;" type="text" value=" ."/>	× .124 =	<input style="width: 80%;" type="text" value=" ."/>	5c Taxable Medicare wages & tips	<input style="width: 80%;" type="text" value="965 . 00"/>	× .029 =	<input style="width: 80%;" type="text" value="27 . 99"/>	5d Taxable wages & tips subject to Additional Medicare Tax withholding	<input style="width: 80%;" type="text" value=" ."/>	× .009 =	<input style="width: 80%;" type="text" value=" ."/>
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5e Add Column 2 from lines 5a, 5b, 5c, and 5d	5e	<input style="width: 80%;" type="text" value="147 . 65"/>																				
5f Section 3121(q) Notice and Demand—Tax due on unreported tips (see instructions)	5f	<input style="width: 80%;" type="text" value=" ."/>																				
6 Total taxes before adjustments (add lines 3, 5e, and 5f)	6	<input style="width: 80%;" type="text" value="244 . 15"/>																				
7 Current quarter's adjustment for fractions of cents	7	<input style="width: 80%;" type="text" value=" ."/>																				
8 Current quarter's adjustment for sick pay	8	<input style="width: 80%;" type="text" value=" ."/>																				
9 Current quarter's adjustments for tips and group-term life insurance	9	<input style="width: 80%;" type="text" value=" ."/>																				
10 Total taxes after adjustments. Combine lines 6 through 9	10	<input style="width: 80%;" type="text" value="244 . 15"/>																				
11 Total deposits for this quarter, including overpayment applied from a prior quarter and overpayment applied from Form 941-X or Form 944-X filed in the current quarter	11	<input style="width: 80%;" type="text" value="0 ."/>																				
12a COBRA premium assistance payments (see instructions)	12a	<input style="width: 80%;" type="text" value=" ."/>																				
12b Number of individuals provided COBRA premium assistance		<input style="width: 80%;" type="text"/>																				
13 Add lines 11 and 12a	13	<input style="width: 80%;" type="text" value="0 ."/>																				
14 Balance due. If line 10 is more than line 13, enter the difference and see instructions	14	<input style="width: 80%;" type="text" value="244 . 15"/>																				
15 Overpayment. If line 13 is more than line 10, enter the difference		<input style="width: 80%;" type="text" value=" ."/>																				

Check one: Apply to next return. Send a refund.

▶ You MUST complete both pages of Form 941 and SIGN it.

Next ▶

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2013)

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For Example 6

Form **941 for 2013: Employer's QUARTERLY Federal Tax Return** (Rev. January 2013) Department of the Treasury — Internal Revenue Service

950113
OMB No. 1545-0029

Employer identification number (EIN)	3	7	-	1	2	3	4	5	6	7	
Name (not your trade name)	Jetties Beach Tavern, LLC										
Trade name (if any)											
Address	4 North Beach Street										
	Number	Street									Suite or room number
	Nantucket			MA		02554					
	City	State									ZIP code

Report for this Quarter of 2013
(Check one.)

- 1: January, February, March
 - 2: April, May, June
 - 3: July, August, September
 - 4: October, November, December
- Instructions and prior year forms are available at www.irs.gov/form941.

Read the separate instructions before you complete Form 941. Type or print within the boxes.

Part 1: Answer these questions for this quarter.

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2	Wages, tips, and other compensation	2	9793 . 00																																																																																										
3	Income tax withheld from wages, tips, and other compensation	3	979 . 30																																																																																										
4	If no wages, tips, and other compensation are subject to social security or Medicare tax	<input type="checkbox"/> Check and go to line 6.																																																																																											
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Check one: Apply to next return. Send a refund.

▶ You MUST complete both pages of Form 941 and SIGN it.

Next ▶

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2013)

5

2013 Workbook

Jetties completes the following Forms W-2 for Lonnie and Rhonda. Social security and Medicare taxes have been applied to both the wage and tip amounts for both employees.

a Employee's social security number 987-65-4321		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 37-1234567		1 Wages, tips, other compensation 5188.00		2 Federal income tax withheld 519.00	
c Employer's name, address, and ZIP code Jetties Beach Tavern, LLC 4 North Beach St. Nantucket, MA 02554		3 Social security wages 960.00		4 Social security tax withheld 321.66	
		5 Medicare wages and tips 5188.00		6 Medicare tax withheld 75.23	
		7 Social security tips 4228.00		8 Allocated tips	
d Control number		9		10 Dependent care benefits	
e Employee's first name and initial Last name Suff. Lonnie B. Catania 61 Emily St. Siasconset, MA 02564		11 Nonqualified plans		12a See instructions for box 12	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
		14 Other		12c	
				12d	
15 State Employer's state ID number MA 37-1234567	16 State wages, tips, etc. 5188.00	17 State income tax 274.96	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

Department of the Treasury—Internal Revenue Service
Safe, accurate, FAST! Use

a Employee's social security number 789-56-1234		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 37-1234567		1 Wages, tips, other compensation 5570.00		2 Federal income tax withheld 557.00	
c Employer's name, address, and ZIP code Jetties Beach Tavern, LLC 4 North Beach St. Nantucket, MA 02554		3 Social security wages 1160.00		4 Social security tax withheld 345.34	
		5 Medicare wages and tips 5570.00		6 Medicare tax withheld 80.77	
		7 Social security tips 4410.00		8 Allocated tips	
d Control number		9		10 Dependent care benefits	
e Employee's first name and initial Last name Suff. Rhonda C. Schroeder 9 King St. Siasconset, MA 02564		11 Nonqualified plans		12a See instructions for box 12	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
		14 Other		12c	
				12d	
15 State Employer's state ID number MA 37-1234567	16 State wages, tips, etc. 5570.00	17 State income tax 295.21	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

Department of the Treasury—Internal Revenue Service
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2013 Workbook

Unreported Tips. If the employee fails to submit to the employer the required written statement reporting cash tip income for the period, or to the extent the report is inaccurate or incomplete, the employer is not immediately liable for payroll taxes on the tip amount. Instead, the employer is deemed to have paid the tip amount to the employee as remuneration subject to payroll tax on the date that the employer receives a notice and demand from the IRS for the payment of payroll taxes on the tip amount.²⁴

The employee must report the tips on Form 1040 and is required to pay income tax plus social security and Medicare taxes on the amount of unreported tips. The employee must use Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, to report the taxable tip income for the year.

Example 7. Assume the same facts as **Example 6**, except Rhonda does not report her tips to Jetties. Because Jetties is unaware of Rhonda's tip income, Jetties completes Rhonda's Form W-2 showing only the wage amounts paid to her and the applicable income tax and payroll taxes withheld on the wage income, as follows.

a Employee's social security number 789-56-1234		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.			
b Employer identification number (EIN) 37-1234567		1 Wages, tips, other compensation 1160.00		2 Federal income tax withheld 116.00			
c Employer's name, address, and ZIP code Jetties Beach Tavern, LLC 4 North Beach St. Nantucket, MA 02554		3 Social security wages 1160.00		4 Social security tax withheld 71.92			
		5 Medicare wages and tips 1160.00		6 Medicare tax withheld 16.82			
		7 Social security tips		8 Allocated tips			
d Control number		9		10 Dependent care benefits			
e Employee's first name and initial Last name Suff. Rhonda C. Schroeder 9 King St. Siasconset, MA 02564		11 Nonqualified plans		12a See instructions for box 12			
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
		14 Other		12c			
				12d			
f Employee's address and ZIP code							
15 State MA	Employer's state ID number 37-1234567	16 State wages, tips, etc. 1160.00	17 State income tax 61.48	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

Form **W-2** Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

Department of the Treasury—Internal Revenue Service

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²⁴ Ibid.

2013 Workbook

Rhonda must use Form 4137 to report the tip income received during the year on her 2013 tax return. The social security and Medicare taxes that Rhonda must pay on her \$4,410 of unreported tip income is calculated on Form 4137 as follows.

	Unreported Tip Amount	×	Tax Rate	=	Total Tax Liability on Unreported Tips
Social security tax	\$4,410	×	6.2%	=	\$273.42
Medicare tax	4,410	×	1.45%	=	63.95
Total					\$337.37

Note. The 2013 version of Form 4137 was not yet available at the time this book was published. However, Form 4137 for 2013 will use the 2013 social security threshold of \$113,700 (to ensure that total wages and tip income in excess of this threshold for the taxpayer will not be subject to social security tax). In addition, the 2013 form will likely be updated to reflect the new 0.9% additional Medicare tax for those taxpayers with incomes high enough to be affected.

Rhonda must include the \$4,410 of tip income in the gross income reported on her 2013 return. The amount of payroll tax owed on the unreported tips is entered on line 57 of her Form 1040, as follows.

	55	More than line 4b, but	55	
Other Taxes	56	Self-employment tax. Attach Schedule SE	56	
	57	Unreported social security and Medicare tax from Form: a <input checked="" type="checkbox"/> 4137 b <input type="checkbox"/> 8919	57	337
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
		Household employment taxes from Schedule H		

Jetties is not liable for payment of the employer portion of social security and Medicare taxes until a notice and demand is issued to Jetties for such payment.²⁵ Jetties is not required to withhold any employee income tax or the employee portion of social security and Medicare taxes on the amount of unreported tips covered in the notice and demand.²⁶

When Jetties completes Form 941 for the quarter in which the notice and demand is received, it must include an adjustment for the uncollected payroll tax amount, as follows.

5e	Section 3121(q) Notice and Demand—Tax due on unreported tips (see instructions)	5f	337	37
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²⁵ Rev. Rul. 95-7, 1995-1 CB 185; Rev. Rul. 2012-18, 2012-26 IRB 1032.

²⁶ Rev. Rul. 2012-18, 2012-26 IRB 1032.

APPLICABLE PENALTIES

An employee is subject to a penalty for failure to report tip income to the employer. There are also various penalties that may be imposed on an employer for failing to properly administer payroll tax reporting or remit payments.

Employee Penalty

In addition to the liability for the payroll taxes on tip income, an employee who fails to report tip income to the employer is subject to a penalty equal to 50% of the employee's share of payroll taxes on the amount of unreported tip income.²⁷ However, the employee may be able to avoid the penalty by showing that the failure to report the tips to the employer was due to reasonable cause instead of willful neglect. To establish reasonable cause, the employee must provide the IRS with a written statement asserting the facts that the employee believes constitute reasonable cause. This written statement accompanies the employee's Form 1040 with which a Form 4137 is also filed. If the IRS agrees that the stated facts are sufficient to establish reasonable cause, the 50% penalty is waived.

Employer Penalties

With respect to payroll taxes, the employer is responsible for timely filing required returns. With respect to Form 941, the employer, including an employer in the hospitality industry, is responsible for:

- The timely filing of the quarterly Form 941 returns, and
- Withholding the employees' share of payroll taxes payable on wage and tip income amounts and making timely deposits of those amounts along with the employer's share of payroll taxes.

Making timely payments (deposits) of payroll taxes and the timely filing of Form 941 are separate employer obligations. The penalties most directly applicable to the late filing of a Form 941 and/or late payment of payroll tax amounts are described in the following sections.

Failure to Timely File Form 941. Form 941 is filed in connection with the following calendar year quarters and corresponding due dates.

	Calendar Months Covered	Due Date for Return
First quarter	January, February, March	April 30
Second quarter	April, May, June	July 31
Third quarter	July, August, September	October 31
Fourth quarter	October, November, December	January 31 (of the following year)

If the due date falls on a Saturday, Sunday, or legal holiday, the return may be filed on the next business day. If the employer has made timely payments (deposits) of all the payroll taxes owed during the quarter, a 10-day extension is automatically available for the filing of the Form 941 that corresponds to those deposits. The rules for payroll tax deposits are discussed later in this chapter.

Note. "Legal holiday" means any statutory holiday in the District of Columbia. A list of these holidays is available each year in IRS Pub. 15, *Employer's Tax Guide*, and on www.irs.gov.

IRC §6651(a)(1) provides the applicable penalty rules associated with the failure to file most types of income and information returns, including the employer's quarterly Form 941.²⁸

²⁷ IRC §6652(b).

²⁸ IRC §6651(a)(1).

2013 Workbook

For a Form 941 that is late by one month or less, the penalty is 5% of the amount that is required to be shown on the return as the correct amount of tax liability.²⁹ For each subsequent month or partial month that the return is late, an additional 5% penalty applies, up to an overall maximum of 25% of the correct amount of tax liability that should be shown on the return.

Forms 941 that are not filed within 60 days of the due date are subject to a **minimum penalty** of the lesser of \$135 or 100% of the correct amount of tax liability that should be reported on the return. Therefore, for Forms 941 that are more than 60 days overdue, the minimum \$135 (or 100%-of-tax) penalty applies if it is greater than the IRC §6651(a)(1) penalty described previously.

Example 8. The Painted Dog Tavern must file its second quarter Form 941 in connection with the following payroll tax amounts. Because the Painted Dog is a monthly payroll tax depositor, the monthly payroll taxes must be deposited by the 15th day of the following month. The following amounts, which include employee income tax and the employee and employer share of social security and Medicare taxes, are due for the second quarter on the dates shown.

Payroll Month	Income and Payroll Tax Payment Due	Deposit Due Date
April	\$1,000	May 15
May	1,500	June 15
June	<u>2,200</u>	July 15
Total	<u>\$4,700</u>	

Although the due date for the second quarter Form 941 is July 31, the Painted Dog does not pay any of the payroll taxes or file the required return until September 20. The Painted Dog will be assessed a 5% penalty for each month or partial month that the return is late. The return is late two months, as follows.

August 1 to August 31	1st late month
September 1 to September 20	2nd late month

The calculation of the penalty follows.

$$2 \text{ months} \times 5\% = 10\%$$

$$10\% \times \$4,700 \text{ tax liability} = \$470 \text{ penalty}$$

Note The \$470 penalty is based on the amount of tax that is due and unpaid. If some of the tax is paid on or before the due date for the Form 941, the penalty is based only on the net amount of unpaid tax.³⁰

²⁹ Ibid.

³⁰ IRC §6651(b)(1).

Example 9. Use the same facts in **Example 8**, except the Painted Dog files the second quarter Form 941 six months late and pays none of the tax owed. The penalty is calculated as follows.

$$6 \text{ months} \times 5\% = 30\%$$

$$30\% \times \$4,700 \text{ tax liability} = \$1,410$$

Maximum penalty that can be assessed is calculated as follows.

$$25\% \times \$4,700 = \$1,175$$

The Painted Dog will be assessed the maximum late-filing penalty of \$1,175 in connection with the late filing of the Form 941.

Note. Employers with an estimated annual employment tax liability (which includes employee income tax, social security, and Medicare tax) of \$1,000 or less may qualify to file an annual Form 944, *Employer's Annual Federal Tax Return*, instead of a quarterly Form 941. In addition, employers of agricultural workers and domestic workers may be required to report payroll taxes using forms other than a quarterly Form 941. See Treas. Reg. §31.611(a)-1 for further details.

Failure to Pay the Tax Shown on the Return. In addition to the IRC §6651(a)(1) penalty for failure to timely file the Form 941, the employer may also be subject to an IRC §6651(a)(2) penalty for a failure to pay the required amounts shown on the return. This penalty is 0.5% of the amount of unpaid tax for each month or partial month of delinquency up to a maximum of 25% of the delinquent tax amount.³¹ A partial payment of tax serves to reduce the amount of penalty for a particular month if the partial payment was made on or before the beginning of that month.³²

Penalty Anti-Stacking Rule. With respect to any month or partial month that the employer is subject to both the failure-to-file penalty under IRC §6651(a)(1) and the failure-to-pay penalty under IRC §6651(a)(2), the failure-to-file penalty is reduced by the amount of the failure-to-pay penalty.³³ However, this reduction does not apply to a return more than 60 days overdue for which the minimum penalty provision applies.

Failure to Make Timely Deposits. Generally, under the payroll tax deposit rules, an employer is either a monthly depositor or a semi-weekly depositor.³⁴ An employer that is a monthly depositor is required to pay the calendar month's payroll taxes by the 15th day of the following month.³⁵ Semi-weekly depositors must make deposits on Wednesday and Friday due dates each week in accordance with Treas. Reg. §31.6302-1(c).

If the deposit due date falls on a date that is a legal holiday in the District of Columbia, the due date is deemed to fall on the next business day after the legal holiday.³⁶

Note. Whether an employer is considered a monthly or semi-weekly depositor is determined by the amount of its employment tax liability during the appropriate "look-back" period. The applicable rules are found in Treas. Reg. §31.6302-1(b).

³¹ IRC §6651(a)(2).

³² IRC §6651(b)(2).

³³ IRC §6651(c)(1).

³⁴ Treas. Reg. §31.6302-1(a).

³⁵ Treas. Reg. §31.6302-1(c)(1).

³⁶ Treas. Reg. §31.6302-1(c)(1), (c)(2)(iii).

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An employer is penalized for failure to make timely deposits. The penalty is assessed on the amount of the underpayment and according to how many days late the payment is made, as shown in the following table.³⁷

Time of Late Payment	Penalty Amount
Payment made 5 days or less after due date	2% of the underpayment amount
Payment made within 6 to 15 days after due date	5% of the underpayment amount
Payment made more than 15 days after the due date or within 10 days after the date of the first delinquency notice	10% of the underpayment amount
Payment made more than 10 days after the date of the first delinquency notice	15% of the underpayment amount

Application of Deposit Payments. The IRS applies federal tax deposits to the most recent period(s) within the tax period to which the deposit relates. Any excess deposit amount is applied to deposit periods ending on or after the date of the deposit in period-ending-date order.³⁸ The taxpayer may contact the IRS within 90 days of the date of the penalty notice to specifically designate a different period to which a payment applies. The IRS may be contacted in writing or by using the phone number indicated on the penalty notice.³⁹

Note. For additional guidance and detailed examples of the application of payments to prior periods for which amounts of payroll tax are owed, see Rev. Proc. 2001-58.⁴⁰

Waiver of Penalties for Reasonable Cause. Penalties for failure to timely file the Form 941, failure to pay the taxes shown on the Form 941, and failure to timely deposit the required amount may be waived if the taxpayer can show that the failure is due to reasonable cause and not willful neglect.

Reasonable cause exists if the taxpayer demonstrates:

1. They exercised **ordinary business care and prudence** in attempting to file Form 941 or make the required payments, and
2. That they were nevertheless **unable** to file Form 941 or make the payments (or could do so only with undue hardship).⁴¹

³⁷ IRC §6656(b)(1).

³⁸ IRC §6656(e)(1); Rev. Proc. 2001-58, 2001-2 CB 579.

³⁹ Rev. Proc. 2001-58, 2001-2 CB 579.

⁴⁰ Ibid.

⁴¹ See Treas. Reg. §1.6161-1(b) and Treas. Reg. §301.6651-1(c).

The determination of whether reasonable cause exists is made by looking at all the facts and circumstances.⁴² The following is a brief summary of the IRS guidance in the Internal Revenue Manual⁴³ in connection with the particular circumstances that may provide the taxpayer with a sufficient basis for a showing of reasonable cause.

Circumstances	Brief Summary of Guidance
Death, serious illness, or unavoidable absence	May establish reasonable cause but other persons authorized to file or make payment is a factor
Fire, casualty, natural disaster, or other disturbance	May establish reasonable cause; eligibility for disaster relief is a factor
Inability to obtain records	May establish reasonable cause particularly if circumstances beyond the taxpayer's control exist
Mistake	Generally not sufficient for reasonable cause but may serve as a supporting factor along with other circumstances
Erroneous advice or reliance	Taxpayer is responsible for compliance obligations and cannot delegate this responsibility; reliance on another is generally insufficient to establish reasonable cause but inability to obtain records or a change in tax law that the taxpayer could not be expected to know are factors considered
Ignorance of the law	May be used to establish reasonable cause; factors such as the taxpayer's education, previous experience with the particular tax, history of penalties, changes with the tax law or forms, level of complexity, and good faith are factors considered
Forgetfulness	Generally not sufficient to show reasonable cause

Note. The preceding table represents only a brief summary of the guidance on what circumstances may constitute reasonable cause. Additional details are found in IRM 20.1.1.3.2 and subsequent sections. Additional guidance for demonstrating reasonable cause is found in Treas. Reg. §301.6651-1(c). For guidance on a waiver of the IRC §6656(b)(1) penalty for failure to make timely deposits, see IRC §§6656(c) and 6656(d) and Treas. Reg. §301.6656-1.

ANNUAL EMPLOYER TIP REPORTING

Employers operating a “large food or beverage establishment” must file an annual Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*. A **large food or beverage establishment** is one to which all of the following apply.

- Food or beverages are provided for consumption on the establishment's premises.
- Tipping of employees is a customary practice.
- The establishment normally employed more than 10 employees on a typical business day during the preceding calendar year. This is determined by applying the 10-employee test (discussed in the next section).

Form 8027 is used by the IRS to assist in identifying establishments with unreported tip income.

⁴² IRM 20.1.1.3.2.1.

⁴³ See IRM 20.1.1.3.2 et seq.

The 10-Employee Test

The following worksheet from the Form 8027 instructions is used by an employer to determine whether it meets this test.

Worksheet for Determining Whether To File Form 8027

Complete the worksheet below to determine if you had more than 10 employees on a typical business day during 2011 and, therefore, must file Form 8027 for 2012. It is the **average number of employee hours worked on a typical business day** that determines whether or not you employed more than 10 employees.

1. Enter **one-half** of the **total** employee hours worked during the month in 2011 with the **greatest** aggregate gross receipts from food and beverages _____
2. Enter the number of **days opened for business** during the month shown in line 1 _____
3. Enter **one-half** of the **total** employee hours worked during the month in 2011 with the **least** aggregate gross receipts from food and beverages _____
4. Enter the number of **days opened for business** during the month shown in line 3. _____
5. Divide line 1 by line 2. _____
6. Divide line 3 by line 4. _____
7. Add lines 5 and 6. If line 7 is greater than 80 (hours), you must file Form 8027 for 2012. _____

The calculation of whether an employer meets the 10-employee test includes the work hours for **all** of the establishment's food or beverage employees, not just the hours for those employees who receive tip income.⁴⁴ Accordingly, work hours are included not only for servers and bartenders, but also for hosts or hostesses, bussing staff, dining room captains, wine stewards, cooks, kitchen staff, and others who provide services in connection with the provision of food or beverages. Employees such as doormen, bellhops, and coat check staff members are not included. An employee who owns 50% or more of the establishment's stock is not considered an employee.⁴⁵

Completing Form 8027

In order to complete Form 8027, the following information is required in connection with the tax year.

- Total charged tips, which includes tip amounts shown on customer credit cards and other types of credit arrangements⁴⁶
- The total sales amount from charge receipts that indicated a tip amount (exclusive of any state or local taxes)
- The total amount of service charges of less than 10% of customers' bills that were distributed to employees as wages
- The total amount of tips reported by directly tipped employees and the total amount of tips reported by indirectly tipped employees (A **directly tipped employee** is an employee such as a server or bartender who receives tips directly from customers. An **indirectly tipped employee**, such as a cook or busser, generally receives tips from other employees and not from the customer.)
- Total gross receipts from food or beverage operations

⁴⁴ Treas. Reg. §31.6053-3(j)(9).

⁴⁵ Ibid.

⁴⁶ Treas. Reg. §§31.6053-3(j)(4) and (5); Form 8027 Instructions.

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Example 10. Claire is a longtime tax return preparer. She prepares and files the annual tax return and related tax information for Bob’s Seaside Grille (Bob’s). She has determined that Bob’s is categorized as a “large food or beverage establishment” and must therefore file a Form 8027. Bob’s serves lunch and dinner six days per week. She has the following information for Bob’s operations for the 2012 tax year.

Total charged tips	\$ 26,010.40
Total charge receipts indicating charged tips	185,785.71
Total amount of service charges less than 10% distributed to employees as wages	3,463.20
Tips reported by indirectly tipped employees	3,641.76
Tips reported by directly tipped employees	33,071.38

The Form 8027 as completed by Claire for 2012 follows.

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For Example 10

Form 8027 Department of the Treasury Internal Revenue Service	Employer's Annual Information Return of Tip Income and Allocated Tips ▶ See the separate instructions.	OMB No. 1545-0714 <div style="font-size: 2em; font-weight: bold; text-align: center;">2012</div>																											
▶ Information about Form 8027 and its separate instructions is available at www.irs.gov/form8027 .																													
Check if: Amended Return <input type="checkbox"/> Final Return <input type="checkbox"/>	Name of establishment Bob's Seaside Grille Number and street (see instructions) 124 Long Wharf Drive City or town, state, and ZIP code New Haven, CT 06511	Employer identification number 33-1234567 Type of establishment (check only one box) <input type="checkbox"/> 1 Evening meals only <input checked="" type="checkbox"/> 2 Evening and other meals <input type="checkbox"/> 3 Meals other than evening meals <input type="checkbox"/> 4 Alcoholic beverages																											
Employer's name (name as shown on Form 941) Bob's Culinary Enterprises, LLC Number and street (P.O. box, if applicable) 124 Long Wharf Drive City, state, and ZIP code (if a foreign address, see instructions) New Haven, CT 06511		Establishment number (see instructions) Apt. or suite no. 200																											
Does this establishment accept credit cards, debit cards, or other charges? <input checked="" type="checkbox"/> Yes (lines 1 and 2 must be completed) <input type="checkbox"/> No																													
1 Total charged tips for calendar year 2012 2 Total charge receipts showing charged tips (see instructions) 3 Total amount of service charges of less than 10% paid as wages to employees 4a Total tips reported by indirectly tipped employees b Total tips reported by directly tipped employees Note. Complete the Employer's Optional Worksheet for Tipped Employees in the instructions to determine potential unreported tips of your employees. c Total tips reported (add lines 4a and 4b) 5 Gross receipts from food or beverage operations (not less than line 2—see instructions) 6 Multiply line 5 by 8% (.08) or the lower rate shown here ▶ _____ granted by the IRS. Attach a copy of the IRS determination letter to this return Note. If you have allocated tips using other than the calendar year (semimonthly, biweekly, quarterly, etc.), mark an "X" on line 6 and enter the amount of allocated tips from your records on line 7. 7 Allocation of tips. If line 6 is more than line 4c, enter the excess here ▶ This amount must be allocated as tips to tipped employees working in this establishment. Check the box below that shows the method used for the allocation. Show the portion, if any, allocated to each employee in box 8 of the employee's Form W-2. a Allocation based on hours-worked method (see instructions for restriction) <input type="checkbox"/> Note. If you marked the checkbox on line 7a, enter the average number of employee hours worked per business day during the payroll period. (see instructions) _____ b Allocation based on gross receipts method <input type="checkbox"/> c Allocation based on good-faith agreement. Attach a copy of the agreement <input type="checkbox"/>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%;">1</td><td style="width: 15%; text-align: right;">26,010</td><td style="width: 5%; text-align: right;">40</td></tr> <tr><td>2</td><td style="text-align: right;">185,785</td><td style="text-align: right;">71</td></tr> <tr><td>3</td><td style="text-align: right;">3,463</td><td style="text-align: right;">20</td></tr> <tr><td>4a</td><td style="text-align: right;">3,641</td><td style="text-align: right;">76</td></tr> <tr><td>4b</td><td style="text-align: right;">33,071</td><td style="text-align: right;">38</td></tr> <tr><td>4c</td><td style="text-align: right;">36,713</td><td style="text-align: right;">14</td></tr> <tr><td>5</td><td style="text-align: right;">238,477</td><td style="text-align: right;">94</td></tr> <tr><td>6</td><td style="text-align: right;">19,078</td><td style="text-align: right;">24</td></tr> <tr><td>7</td><td></td><td></td></tr> </table>	1	26,010	40	2	185,785	71	3	3,463	20	4a	3,641	76	4b	33,071	38	4c	36,713	14	5	238,477	94	6	19,078	24	7			
1	26,010	40																											
2	185,785	71																											
3	3,463	20																											
4a	3,641	76																											
4b	33,071	38																											
4c	36,713	14																											
5	238,477	94																											
6	19,078	24																											
7																													
8 Enter the total number of directly tipped employees at this establishment during 2012 ▶		16																											
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.																													
Signature ▶	Title ▶	Date ▶																											
For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.																													
		Cat. No. 49989U Form 8027 (2012)																											

Optional Employer Worksheet. An employer or tax return preparer may use an optional worksheet to determine the amount to enter on Form 8027, line 4b. The worksheet calculates the employer’s potential exposure to liability for unpaid payroll taxes on unreported tips. Although the worksheet calculation is not definitive as to whether there are unreported tips, it serves as an indicator as to whether this may be an issue for the employer based on the amounts used to complete the Form 8027. In the worksheet calculation, the percentage of total tips (both charged and cash) is subtracted from the percentage of charged tips to estimate the amount of unreported cash tips that may exist.

Example 11. Use the same facts as **Example 10**. Claire wants to determine whether she should advise Bob’s that there may be a potential for payroll tax liability for unreported tips. Claire decides to complete the optional worksheet in the Form 8027 instructions. Her calculations are as follows.

Employer's Optional Worksheet for Tipped Employees

Unreported tip income can lead to additional employer liability for FICA taxes. As a means of determining if your employees are reporting all of their tips to you, please take a few minutes to voluntarily complete the following worksheet. Completing this worksheet is only for the employer’s information (it is not sent to the IRS).

1. Enter amount from Form 8027, line 1	1.	<u>26.010</u>
2. Enter amount from Form 8027, line 2	2.	<u>185.786</u>
3. Divide line 1 by line 2, enter as a decimal (at least 4 decimal places)	3.	<u>14.0000</u>
4. Enter amount from Form 8027, line 4c	4.	<u>36.713</u>
5. Enter amount from Form 8027, line 5	5.	<u>238.478</u>
6. Divide line 4 by line 5, enter as a decimal (at least 4 decimal places)	6.	<u>15.3947</u>
7. Subtract line 6 from line 3; if zero or less, stop here	7.	<u>0</u>
8. Potential unreported tips. Multiply line 7 by line 5	8.	<u> </u>

Because the amount on line 7 is zero, the employees at Bob’s are likely reporting tips properly. Claire concludes that, on a preliminary basis, it does not appear Bob’s should be very concerned about payroll tax liability for unreported tips. However, she should advise Bob’s that such liability is always possible if the IRS finds unreported tips through either an employee’s Form 4137, through a tip examination, or other means.

Allocation of Tips. If Form 8027 shows that 8% of gross receipts (or lower percentage granted by the IRS) is greater than the amount of total tips reported, the excess amount must be allocated as additional tip income to those employees who received tips. There are three methods that can be used to accomplish this allocation.

1. Gross receipts method, which allocates the excess amount based on each employee’s share of gross receipts
2. Hours-worked method, which allocates the excess amount based on the hours worked by each employee
3. Good-faith agreement method, which allocates the excess based on an agreement between the employer and at least two-thirds of the tip-receiving employees (The agreement must meet certain criteria in order to qualify.)

The amount of allocated tips for employees is reported in box 8 of Form W-2 and must be included in income on line 7 of each employee’s Form 1040. This amount is subject to income, social security, and Medicare taxes. Generally, the employee uses Form 4137 to report the allocated tip income and calculate the employee’s share of social security and Medicare taxes owed on this amount. The employer is liable for its share of social security and Medicare taxes on the allocated tip amount only after the employer receives a notice and demand from the IRS for such payment.⁴⁷

Note. Further guidance on the allocation of tips from Form 8027 can be found in Treas. Reg. §31.6053-3 and the Form 8027 instructions. An employer allocating tips from Form 8027 may need to correct previously completed Forms W-2 for affected employees.

⁴⁷ SSA Handbook, §1408.9.

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EMPLOYER CREDIT FOR FICA TAXES PAID ON TIPS

IRC §45B provides that an employer receives a tax credit for the FICA taxes paid on tip income received by employees. To qualify for the credit, the employer must have:

1. Employees who received tips from customers for providing, delivering, or serving food or beverages for consumption; and
2. Paid or incurred liability for FICA tax on those tips.

The following rules apply to this credit.

1. The credit only applies to tips received by food and beverage employees and not to other employees who receive tips.
2. The credit is available for FICA taxes paid or incurred even on tips that are unreported by the employee for which the employer receives a notice and demand for payment.
3. The credit is nonrefundable and may be used to reduce the employer's regular income tax liability but not its payroll tax liability.

This credit is part of the general business tax credit and is claimed by the employer on Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*.

Note. The employer share of FICA tax is composed of 6.2% of compensation for social security plus 1.45% for Medicare, for a total of 7.65%. This amount is entered on Form 8846, line 4, as shown in the following example.

Example 12. Carmelina's Family Pizzeria, Ltd. (Carmelina's) has one employee, Alfonso, who is the dining room server. During the 2012 tax year, Alfonso received a total of \$10,340 in tip income, on which Carmelina's paid the employer share of payroll tax. Carmelina's claimed a credit for the employer share of FICA tax paid on Alfonso's tips using Form 8846, which follows.

Form 8846 Department of the Treasury Internal Revenue Service	Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips ▶ Attach to your tax return. ▶ Information about Form 8846 and its instructions is at www.irs.gov/form8846	OMB No. 1545-1414 2012 Attachment Sequence No. 98																																
Name(s) shown on return Carmelina's Family Pizzeria, Ltd.		Identifying number 28-3456789																																
<p>Note. Claim this credit only for social security and Medicare taxes paid by a food or beverage establishment where tipping is customary for providing food or beverages. See the instructions for line 1.</p>																																		
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">1</td> <td style="width: 60%;">Tips received by employees for services on which you paid or incurred employer social security and Medicare taxes during the tax year (see instructions)</td> <td style="width: 5%; text-align: center;">1</td> <td style="width: 10%; text-align: right;">10,340</td> <td style="width: 10%;"></td> </tr> <tr> <td style="text-align: center;">2</td> <td>Tips not subject to the credit provisions (see instructions)</td> <td style="text-align: center;">2</td> <td style="text-align: right;">0</td> <td></td> </tr> <tr> <td style="text-align: center;">3</td> <td>Creditable tips. Subtract line 2 from line 1</td> <td style="text-align: center;">3</td> <td style="text-align: right;">10,340</td> <td></td> </tr> <tr> <td style="text-align: center;">4</td> <td>Multiply line 3 by 7.65% (.0765). If you had any tipped employees whose wages (including tips) exceeded \$110,100, see instructions and check here ▶ <input type="checkbox"/></td> <td style="text-align: center;">4</td> <td style="text-align: right;">791</td> <td></td> </tr> <tr> <td style="text-align: center;">5</td> <td>Credit for employer social security and Medicare taxes paid on certain employee tips from partnerships and S corporations</td> <td style="text-align: center;">5</td> <td></td> <td></td> </tr> <tr> <td style="text-align: center;">6</td> <td>Add lines 4 and 5. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, line 4f</td> <td style="text-align: center;">6</td> <td style="text-align: right;">791</td> <td></td> </tr> </table>	1	Tips received by employees for services on which you paid or incurred employer social security and Medicare taxes during the tax year (see instructions)	1	10,340		2	Tips not subject to the credit provisions (see instructions)	2	0		3	Creditable tips. Subtract line 2 from line 1	3	10,340		4	Multiply line 3 by 7.65% (.0765). If you had any tipped employees whose wages (including tips) exceeded \$110,100, see instructions and check here ▶ <input type="checkbox"/>	4	791		5	Credit for employer social security and Medicare taxes paid on certain employee tips from partnerships and S corporations	5			6	Add lines 4 and 5. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, line 4f	6	791					
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For Paperwork Reduction Act Notice, see instructions.			Cat. No. 16148Z	Form 8846 (2012)																														

EFFECT OF FEDERAL MINIMUM HOURLY WAGE RATE

Generally, employers are subject to federal minimum wage laws if the employer has gross income of \$500,000 or more and has employees who are categorized as workers in interstate commerce.⁴⁸ There are several employer exemptions from this law.⁴⁹

Federal law requires that certain employers in the hospitality industry ensure that their tipped employees receive at least the federal basic hourly minimum wage rate. A “tipped employee” is defined as an employee engaged in an occupation in which more than \$30 per month in tips is customarily received.⁵⁰ The Fair Minimum Wage Act of 2007,⁵¹ signed into law on May 25, 2007, increased the federal basic hourly minimum wage rate from \$5.15 to \$7.25 per hour, which is the current federal hourly rate. However, the Fair Minimum Wage Act of 2007 did not change the federal minimum tipped employee wage of \$2.13.

Employers covered under this law may pay the minimum \$2.13 wage to tipped employees as long as the employer ensures that the tipped employee receives at least the federal basic hourly minimum wage rate of \$7.25 from a combination of the tipped employee’s hourly minimum wage plus the tips that the employee receives. Accordingly, a certain amount of tip income may be designated by the employer as necessary to meet the federal minimum hourly wage requirement. If the employee does not earn at least \$7.25 per hour, the employer must make up the difference.

Limitation on Qualifying Tips for Tax Credit

For employers subject to these federal minimum wage requirements, the employer FICA tax credit is equal to the FICA taxes paid on the qualifying tips. However, no credit is available for those tips that the employer uses to meet the federal minimum hourly wage rate requirement. For purposes of this calculation, however, the pre-2007 federal minimum wage rate of \$5.15 is used,⁵² rather than the current rate of \$7.25. The nonqualifying wages are indicated on Form 8846, line 2.

Note. Tax return preparers should be knowledgeable about this valuable credit available to their clients. Because many states have a higher minimum wage than the federal minimum wage, most if not all, of the reported tips qualify for this tax credit. The resulting tip credit amount can result in a sizeable tax credit for the owners of the business.

The business’s payroll tax deduction must be reduced by any resulting credit.

TIP PAYROLL TAX AUDIT ISSUES

Tax practitioners advising clients who are subject to the tip income tax rules should have an understanding of the following, which affect tip audits.

- Case law that affects the IRS approach to tip audits
- IRS initiatives and information-exchanging ability with various state employment agencies

⁴⁸ 29 USC §203(s).

⁴⁹ 29 USC §213.

⁵⁰ 29 USC §203(t).

⁵¹ PL. 110-28, amending the Fair Labor Standards Act of 1938, 29 USC §201 et seq.

⁵² See Form 8846 Instructions.

Employer-Only Assessments and Estimating Tip Income in Audits

In *U.S. v. Fior d'Italia*,⁵³ the Supreme Court held that the IRS may use an aggregate estimation method when auditing an employer and assessing unpaid payroll tax amounts on tip income.

Fior d'Italia, a San Francisco-based restaurant, was audited for unpaid payroll taxes on tip income that was not reported to the restaurant by its employees. The restaurant servers received tips from customers on cash and credit card sales. The IRS determined the credit card tip income received by employees by reviewing charge card data. However, such records did not exist for the amount of tips received on cash sales. Using the credit card data, the IRS calculated that credit card customers tipped 14.49% and 14.29% of their bills for the 1991 and 1992 tax years, respectively, which were the two tax years under audit. The IRS used these percentages to calculate the underreported tip income for cash sales for 1991 and 1992. This led to an assessment of \$23,262 of additional payroll tax owed on the unreported tips on cash sales.

The restaurant's owners argued that the IRS was required to determine the actual amount of cash tips that were unreported on a per-employee basis to arrive at the correct tip amount for assessment of payroll taxes. The restaurant's owners further argued that use of an aggregate estimation method was unreasonable because cash customers typically leave lower tips than credit card customers. Despite these arguments, the Supreme Court reversed the 9th Circuit's decision⁵⁴ that was in favor of the restaurant, confirming that:

- Tax law allows the IRS to use an aggregate estimation method, and
- The IRS may conduct an employer-only assessment for the employer's share of employment taxes on the total estimated amount of employees' unreported tips without allocating the tip income to the individual employees or assessing those employees for their respective shares of payroll taxes.⁵⁵

Questionable Employment Tax Practices Initiative

Although the IRS may initiate an employer audit to ascertain whether payroll tax is properly assessable with respect to unreported tip income, payroll tax audits frequently arise at the state level due to conflicting information from the employee and employer regarding an employee's claim for state benefits, such as unemployment compensation.

The Questionable Employment Tax Practices (QETP) initiative was introduced in November 2007 to help close the tax gap. The initiative was developed through the combined work of the IRS; the National Association of State Workforce Agencies; the U.S. Department of Labor; the Federation of Tax Administrators; and the state workforce agencies of California, Michigan, New Jersey, New York, and North Carolina.⁵⁶

Currently, there are at least 37 states that have entered into a Memorandum of Understanding with the IRS to share audit reports, audit plans, and even to participate in joint examinations when appropriate.⁵⁷ The IRS and participating states exchange information under the QETP initiative, and joint federal and state audits of taxpayers are completed. The QETP seeks to address many types of noncompliance issues regarding payroll taxes, and tip income compliance is one goal of this initiative. As of April 2011, when the QETP initiative progress report was published, approximately \$23 million in additional payroll taxes have been assessed from audits of 6,981 businesses since the initiative began in November 2007.⁵⁸ The IRS indicates that it seeks to continue holding regional summit meetings and exchanging information with participating states in connection with payroll tax issues.⁵⁹

⁵³ *U.S. v. Fior d'Italia*, 536 U.S. 238 (2002).

⁵⁴ *Fior d'Italia v. U.S.*, 242 F.3d 844 (9th Cir. 2001).

⁵⁵ The IRS was successful in appellate litigation regarding employer-only assessments against restaurants prior to the Supreme Court's *Fior d'Italia* decision. See *Morrison Restaurants, Inc. v. U.S.*, 118 F.3d 1526 (11th Cir. 1997) and *The Bubble Room, Inc. v. U.S.*, 159 F.3d 553 (Fed. Cir. 1998).

⁵⁶ IRS Fact Sheet FS-2007-25. Nov. 2007. [www.irs.gov/uac/Information-on-the-Questionable-Employment-Tax-Practices-Memorandum-of-Understanding] Accessed Dec. 19, 2012; *The Questionable Employment Tax Practices Initiative Progress Report* (Apr. 2011) [www.labor.ny.gov/ui/PDFs/QETP%20Report-0406111.pdf] Accessed on Dec. 19, 2012.

⁵⁷ *Ibid.*

⁵⁸ *The Questionable Employment Tax Practices Initiative Progress Report*. Apr. 2011. [www.labor.ny.gov/ui/PDFs/QETP%20Report-0406111.pdf] Accessed on Dec. 19, 2012.

⁵⁹ *Ibid.*

IRS TIP REPORTING PROGRAMS

The IRS has initiated reporting programs that seek to eliminate the difficulty involved with ascertaining whether employees have reported all tip income to the employer and whether all income and FICA taxes have been paid. These programs were developed to encourage voluntary compliance and eliminate the burdens associated with tip examinations.

Tip Rate Determination and Education Program

The Tip Rate Determination and Education Program (TRD/EP) was introduced in October 1993.⁶⁰ Under this voluntary program, the employer and the IRS enter into a tip income agreement. The employer and the IRS determine initial tip rates for the employer's employees using information available to the employer as well as historical information and various occupational categories that apply to the employer's staff. Participating employees sign a Tipped Employee Participation Agreement (TEPA), agreeing to report tips at or above the tip rate established for their occupational category. In order to qualify for a TRD/EP agreement with the IRS, the employer must obtain TEPA's from at least 75% of its employees.⁶¹

During the term of the TRD/EP agreement between the employer and the IRS, the employer agrees to several items, which include the following.

- Maintaining records regarding its employees, tips reported, wages, occupational categories, and other data that was used to determine the tip rates established in the agreement
- Furnishing the IRS with a quarterly employee report showing the total number of employees and the number of participating employees who signed a TEPA
- Furnishing the IRS with an annual report of which employees were not participating employees and information regarding these nonparticipating employees, including the amount of reported tip income for the year for each of them
- Complying with the requirements for filing all federal tax returns, paying and depositing all federal taxes, and filing Form 8027, if applicable

As part of the agreement, the IRS agrees to several items, including the following.

- That it will not initiate any employer tip examinations for any period for which the TRD/EP agreement is in effect, except in relation to a tip examination of any employee or former employee
- Any notice and demand to pay additional payroll tax amounts directed to the employer will be based only on limited circumstances, including a Form 4137 filed by an employee with their personal tax return

Under the terms of the TRD/EP agreement, if a participating employee fails to report tips at or above the established rate, the employer will provide the name, social security number, and other information about that employee to the IRS.⁶²

Note. The basic TRD/EP agreement used by the IRS may be found at www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Voluntary-Compliance-Agreements---Restaurant-Tax-Tips, along with additional details regarding this program.

⁶⁰ IRS Market Segment Specialization Program, *Bars and Restaurants Audit Technique Guide (ATG)*, Catalog No. 83849L (2002).

⁶¹ *Voluntary Compliance Agreements — Restaurant Tax Tips*. Feb. 8, 2012. [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Voluntary-Compliance-Agreements---Restaurant-Tax-Tips] Accessed on Nov. 28, 2012.

⁶² *Ibid.*

Tip Reporting Alternative Commitment

Although the TRD/EP requires the establishment of one or more occupational category-based tip rates, the Tip Reporting Alternative Commitment (TRAC) is another voluntary compliance agreement that does not require specific tip rates to be established. The TRAC agreement generally requires the employer to do the following.

- Provide each tipped employee with a written statement of the amount of charged tips attributed to that employee for periods not greater than one month
- Provide the employee with the ability to verify or correct the written charged tip statement
- Establish a method for each employee to report tip income and for the processing of a written statement reflecting all cash tips attributable to each employer for periods not longer than one month

In contrast to the TRD/EP which requires 75% of employees to sign a TEPA agreement, the TRAC program covers 100% of employees but does not require any agreements between the employer and its employees.

Moreover, the TRAC agreement requires the employer to educate and reeducate all tipped employees on a quarterly basis on the subject of the statutory requirement to report tips to the employer.⁶³ New hires must also be educated on their reporting requirement.

The IRS and employer commitments under the TRAC agreement are similar to those agreed to under the TRD/EP agreement.

Note. The basic TRAC agreement used by the IRS for this program may be found at www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Voluntary-Compliance-Agreements---Restaurant-Tax-Tips, along with additional details regarding the TRAC program.

The IRS EmTRAC program is another voluntary program using an agreement that retains most of the features of the TRAC agreement. However, it provides the employer with greater flexibility for the design of the required educational program and tip reporting procedures.⁶⁴

SMALLWARES DEDUCTION

Generally, whether a particular expenditure by a restaurant, banquet hall, hotel, or other business in the hospitality industry may be immediately expensed in the year incurred or capitalized depends on the nature of the expenditure.

A hospitality business may deduct current-year expenditures that represent ordinary and necessary expenses of carrying on its trade or business.⁶⁵ Generally, the cost of supplies and materials may be deducted only to the extent that they are actually consumed and used in the business during the tax year.⁶⁶ Accordingly, no current-year deduction may be taken for the cost of permanent improvements or betterments. This includes the cost of items such as equipment, furniture and fixtures, and other such property with a useful life substantially greater than one year.⁶⁷

⁶³ Ibid.

⁶⁴ IRS Notice 2001-1, 2001-2 CB 261.

⁶⁵ IRC §162(a).

⁶⁶ Temp. Treas. Reg. §1.162-3T(a)(1).

⁶⁷ Temp. Treas. Reg. §1.263(a)-2T.

“Smallwares” consists of the following 10 categories of items⁶⁸ used by the restaurant or other business in the hospitality industry.

1. Glassware and paper or plastic cups
2. Flatware, including silverware and plastic utensils
3. Dishes, including paper or plastic plates
4. Pots and pans
5. Tabletop items such as salt and pepper shakers, cheese shakers, teapots, tablecloths, napkins, vases, candles, and candleholders
6. Bar supplies, including mixing glasses, strainers, cutting boards, pourers, jiggers, corkscrews, bottle openers, storage bottles, wine coolers, decanters, and glass rimmers
7. Food preparation utensils and tools, such as spoons, spatulas, whisks, knives, pastry and grill brushes, colanders, measuring cups and spoons, thermometers, timers, scales, mixing bowls, pastry bags and tubes, kitchen towels, and kitchen staff uniforms
8. Storage supplies, including food containers, flatware sorters, dish containers, and spice racks
9. Service items such as pepper mills, cheese graters, bread boards, server trays, soup and salad bar trays, and server uniforms
10. Small appliances with a cost of \$500 or less, including items such as can openers, condiment pumps, food warmers, heat lamps, slicers, knife sharpeners, blenders, and juicers

The restaurant or other hospitality business is deemed to consume and use smallwares in the tax year in which the smallwares are **received at the business premises** and are **available for use**. Smallwares that are purchased and stored at a warehouse or facility other than the premises where they will be used do not qualify for a current-year expense deduction.⁶⁹ In addition, smallwares purchased before the business commences operations are not considered to be eligible for the smallwares deduction but rather are treated as start-up costs under IRC §195.⁷⁰

The following items are **not** considered smallwares.⁷¹

- Office supplies
- General purpose cleaning supplies or maintenance tools
- Extraordinary items (such as flatware made of precious metal, antique vases, collectibles, or other items of significant artistic or intrinsic value)
- Items accounted for separately for tax or financial purposes
- Items generally listed as scheduled property for insurance purposes

Example 13. FreddieJack’s BBQ Palace has been operating for five years. During the 2013 tax year, FreddieJack’s purchases \$20,000 of smallwares, including new glassware, plates, pots and pans, and kitchen utensils. The new smallwares purchased are delivered to FreddieJack’s restaurant premises and are used (or available for use) in the course of day-to-day business. FreddieJack’s may deduct the \$20,000 as an ordinary and necessary business expense in the 2013 tax year.

⁶⁸ Rev. Proc. 2002-12, 2002-1 CB 374.

⁶⁹ Ibid.

⁷⁰ Ibid.

⁷¹ Ibid.

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Example 14. Assume the same facts as **Example 13**, except that \$15,000 of the smallwares was delivered to the restaurant premises and the other \$5,000 was placed in storage at a nearby warehouse for later use. FreddieJack’s may only claim a \$15,000 current-year expense deduction for the smallwares delivered to the premises and available for use. The remaining \$5,000 of smallwares stored in the warehouse are not considered available for use and therefore are not treated as consumed and used in FreddieJack’s business in the 2013 tax year.

Example 15. Assume the same facts as **Example 13**, except FreddieJack’s is a new business that has not yet opened. The \$20,000 of smallwares purchased in 2013 was before FreddieJack’s grand opening. The smallwares purchase was an “opening package” that FreddieJack’s required to commence business later in the year. FreddieJack’s may not claim the \$20,000 smallwares expense as a current-year deduction in 2013. The smallwares purchase constitutes a start-up expense.⁷²

Making a change from capitalizing smallwares to using the smallwares deduction constitutes a change in accounting method.⁷³ Accordingly, a restaurant or other hospitality business that previously capitalized smallwares but wants to begin making use of the smallwares deduction must adhere to the procedure set forth in Rev. Proc. 2002-9⁷⁴ and apply for the change using Form 3115, *Application for Change in Accounting Method*. The limitations provided under section 4.02 of Rev. Proc. 2002-9 (involving exceptions to the applicability of Rev. Proc. 2002-9) do not apply for purposes of an accounting change for the smallwares deduction. If the restaurant or hospitality business complies with the rules regarding smallwares and changes its method of accounting to take advantage of current-year deductions for smallwares, the IRS will not make the pre-accounting change treatment of smallwares an audit issue.⁷⁵ Any resulting adjustment that results from the accounting change under IRC §481(a) must be taken into account in the year in which the change is made.⁷⁶

Note. In addition to IRC §481 and the underlying regulations, see Rev. Proc. 2002-9⁷⁷ and the 2011 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues, for guidance on applying for a change in accounting method.

TAXATION RULES FOR DEPENDENTS

There are several tax rules that specifically apply to a dependent child of the taxpayer. Not only are these rules often confusing, but they are frequently overlooked by tax return preparers. These tax rules are not only essential for the tax return preparer to understand, but they often provide some beneficial tax planning opportunities for taxpayers with dependent children.

The filing requirements for children and the tax treatment of a child’s income depend largely on the following factors.

- The amount of the child’s income
- Whether the child has earned income, unearned income, or both
- Whether the child is married
- Whether the child is blind

⁷² Ibid.

⁷³ Ibid.

⁷⁴ See Rev. Proc. 2002-9, 2002-3 IRB 327.

⁷⁵ Rev. Proc. 2002-12, 2002-1 CB 374.

⁷⁶ Ibid.

⁷⁷ Rev. Proc. 2002-9, 2002-3 IRB 327.

Earned income is defined as an amount received as pay (such as salaries, wages, or tip income) by the dependent child for work actually performed.⁷⁸ **Unearned income** consists of the amount of the dependent child's income that is not earned income. Unearned income includes interest, dividends, and capital gains.⁷⁹

GENERAL RULES

In order to determine whether a dependent child must file a return and how that child's income will be taxed, it is first necessary to know the rules regarding a dependent child's exemption and standard deduction.

Dependent Child's Exemption

A dependent child who can be claimed as a dependent on another taxpayer's return cannot claim an exemption of their own.

Note. No exemption can be claimed by the dependent child even if the parent or other taxpayer does not actually claim the child as a dependent. The fact that the dependent child **can** be claimed as a dependent on another taxpayer's return is enough to deny the child an exemption of their own.⁸⁰

Dependent Child's Standard Deduction

The following standard deduction base amounts are applicable to taxpayers for the 2013 tax year.

Filing Status	Standard Deduction Amount
Single and MFS	\$ 6,100
MFJ and Qualifying Widow(er)	12,200
Head of Household	8,950
Additional amount if blind (married)	1,200
Additional amount if blind (unmarried)	1,500
Additional amount if age 65+ (married)	1,200
Additional amount if age 65+ (unmarried)	1,500

If the child is claimed as a dependent on another taxpayer's return (such as the return of a parent or other person), the child's own standard deduction is reduced. For 2013, the dependent child's standard deduction is the **greater** of:

1. \$1,000, or
2. The child's earned income plus \$350 (up to a maximum of \$6,100 for a single child or \$12,200 for a married child filing jointly)⁸¹

Note. For purposes of calculating a dependent child's standard deduction amount, income from a scholarship or fellowship grant that is included in the child's income is considered to be earned income.

⁷⁸ IRS Pub. 929, *Tax Rules for Children and Dependents*.

⁷⁹ Ibid.

⁸⁰ Ltr. Rul. 200236001 (Dec. 18, 2001).

⁸¹ Rev. Proc. 2013-15, 2013-5 IRB 444.

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Example 16. Benny is age 16 and his parents can claim him as a dependent on their joint tax return. Benny works as a server at a local family restaurant. Benny has the following income for 2013.

Wages and tips	\$3,750
Taxable interest	600
Dividend income	1,240
Total	\$5,590

Benny's standard deduction is the greater of:

1. \$1,000, or
2. \$3,750 (wages) + \$350 = \$4,100

Benny's standard deduction is \$4,100 for 2013. Because he can be claimed as a dependent on his parents' 2013 return, he cannot claim any personal exemption for 2013.

Example 17. Assume the same facts as **Example 16**, except Benny is blind and his earned income is from assembling simple toys in a local children's hospital. Because Benny is blind, he adds the additional amount of \$1,500 to the \$4,100 amount calculated previously to arrive at a standard deduction amount of \$5,600 for 2013.

Note. The rule on the standard deduction limitation is designed to prevent a dependent child's maximum standard deduction amount from sheltering unearned income, such as interest and dividends, while allowing the full standard deduction to shelter earned income of the dependent child. Additional details and examples regarding the calculation of the standard deduction for dependent children may be found in IRS Pub. 929, *Tax Rules for Children and Dependents*.

Filing Requirements for Dependent Children

Generally, a child is subject to the same filing requirements as adult taxpayers. A taxpayer is generally required to file a return if gross income equals or exceeds the sum of:

1. The taxpayer's exemption amount, plus
2. The standard deduction amount that applies to the taxpayer.⁸²

Dependent children are subject to this same rule. Because dependent children receive no personal exemption if another taxpayer can claim that child as a dependent, the dependent child's filing requirement therefore depends upon the applicable standard deduction amount. If unearned and/or earned income exceeds the child's standard deduction amount, a filing requirement exists. For 2013, a dependent child must file a return if any of the following applies.

Unearned Income Only	Earned Income Only	Both Earned and Unearned Income
Unearned income exceeds \$1,000	Earned income exceeds \$6,100	Gross income exceeds the larger of: <ul style="list-style-type: none">• \$1,000, or• Earned income (up to \$5,750) plus \$350

Note. For 2012, the threshold amounts for unearned income and earned income are \$950 and \$5,950. For children with both earned and unearned income in 2012, a filing requirement exists if gross income exceeds the larger of \$950 or earned income (up to \$5,650 plus \$300).⁸³

⁸² IRC §6012(a)(1)(A)(i)-(iii). Spouses must file if combined gross income for both spouses exceeds twice the exemption amount plus the standard deduction for joint filers. See IRC §6012(a)(1)(A)(iv). However, under IRC §6012(a)(1)(A), a married taxpayer filing separately is required to file a return if gross income exceeds only the exemption amount, without regard to any standard deduction amount.

⁸³ IRS Pub. 929, *Tax Rules for Children and Dependents*.

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These filing requirements apply to both single and married dependent children.⁸⁴ In addition, for a married dependent child with a spouse who itemizes and files MFS, the child must file a return if gross income is at least \$5.⁸⁵

Note. Children are generally subject to the same rules for itemizing expenses as other taxpayers.

For dependent children with a combination of earned and unearned income, IRS Pub. 929 provides a worksheet that can be used to determine whether a filing requirement exists.

Example 18. Matilda is age 17. Her parents claim her as a dependent on their return. Matilda has the following income for the 2013 tax year.

Wages	\$3,000
Taxable interest	200
Gross income	\$3,200

Matilda's filing requirement may be determined using the worksheet in IRS Pub. 929, as follows.⁸⁶

Filing Requirement Worksheet

1	Earned income plus \$350	\$3,350
2	Minimum amount	1,000
3	Larger of lines 1 and 2	3,350
4	Maximum amount	6,100
5	Smaller of lines 3 and 4	3,350
6	Gross income	3,200
	(If line 6 is larger than line 5, a return must be filed)	

Matilda does not need to file a return for 2013.

Caution. In this example, Matilda was not required to file a federal tax return. However, she may have a state reporting requirement.

⁸⁴ Ibid.

⁸⁵ IRS Pub. 17, *Your Federal Income Tax*, Table 1-2.

⁸⁶ Although the 2013 version of Pub. 929 was not available at the time this book was published, the 2013 version's worksheet will use the inflation-adjusted amounts for 2013 announced by the IRS in Rev. Proc. 2013-15, 2013-5 IRB 444. Those 2013 amounts are used in this example.

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Example 19. Assume the same facts as **Example 18**, except Matilda has \$400 in taxable interest income instead of \$200. Her filing requirement is determined as follows.

Filing Requirement Worksheet

1	Earned income plus \$350	\$3,350
2	Minimum amount	1,000
3	Larger of lines 1 and 2	3,350
4	Maximum amount	6,100
5	Smaller of lines 3 and 4	3,350
6	Gross income	3,400
	(If line 6 is larger than line 5, a return must be filed)	

Matilda must file a return for the 2013 tax year.

Other Filing Requirements. Even if the child's income is less than the threshold amounts discussed previously, a return is required under the following conditions.⁸⁷

- Payroll tax is owed on tips not reported to the child's employer.
- Payroll tax is owed on wage amounts received from an employer that did not withhold the required payroll tax.
- Uncollected payroll tax is owed on group-term life insurance.
- Alternative minimum tax is owed.
- Additional tax is owed on Form 8889, *Health Savings Accounts (HSAs)*, Part III.
- A type of recapture tax is owed, such as tax on the recapture of an education credit.
- Wages in excess of \$108.28 were received from a church or church-controlled organization that is exempt from payroll tax.
- The child has self-employment net earnings of \$400 or more.

If the child owes tax on distributions from a qualified plan, such as an IRA, a return is also required. However, if this tax on a qualified plan is the sole reason for filing a return, the child can file only Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, without it accompanying an entire tax return.⁸⁸

⁸⁷ IRS Pub. 929, *Tax Rules for Children and Dependents*.

⁸⁸ Ibid.

Filing and Preparing the Child's Return. A child is generally responsible for the filing of a required personal return. However, if the child fails to file or is unable to do so, the child's parent or guardian is responsible for filing the return on behalf of the child.⁸⁹ A parent signing the child's return should sign the child's name on the signature line followed by the parent's own signature and the words "parent (or guardian) for minor child." A signing parent may discuss and negotiate matters regarding the return with the IRS. A parent who does not sign the return for the child may furnish information to the IRS on the child's behalf but cannot receive information from the IRS, or discuss or negotiate matters relating to the return unless a Form 2848, *Power of Attorney and Declaration of Representative*, is provided.⁹⁰

Note. Even after filing a Form 2848, a parent may not bind the child in connection with a tax liability unless authorized to do so by the law of the state in which the child resides.⁹¹

A parent or guardian who receives an IRS notice with respect to a child's tax return or tax liability should immediately notify the IRS that the notice involves a child taxpayer. Upon receipt of such notice, the IRS will attempt to resolve the matter with a parent or guardian who has the requisite authority to discuss the child's tax matters. The IRS recognizes that there are possible communication problems when addressing a child's tax liabilities. The IRS indicates that every effort will be made to resolve the matter with a parent or guardian. Collection efforts may be suspended while such resolution is pending.⁹²

Liability for Child's Tax. A child is generally responsible for their own personal tax liability, including interest and penalties. However, a parent is liable for the taxes assessed to a child with respect to employment compensation paid by the parent.⁹³

Example 20. Glenda is a civil engineer. She has her own consulting engineer business, which she operates as a sole proprietorship. Her 12-year-old son, Junior, works in the consulting business every day after school. Glenda pays Junior a salary to perform clerical and filing services. For the 2013 tax year, Junior has \$17,000 of interest and dividend income and \$14,000 of wages from his mother's consulting business. Junior's 2013 tax liability on the interest income alone is \$100. His tax liability is \$800 for the \$14,000 of wage income, for a total 2013 tax liability of \$900 (\$100 + \$800). As a parent, Glenda is liable for the \$800 of tax payable on the wage income that is included in Junior's gross income under IRC §73(a), but she is generally not liable for the tax payable on Junior's interest income.⁹⁴

A parent who is responsible for filing a child's return but fails to do so is not liable for any interest or penalties that may result.⁹⁵

UNEARNED INCOME AND THE KIDDIE TAX

A special tax rule exists with respect to how a dependent child's unearned income is taxed. This rule is designed to discourage the shifting of various types of income such as interest or dividends from a higher-tax-bracket parent to a lower-tax-bracket child. This special tax rule is known as the "kiddie tax."

⁸⁹ IRS Notice 89-7, 1989-1 CB 627.

⁹⁰ Ibid.

⁹¹ Ibid.

⁹² Ibid.

⁹³ Treas. Reg. §301.6201-1(c).

⁹⁴ Ibid.

⁹⁵ Ibid.

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The kiddie tax applies to dependent children who are not filing a joint return and who have at least one living parent. The child must also meet one of the following criteria.

1. The child has not attained age 18 by the end of the tax year.⁹⁶
2. The child has not attained age 19 (or is a student who has not attained age 24) at the end of the tax year, and the earned income of the child is less than half of the child's support for the year.⁹⁷

There is a special rule that applies to children with a January 1 birthday. A child born January 1 is considered to be a year older on the immediately preceding December 31 for purposes of the kiddie tax.⁹⁸

Example 21. Yasmine is a full-time student pursuing her chemistry degree at a local university. She lives with her parents and receives investment income, which was subject to the kiddie tax in 2012 and prior years. She was born on January 1, 1990. She will attain age 24 on January 1, 2014. However, for purposes of the kiddie tax, she is considered to have attained age 24 on December 31, 2013. Because she is considered to be age 24 at the end of the 2013 tax year, the kiddie tax no longer applies to her investment income for 2013 and subsequent years.

Note. See IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information*, for the definitions of “student” and “support” with respect to a qualifying child for dependency exemption purposes. These same definitions apply for kiddie tax purposes. However, a disabled child of any age meets the age requirement for dependency exemption purposes, but a disabled child must be under 19 (under 24 if a student) in order for the kiddie tax rule to apply.

Unearned Income

For kiddie tax purposes, unearned income is defined as the portion of the child's gross income not attributed to earned income.⁹⁹ Although the purpose of the kiddie tax is to tax investment income received by the child, the kiddie tax also reaches other types of income falling into the broad definition of “unearned income.” These types of income include social security and pension benefits received by the child.¹⁰⁰ The source of the property that generates the unearned income is not relevant. Even investment income earned by the child on the child's own savings is subject to the kiddie tax.¹⁰¹

Note. A distribution from a qualified disability trust to a child beneficiary is treated as the child's **earned** income in the year of the distribution. This prevents the disability income from being subjected to the kiddie tax.

⁹⁶ IRC §1(g)(2)(A)(i).

⁹⁷ IRC §1(g)(2)(A)(ii).

⁹⁸ IRS Pub. 929, *Tax Rules for Children and Dependents*.

⁹⁹ IRC §1(g)(4)(A)(i).

¹⁰⁰ Temp. Treas. Reg. §1.1(i)-1T.

¹⁰¹ *Ibid.*

Net Unearned Income. For 2013, net unearned income for kiddie tax purposes is that amount of income not categorized as earned income,¹⁰² reduced by:

1. \$1,000¹⁰³ (the amount of the dependent child's standard deduction applicable to unearned income), plus
2. The greater of:
 - a. \$1,000, or
 - b. If the child itemizes, the amount of the itemized deductions directly connected with the production of the unearned income.¹⁰⁴

Note. For the 2012 tax year, \$950 should be substituted for \$1,000 in the above formula.

If the child has a higher standard deduction because of earned income, the first \$1,000 of that standard deduction is applied against unearned income. Any remaining amount of the standard deduction is applied against the earned income.

Application of the Kiddie Tax

Because most dependent children do not itemize, the usual effect of the above adjustment from unearned income to net unearned income is to reduce unearned income by two times the \$1,000 standard deduction amount. This results in the following application of the kiddie tax on the child's unearned income.

- The first \$1,000 of unearned income is not taxed because it is covered by the child's \$1,000 standard deduction.
- The second \$1,000 of unearned income is taxed at the child's own tax rate.
- The remaining amount of unearned income (the net unearned income amount) is taxed at the appropriate parent's tax rate.

Observation. Even when the kiddie tax applies to a child, the first \$1,000 of investment income is tax free because the child's minimum standard deduction of \$1,000 eliminates tax on this amount. The next \$1,000 of investment income is taxed at the child's own tax rate. This is true for each child to whom the kiddie tax applies. This may provide some useful tax planning opportunities.

¹⁰². IRC §1(g)(4)(A)(i).

¹⁰³. IRC §1(g)(4)(A)(ii)(I).

¹⁰⁴. IRC §1(g)(4)(A)(ii)(II).

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Which Parent's Tax Rate to Use. The following table provides a summary of the rules applicable to the taxation of the child's net unearned income amount on a parent's return in various family situations.

Family Situation	Return Used to Tax Net Unearned Income
Parents file MFJ	Parents' joint return
MFS and parents live together or parents never married and live together all year	Return of the parent with the highest taxable income
MFS and not living together	Return of the parent with the highest taxable income or the custodial parent's return if the custodial parent is considered to be unmarried (using the HoH filing status definition)
Custodial parent divorced or widowed and has not remarried	Return of the custodial parent
Custodial parent divorced or widowed and has remarried	Joint return of the custodial parent and step-parent or the highest taxable income MFS return if separate returns are filed

Note. Further details on which parent's return to use for the taxation of net unearned income for kiddie tax purposes may be found in IRS Pub. 929, *Tax Rules for Children and Dependents*.

Example 22. Nadine is 17 years old at the end of 2013. She is a student and her parents are divorced. Nadine has no siblings and lives with her mother, Carole, who is the custodial parent. Her mother has not remarried. Nadine has \$4,300 of unearned income and no earned income. For 2013, Nadine's standard deduction is \$1,000, which is applied against her \$4,300 of unearned income, reducing it to \$3,300. The next \$1,000 of unearned income is taxed at Nadine's tax rate. This leaves \$2,300 of unearned income that is subject to the kiddie tax, which is taxed at her mother's tax rate.

Example 23. Assume the same facts as **Example 22**, except Nadine has wages of \$5,600 in addition to the \$4,300 of unearned income. Nadine does not itemize deductions in 2013. With a combination of earned and unearned income, the maximum standard deduction available to Nadine is \$6,100 (earned income up to \$5,750 + \$350). Because Nadine has \$5,600 of wages, her applicable standard deduction is \$5,950 (\$5,600 + \$350). Of the \$5,950 standard deduction amount, \$1,000 is applied against Nadine's unearned income of \$4,300, reducing the unearned income to \$3,300. The next \$1,000 of unearned income is taxed at Nadine's tax rate, leaving \$2,300 of unearned income subject to the kiddie tax, which is taxed at her mother's tax rate. After \$1,000 of Nadine's standard deduction amount is applied against her unearned income, the remaining \$4,950 (\$5,950 - \$1,000) is applied against her \$5,600 of earned income for the year.

Reporting the Kiddie Tax

The kiddie tax is calculated and reported using Form 8615, *Tax for Certain Children Who Have Investment Income of More Than \$1,900*.¹⁰⁵ This form applies the kiddie tax in the manner outlined earlier in the section entitled "Application of the Kiddie Tax." Form 8615 is filed with the child's return and the additional liability for the kiddie tax is shown on the child's return.

¹⁰⁵ The 2013 version of Form 8615 is anticipated to use the amount of \$2,000 instead of \$1,900.

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Example 24. Use the same facts as **Example 23**, except that Francine is the tax return preparer for Carole and Nadine and will be preparing their returns for the **2012** tax year. At the end of 2012, Nadine is 16 years old. Francine first determines that Nadine is required to file a tax return. This is because her gross income in the amount of \$9,900 (\$5,600 + \$4,300) exceeds the larger of \$950 or her earned income of \$5,600 plus \$300.

After Francine reviews the relevant tax information for Carole and Nadine, Francine completes Carole's 2012 return. Once she has the taxable income and tax liability amounts from Carole's return, Francine completes Nadine's Form 8615 and Form 1040A. The relevant parts of Carole's return are as follows.

Form 1040 Department of the Treasury—Internal Revenue Service (99)		U.S. Individual Income Tax Return		2012	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.	
For the year Jan. 1–Dec. 31, 2012, or other tax year beginning					, 2012, ending	, 20	See separate instructions.
Your first name and initial Carole M.		Last name Neville		Your social security number 0 6 4 6 4 0 6 4 0			
If a joint return, spouse's first name and initial		Last name		Spouse's social security number			
Home address (number and street). If you have a P.O. box, see instructions. 468 Morton Street					Apt. no.		▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Chicago, IL 63303					Foreign country name		
Foreign province/state/county		Foreign postal code		Presidential Election Campaign			
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse							
Filing Status	1 <input type="checkbox"/> Single		4 <input checked="" type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶		5 <input type="checkbox"/> Qualifying widow(er) with dependent child		
Check only one box.		2 <input type="checkbox"/> Married filing jointly (even if only one had income)		3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶			
Exemptions	6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a		6b <input type="checkbox"/> Spouse		Boxes checked on 6a and 6b		1
c Dependents:		(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)	No. of children on 6c who:		
(1) First name	Last name				• lived with you		1
Nadine	Neville	0 6 5 6 5 0 6 5 0	Daughter	<input checked="" type="checkbox"/>	• did not live with you due to divorce or separation (see instructions)		
If more than four dependents, see instructions and check here ▶ <input type="checkbox"/>					Dependents on 6c not entered above		
d Total number of exemptions claimed						Add numbers on lines above ▶	2
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2		7		50,000		
	8a Taxable interest. Attach Schedule B if required		8a				
	b Tax-exempt interest. Do not include on line 8a		8b				
	9a Ordinary dividends. Attach Schedule B if required		9a				

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For Example 24

Form 1040 (2012)		Page 2
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38 50,000
	39a Check <input type="checkbox"/> You were born before January 2, 1948, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1948, <input type="checkbox"/> Blind. } checked ▶ 39a	
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>	
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$5,950 Married filing jointly or Qualifying widow(er), \$11,900 Head of household, \$8,700	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 8,700
	41 Subtract line 40 from line 38	41 41,300
	42 Exemptions. Multiply \$3,800 by the number on line 6d.	42 7,600
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43 33,700
	44 Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election	44 4,439
	45 Alternative minimum tax (see instructions). Attach Form 6251	45
	46 Add lines 44 and 45 ▶	46 4,439
	47 Foreign tax credit. Attach Form 1116 if required 47	
	48 Credit for child and dependent care expenses. Attach Form 2441 48	
	49 Education credits from Form 8863, line 19 49	
50 Retirement savings contributions credit. Attach Form 8880 50		
51 Child tax credit. Attach Schedule 8812, if required. 51 1,000		
52 Residential energy credits. Attach Form 5695 52		
53 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53	
54 Add lines 47 through 53. These are your total credits 54 1,000		
55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶	55 3,439	
Other Taxes	56 Self-employment tax. Attach Schedule SE 56	
	57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 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 60	
	61 Add lines 55 through 60. This is your total tax ▶	61 3,439
Payments	62 Federal income tax withheld from Forms W-2 and 1099 62 15,000	
	63 2012 estimated tax payments and amount applied from 2011 return 63	
If you have a qualifying child, attach Schedule EIC.	64a Earned income credit (EIC) 64a	
	b Nontaxable combat pay election 64b	
	65 Additional child tax credit. Attach Schedule 8812 65	
	66 American opportunity credit from Form 8863, line 8 66	
	67 Reserved 67	
	68 Amount paid with request for extension to file 68	
	69 Excess social security and tier 1 RRTA tax withheld 69	
	70 Credit for federal tax on fuels. Attach Form 4136 70	
	71 Credits from Form: a <input type="checkbox"/> 2439 b <input checked="" type="checkbox"/> Reserved c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885 71	
	72 Add lines 62, 63, 64a, and 65 through 71. These are your total payments ▶	72 15,000
Refund	73 If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid 73 11,561	
	74a Amount of line 73 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/>	74a 11,561
Direct deposit? ▶ See instructions.	b Routing number ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	d Account number	
	75 Amount of line 73 you want applied to your 2013 estimated tax ▶ 75	
Amount You Owe	76 Amount you owe. Subtract line 72 from line 61. For details on how to pay, see instructions ▶	76
	77 Estimated tax penalty (see instructions) 77	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No	
	Designee's name ▶	Phone no. ▶
	Personal identification number (PIN) ▶	
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	
Joint return? See instructions. Keep a copy for your records.	Your signature	Date
	Spouse's signature. If a joint return, both must sign.	Date
	Your occupation	Daytime phone number
	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Paid Preparer Use Only	Print/Type preparer's name Francine C. McKelbey	Preparer's signature
	Date	Check <input type="checkbox"/> if self-employed PTIN P12345678
	Firm's name ▶ FCM Accounting & Tax	Firm's EIN ▶ 21-1234568
	Firm's address ▶ 56 Clark Street, Chicago, IL 63303	Phone no. 312-123-4567

2013 Workbook

Francine completes the Form 8615, calculating the kiddie tax on Nadine's unearned income, as follows.

Form 8615	Tax for Certain Children Who Have Investment Income of More Than \$1,900 ▶ Attach only to the child's Form 1040, Form 1040A, or Form 1040NR. ▶ Information about Form 8615 and its separate instructions is at www.irs.gov/form8615 .	OMB No. 1545-0074 2012 Attachment Sequence No. 33
Department of the Treasury Internal Revenue Service (99)		
Child's name shown on return Nadine G. Neville		Child's social security number 065-65-0650
Before you begin: If the child, the parent, or any of the parent's other children for whom Form 8615 must be filed must use the Schedule D Tax Worksheet or has income from farming or fishing, see Pub. 929 , Tax Rules for Children and Dependents. It explains how to figure the child's tax using the Schedule D Tax Worksheet or Schedule J (Form 1040).		
A Parent's name (first, initial, and last). Caution: See instructions before completing. Carole M. Neville		B Parent's social security number 064-64-0640
C Parent's filing status (check one): <input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input checked="" type="checkbox"/> Head of household <input type="checkbox"/> Qualifying widow(er)		
Part I Child's Net Investment Income		
1 Enter the child's investment income (see instructions)	1	4,300
2 If the child did not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,900. Otherwise, see instructions	2	1,900
3 Subtract line 2 from line 1. If zero or less, stop ; do not complete the rest of this form but do attach it to the child's return	3	2,400
4 Enter the child's taxable income from Form 1040, line 43; Form 1040A, line 27; or Form 1040NR, line 41. If the child files Form 2555 or 2555-EZ, see the instructions	4	4,000
5 Enter the smaller of line 3 or line 4. If zero, stop ; do not complete the rest of this form but do attach it to the child's return	5	2,400
Part II Tentative Tax Based on the Tax Rate of the Parent		
6 Enter the parent's taxable income from Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, enter -0-. If the parent files Form 2555 or 2555-EZ, see the instructions	6	33,700
7 Enter the total, if any, from Forms 8615, line 5, of all other children of the parent named above. Do not include the amount from line 5 above	7	
8 Add lines 5, 6, and 7 (see instructions)	8	36,100
9 Enter the tax on the amount on line 8 based on the parent's filing status above (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	9	4,799
10 Enter the parent's tax from Form 1040, line 44; Form 1040A, line 28, minus any alternative minimum tax; Form 1040EZ, line 10; Form 1040NR, line 42; or Form 1040NR-EZ, line 15. Do not include any tax from Form 4972 or 8814 or any tax from recapture of an education credit. If the parent files Form 2555 or 2555-EZ, see the instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) was used to figure the tax, check here ▶ <input type="checkbox"/>	10	4,439
11 Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to Part III	11	360
12a Add lines 5 and 7	12a	2,400
b Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	× 1.000
13 Multiply line 11 by line 12b	13	360
Part III Child's Tax —If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.		
14 Subtract line 5 from line 4	14	1,600
15 Enter the tax on the amount on line 14 based on the child's filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	15	161
16 Add lines 13 and 15	16	521
17 Enter the tax on the amount on line 4 based on the child's filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	17	403
18 Enter the larger of line 16 or line 17 here and on the child's Form 1040, line 44; Form 1040A, line 28; or Form 1040NR, line 42. If the child files Form 2555 or 2555-EZ, see the instructions	18	521
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 64113U Form 8615 (2012)		

2013 Workbook

Nadine's Form 1040A, to be filed with the Form 8615, follows.

Form 1040A	Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return (99)	2012	IRS Use Only—Do not write or staple in this space.	
Your first name and initial Nadine G.		Last name Neville		
If a joint return, spouse's first name and initial		Last name		
		OMB No. 1545-0074 Your social security number 0 6 5 | 6 5 0 6 5 0		
		Spouse's social security number		
Home address (number and street). If you have a P.O. box, see instructions. 468 Morton Street		Apt. no.		
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Chicago, IL 63303		Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse		
Foreign country name		Foreign province/state/county		
		Foreign postal code		
Filing status Check only one box.	1 <input checked="" type="checkbox"/> Single		4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.)	
	2 <input type="checkbox"/> Married filing jointly (even if only one had income)		If the qualifying person is a child but not your dependent, enter this child's name here. ▶	
	3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶		5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see instructions)	
Exemptions If more than six dependents, see instructions.	6a <input type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a.		Boxes checked on 6a and 6b No. of children on 6c who: <input type="checkbox"/> lived with you <input type="checkbox"/> did not live with you due to divorce or separation (see instructions) <input type="checkbox"/> Dependents on 6c not entered above <input type="checkbox"/> Add numbers on lines above ▶	
	b <input type="checkbox"/> Spouse			
	c Dependents:			
	(1) First name	Last name		(2) Dependent's social security number
				(3) Dependent's relationship to you
		(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)		
d Total number of exemptions claimed.				
Income Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld. If you did not get a W-2, see instructions. Enclose, but do not attach, any payment. Also, please use Form 1040-V.	7 Wages, salaries, tips, etc. Attach Form(s) W-2.		7 5,600	
	8a Taxable interest. Attach Schedule B if required.		8a 4,300	
	b Tax-exempt interest. Do not include on line 8a.		8b	
	9a Ordinary dividends. Attach Schedule B if required.		9a	
	b Qualified dividends (see instructions).		9b	
	10 Capital gain distributions (see instructions).		10	
	11a IRA distributions.	11a	11b Taxable amount (see instructions).	11b
	12a Pensions and annuities.	12a	12b Taxable amount (see instructions).	12b
	13 Unemployment compensation and Alaska Permanent Fund dividends.		13	
	14a Social security benefits.	14a	14b Taxable amount (see instructions).	14b
15 Add lines 7 through 14b (far right column). This is your total income .		15 9,900		
Adjusted gross income	16 Educator expenses (see instructions).		16	
	17 IRA deduction (see instructions).		17	
	18 Student loan interest deduction (see instructions).		18	
	19 Tuition and fees. Attach Form 8917.		19	
	20 Add lines 16 through 19. These are your total adjustments .		20	
21 Subtract line 20 from line 15. This is your adjusted gross income .		21 9,900		
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11327A Form 1040A (2012)				

2013 Workbook

For Example 24

Form 1040A (2012)		Page 2
Tax, credits, and payments	22 Enter the amount from line 21 (adjusted gross income).	22 9,900
	23a Check <input type="checkbox"/> You were born before January 2, 1948, <input type="checkbox"/> Blind } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1948, <input type="checkbox"/> Blind } checked ▶ 23a <input type="checkbox"/>	
	b If you are married filing separately and your spouse itemizes deductions, check here ▶ 23b <input type="checkbox"/>	
	24 Enter your standard deduction .	24 5,900
	25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25 4,000
	26 Exemptions. Multiply \$3,800 by the number on line 6d.	26
	27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-.	27 4,000
	This is your taxable income .	▶ 27 4,000
	28 Tax , including any alternative minimum tax (see instructions).	28 521
	29 Credit for child and dependent care expenses. Attach Form 2441.	29
	30 Credit for the elderly or the disabled. Attach Schedule R.	30
	31 Education credits from Form 8863, line 19.	31
	32 Retirement savings contributions credit. Attach Form 8880.	32
	33 Child tax credit. Attach Schedule 8812, if required.	33
	34 Add lines 29 through 33. These are your total credits .	34
	35 Subtract line 34 from line 28. If line 34 is more than line 28, enter -0-. This is your total tax .	35 521
	36 Federal income tax withheld from Forms W-2 and 1099.	36 756
	37 2012 estimated tax payments and amount applied from 2011 return.	37
	38a Earned income credit (EIC) .	38a
	b Nontaxable combat pay election.	38b
	39 Additional child tax credit. Attach Schedule 8812.	39
	40 American opportunity credit from Form 8863, line 8.	40
	41 Add lines 36, 37, 38a, 39, and 40. These are your total payments .	▶ 41 756
	42 If line 41 is more than line 35, subtract line 35 from line 41. This is the amount you overpaid .	42 235
	43a Amount of line 42 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/> 43a 235	▶ <input type="checkbox"/> 43a 235
	▶ b Routing number <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	▶ d Account number <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/>	
	44 Amount of line 42 you want applied to your 2013 estimated tax .	44
	45 Amount you owe . Subtract line 41 from line 35. For details on how to pay, see instructions.	▶ 45
	46 Estimated tax penalty (see instructions).	46
	Third party designee Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes . Complete the following. <input type="checkbox"/> No	
	Designee's name ▶ Phone no. ▶ Personal identification number (PIN) <input type="text"/> <input type="text"/> <input type="text"/>	
	Sign here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.	
	Your signature Date Your occupation Daytime phone number	
	Spouse's signature. If a joint return, both must sign. Date Spouse's occupation If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/> <input type="text"/> <input type="text"/>	
	Paid preparer use only Print/type preparer's name Preparer's signature Date Check <input type="checkbox"/> if self-employed PTIN P12345678	
	Firm's name ▶ FCM Accounting & Tax Firm's EIN ▶ 21-1234568	
	Firm's address ▶ 56 Clark Street, Chicago, IL 63303 Phone no. 312-123-4567	

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2013 Workbook

Child Income Information Not Available. Due to separation, divorce, or other reasons, a parent or guardian may not be able to obtain the child's investment income amounts necessary to complete Form 8615. Under such circumstances, reasonable estimates may be used to complete the form. The word "estimated" must be entered on each line on Form 8615 for which an amount is estimated by the parent or guardian completing the form. The IRS will not assess any penalties in connection with the use of reasonable estimates. However, if correct information is subsequently obtained, the child's return must be amended to reflect the correct amounts. If the amendment results in a refund, interest is payable from the April 15 due date if the original estimated return was timely filed. If the amended return results in a balance due, interest is charged from the April 15 due date.¹⁰⁶

More Than One Child Subject to the Kiddie Tax

The excess of a parent's tax liability after the inclusion of a child's unearned income over the amount of the parent's tax before the inclusion of that unearned income is the **allocable parent's tax**. When two or more children are subject to the kiddie tax in the same tax year, each child pays their respective pro rata share of the allocable parent's tax. Form 8615, lines 7, 12a, 12b, and 13 allocate the extra tax ratably among two or more children.

Example 25. Phil and Jennifer have 2013 taxable income of \$89,000. They have two children, Rebecca and Rick. Rebecca and Rick are ages 12 and 16, respectively, and each child has unearned income that is subject to the kiddie tax in 2013. Neither child has earned income or itemizes. The following amounts apply to the children's unearned income.

	Rebecca	Rick	Total
Amount of unearned income	\$4,000	\$10,000	\$14,000
Less: minimum standard deduction	(1,000)	(1,000)	(2,000)
Taxable income	\$3,000	\$ 9,000	\$12,000
Less: IRC §1(g)(4)(A)(ii)(II) adjustment	(1,000)	(1,000)	(2,000)
Net unearned income	\$2,000	\$ 8,000	\$10,000

The kiddie tax applies to the children's unearned income as follows.

- Neither child pays tax on the first \$1,000 of their respective amounts of unearned income because their minimum standard deduction of \$1,000 is applied against that unearned income amount.
- The next \$1,000 of unearned income for each child is taxed at the child's own tax rate. IRC §1(g)(4)(A)(ii)(II) provides for another reduction of unearned income in the same amount as the minimum standard deduction before arriving at the net unearned income to be taxed at the parent's tax rate. Based on the tax brackets for 2013, this \$1,000 for each child is taxed at 10% (for \$100 of tax liability for each child).
- The remaining amount of unearned income for each child (\$2,000 for Rebecca and \$8,000 for Rick) represents the net unearned income that is taxed at Phil and Jennifer's tax rate. Phil and Jennifer have the following tax liability before and after the addition of the net unearned income on which their tax rate applies.

Phil and Jennifer's tax liability on \$89,000	\$14,108
Phil and Jennifer's tax liability on \$99,000	16,608

The tax liability attributable to the \$10,000 of net unearned income is \$2,500 (\$16,608 – \$14,108). This \$2,500 of extra tax liability is allocable to the parents. Rebecca and Rick each will pay their respective pro rata share of the \$2,500 tax. Each child's pro rata share is calculated based on each child's respective percentage of net unearned income to which the parents' tax rate applies. The calculations are as follows.

¹⁰⁶ IRS Ann. 88-70, 1988-16 IRB 37.

$$\begin{aligned}
 \text{Rebecca's share of allocable parents' tax} &= \frac{\text{Net unearned income}}{\text{Total net unearned income}} \times \text{Allocable parents' tax} \\
 &= \frac{\$2,000}{\$10,000} \times \$2,500 \\
 &= \$500
 \end{aligned}$$

$$\begin{aligned}
 \text{Rick's share of allocable parents' tax} &= \frac{\text{Net unearned income}}{\text{Total net unearned income}} \times \text{Allocable parents' tax} \\
 &= \frac{\$8,000}{\$10,000} \times \$2,500 \\
 &= \$2,000
 \end{aligned}$$

Each child's portion of kiddie tax on the respective amounts of unearned income is as follows.

	Rebecca	Rick	Total
Tax on the unearned income amount covered by the \$1,000 minimum standard deduction	\$ 0	\$ 0	\$ 0
Tax on the next \$1,000 for IRC §1(g)(4)(A)(ii)(II) (taxed at the child's 10% tax rate)	100	100	200
Pro rata share of parents' tax	500	2,000	2,500
Total tax on unearned income for Rebecca and Rick	\$600	\$2,100	\$2,700

A separate Form 8615 must be completed for each child and will reflect each child's individual tax amounts.

Parent's Election to Report Child's Investment Income

Instead of filing Form 8615 in connection with the kiddie tax, the parent may elect to include a child's unearned income in their own income and report that income on the parent's return. This election may be made if **all** of the following apply.

1. The child is under age 19 (or under age 24 if a student) at the end of the tax year.
2. The child has only interest and/or dividend income (including capital gains distributions).
3. The child's 2013 gross income is less than \$10,000.
4. The child is required to file a return unless the parent makes this election.
5. The child does not file a joint return.
6. There was no estimated tax payment made under the child's social security number, and there is no overpayment of estimated tax for the child from the prior year or from any amended return.
7. There was no federal income tax withheld from the child's income.¹⁰⁷
8. None of the child's interest or dividend income was subject to backup withholding during the year.¹⁰⁸
9. The parent making the election is the parent whose return would be used under the kiddie tax rules.¹⁰⁹
10. The parent files a Form 1040 and not a Form 1040A or Form 1040EZ.¹¹⁰

¹⁰⁷ Form 8814 Instructions.

¹⁰⁸ IRC §1(g)(7)(A)(iii).

¹⁰⁹ IRS Pub. 929, *Tax Rules for Children and Dependents*.

¹¹⁰ *Ibid.*

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The election is made using Form 8814, *Parents' Election To Report Child's Interest and Dividends*. This form accompanies the parent's tax return for the year in which the election is made.

Note. The special rule for a child with a January 1 birthday applies to this election. Accordingly, if a child with a January 1 birthday is not considered to be under age 19 (or age 24 if a student) at the end of the tax year, the parent cannot make this election.

Example 26. Use the same facts as **Example 24**, except that Nadine's only income is \$4,300 of taxable interest. Nadine has no earned income. Nadine and her mother, Carole, meet all of the criteria necessary for Carole to elect to report Nadine's interest income on her own return, eliminating the need for Nadine to file her own return. Francine, the tax return preparer, prepares Form 8814 for Carole (shown on the following page).

Note. There are several important factors to consider when deciding to make this election, including tax preparation costs to the client and the impact the election will have on other areas of the parent's return, such as taxable social security, IRA deduction, and education credit phaseout.

Francine must include the \$2,400 of net unearned income in Carole's gross income for the year. The interest is included on Carole's Form 1040, line 21. She must also include the \$95 of tax calculated at Nadine's tax rate on Carole's return. This is done by adding the \$95 of tax to Carole's tax shown on Form 1040, line 44 (and by checking the appropriate box indicating that the additional \$95 added to the tax is from Form 8814). Carole's tax on her taxable income of \$36,100 is \$4,799. The tax shown is \$4,894 (\$4,799 + \$95 tax at the child's tax rate on \$950 of unearned income). The inclusion of interest income and additional tax is shown on the relevant portions of Carole's return, which are shown on subsequent pages.

2013 Workbook

For Example 26

Form 8814	Parents' Election To Report Child's Interest and Dividends ▶ Information about Form 8814 and its instructions is at www.irs.gov/form8814 . ▶ Attach to parents' Form 1040 or Form 1040NR.	OMB No. 1545-0074 2012 Attachment Sequence No. 40
Department of the Treasury Internal Revenue Service (99)		
Name(s) shown on your return Carole M. Neville		Your social security number 064-64-0640
Caution. The federal income tax on your child's income, including qualified dividends and capital gain distributions, may be less if you file a separate tax return for the child instead of making this election. This is because you cannot take certain tax benefits that your child could take on his or her own return. For details, see Tax benefits you cannot take in the instructions.		
A Child's name (first, initial, and last) Nadine G. Neville		B Child's social security number 065-65-0650
C If more than one Form 8814 is attached, check here <input type="checkbox"/>		

Part I Child's Interest and Dividends To Report on Your Return

1a Enter your child's taxable interest. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions	1a	4,300	
b Enter your child's tax-exempt interest. Do not include this amount on line 1a	1b		
2a Enter your child's ordinary dividends, including any Alaska Permanent Fund dividends. If your child received any ordinary dividends as a nominee, see the instructions	2a		
b Enter your child's qualified dividends included on line 2a. See the instructions	2b		
3 Enter your child's capital gain distributions. If your child received any capital gain distributions as a nominee, see the instructions	3		
4 Add lines 1a, 2a, and 3. If the total is \$1,900 or less, skip lines 5 through 12 and go to line 13. If the total is \$9,500 or more, do not file this form. Your child must file his or her own return to report the income	4	4,300	
5 Base amount	5	1,900	00
6 Subtract line 5 from line 4	6	2,400	
If both lines 2b and 3 are zero or blank, skip lines 7 through 10, enter -0- on line 11, and go to line 12. Otherwise, go to line 7.			
7 Divide line 2b by line 4. Enter the result as a decimal (rounded to at least three places)	7		
8 Divide line 3 by line 4. Enter the result as a decimal (rounded to at least three places)	8		
9 Multiply line 6 by line 7. Enter the result here. See the instructions for where to report this amount on your return	9		
10 Multiply line 6 by line 8. Enter the result here. See the instructions for where to report this amount on your return	10		
11 Add lines 9 and 10	11	0	
12 Subtract line 11 from line 6. Include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. If you checked the box on line C above, see the instructions. Go to line 13 below	12	2,400	

Part II Tax on the First \$1,900 of Child's Interest and Dividends

13 Amount not taxed	13	950	00
14 Subtract line 13 from line 4. If the result is zero or less, enter -0-	14	3,350	
15 Tax. Is the amount on line 14 less than \$950? <input checked="" type="checkbox"/> No. Enter \$95 here and see the Note below. <input type="checkbox"/> Yes. Multiply line 14 by 10% (.10). Enter the result here and see the Note below.	15	95	

Note. If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 15 in the tax you enter on Form 1040, line 44, or Form 1040NR, line 42. Be sure to check box a on Form 1040, line 44, or Form 1040NR, line 42.

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 10750J

Form **8814** (2012)

Observation. If Carole elects to report Nadine's income on her own return, the same amount of tax on Nadine's unearned income will be paid. Part II of Form 8814 accounts for the first \$950 that is tax-free due to the application of the child's minimum standard deduction against the unearned income. Part II also calculates the tax on the next \$950 at the child's 10% tax rate (\$95). Part I of Form 8814 calculates the net unearned income amount that is subject to Carole's tax rate.

2013 Workbook

For Example 26

Form	1040	Department of the Treasury—Internal Revenue Service (99)	2012	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																									
For the year Jan. 1–Dec. 31, 2012, or other tax year beginning _____, 2012, ending _____, 20					See separate instructions.																									
Your first name and initial Carole M.		Last name Neville		Your social security number 0 6 4 6 4 0 6 4 0																										
If a joint return, spouse's first name and initial		Last name		Spouse's social security number																										
Home address (number and street). If you have a P.O. box, see instructions. 468 Morton Street				Apt. no.																										
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Chicago, IL 63303				▲ Make sure the SSN(s) above and on line 6c are correct. Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse																										
Foreign country name		Foreign province/state/county		Foreign postal code																										
Filing Status	1 <input type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶ 4 <input checked="" type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child																													
Exemptions	6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a } Boxes checked on 6a and 6b b <input type="checkbox"/> Spouse } 1 c Dependents: <table border="1" style="width: 100%; border-collapse: collapse; font-size: 8pt;"> <thead> <tr> <th style="width: 25%;">(1) First name</th> <th style="width: 25%;">Last name</th> <th style="width: 25%;">(2) Dependent's social security number</th> <th style="width: 25%;">(3) Dependent's relationship to you</th> <th style="width: 25%;">(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)</th> </tr> </thead> <tbody> <tr> <td>Nadine</td> <td>Neville</td> <td>0 6 5 6 5 0 6 5 0</td> <td>Daughter</td> <td><input checked="" type="checkbox"/></td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td><input type="checkbox"/></td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td><input type="checkbox"/></td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td><input type="checkbox"/></td> </tr> </tbody> </table> If more than four dependents, see instructions and check here <input type="checkbox"/> No. of children on 6c who: • lived with you 1 • did not live with you due to divorce or separation (see instructions) Dependents on 6c not entered above Add numbers on lines above 2					(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)	Nadine	Neville	0 6 5 6 5 0 6 5 0	Daughter	<input checked="" type="checkbox"/>					<input type="checkbox"/>					<input type="checkbox"/>					<input type="checkbox"/>
(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)																										
Nadine	Neville	0 6 5 6 5 0 6 5 0	Daughter	<input checked="" type="checkbox"/>																										
				<input type="checkbox"/>																										
				<input type="checkbox"/>																										
				<input type="checkbox"/>																										
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 50,000 8a Taxable interest. Attach Schedule B if required 8a b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a b Qualified dividends 9b 10 Taxable refunds, credits, or offsets of state and local income taxes 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/> 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a Taxable amount 15b 16a Pensions and annuities 16a Taxable amount 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 20a Social security benefits 20a Taxable amount 20b 21 Other income. List type and amount Form 8814 21 2,400 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶ 22 52,400																													
Adjusted Gross Income	23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN ▶ 31a 32 IRA deduction 32 33 Student loan interest deduction 33 34 Tuition and fees. Attach Form 8917 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income ▶ 37 52,400																													

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2012)

2013 Workbook

For Example 26

Form 1040 (2012)		Page 2
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38 52,400
	39a Check <input type="checkbox"/> You were born before January 2, 1948, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1948, <input type="checkbox"/> Blind. } checked ▶ 39a	
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>	
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$5,950 Married filing jointly or Qualifying widow(er), \$11,900 Head of household, \$8,700	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 8,700
	41 Subtract line 40 from line 38	41 43,700
	42 Exemptions. Multiply \$3,800 by the number on line 6d.	42 7,600
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43 36,100
	44 Tax (see instructions). Check if any from: a <input checked="" type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election	44 4,894
	45 Alternative minimum tax (see instructions). Attach Form 6251	45
	46 Add lines 44 and 45	46 4,894
	47 Foreign tax credit. Attach Form 1116 if required	47
	48 Credit for child and dependent care expenses. Attach Form 2441	48
	49 Education credits from Form 8863, line 19	49
50 Retirement savings contributions credit. Attach Form 8880	50	
51 Child tax credit. Attach Schedule 8812, if required.	51 1,000	
52 Residential energy credits. Attach Form 5695	52	
53 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53	
54 Add lines 47 through 53. These are your total credits	54 1,000	
55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-	55 3,894	
Other Taxes	56 Self-employment tax. Attach Schedule SE	56
	57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 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	60
	61 Add lines 55 through 60. This is your total tax	61 3,894
	Federal income tax withheld from Forms W-2, 1099	62

5

Note. Making the election resulted in slightly higher tax on Nadine’s investment income. It would be best to use Form 8615 and not make the election. Using Form 8615 and the kiddie tax rules might be especially advantageous if Nadine had qualified dividends and/or capital gain distributions. This would allow Nadine to take advantage of the preferential tax rates on these types of investment income, which might be precluded by making the election and reporting the income on Carole’s return.

Observation. The new 3.8% Medicare tax on investment income became effective on January 1, 2013. It may not be prudent for parents who are subject to this tax to elect to report a child’s interest and/or dividend income on the parent’s tax return.

TAXATION OF A DEPENDENT CHILD'S EARNED INCOME

Earned income includes amounts such as wages, salaries, tips, and other amounts received in connection with services performed by the child.¹¹¹ Compensation received for the child's personal services is considered the child's income even if the amounts are actually received by a parent¹¹² and even if state law entitles the parent to that income.¹¹³ The child's compensation is reportable by the child on the child's separate return.¹¹⁴ Business expenses that are attributable to the child's compensation must be claimed on the child's return even if the expenditure was made by a parent.¹¹⁵

Compensation from a Family Business

Compensation from an employer-parent to a child in return for the child's personal services as a bona fide employee may be deductible as an ordinary and necessary business expense if the compensation is reasonable.¹¹⁶

Note. Compensation arrangements between related parties, including those between parent and child, may be subject to heightened IRS scrutiny. The parent must establish that the child actually performs services under the same circumstances that an arm's-length employee would provide such services.

Child Compensation and FICA. Compensation paid to a child under the age of 18 (21 for domestic work) is exempt from FICA taxation if the child is employed by a parent-owned business that is:

- A sole proprietorship,
- A disregarded entity that is treated as a corporation for tax purposes under the "check-the-box" rules, or
- A partnership if each partner is a parent.¹¹⁷

Children employed by a parent-owned corporation do not qualify for the FICA exemption with respect to the compensation received.

Note. Even if the child's compensation is exempt from FICA, there is still an obligation to properly withhold income tax on amounts paid to that child. Children under 21 working for parents are exempt from FUTA.

¹¹¹. Temp. Treas. Reg. §1.1(i)-1T.

¹¹². IRC §73(a).

¹¹³. Treas. Reg. §1.73-1(a).

¹¹⁴. Ibid.

¹¹⁵. Treas. Reg. §1.73-1(b).

¹¹⁶. Rev. Rul. 72-23, 1972-1 CB 43.

¹¹⁷. Temp. Treas. Reg. §§31.3306(c)(5)-1T and 31.3121(b)(3)-1T; IRC §3121(b)(3).

HOME-BASED BUSINESSES

INTRODUCTION

According to a report from the Small Business Success Index (SBSI),¹¹⁸ “homepreneurs” are operating home businesses that are just as successful as nonhome-based businesses.¹¹⁹ The home-based business sector has grown to become an important contributor to employment and the growth of the U.S. economy. Several trends have contributed to a substantial growth trend in home-based businesses.

- Lower costs and risks associated with starting a home-based business
- An increasing number of people who see home business ownership as a viable work option
- A lack of corporate jobs in an environment of slow economic growth

The SBSI research report contains the following statistics.

- About 6.6 million home businesses generate at least half of the household income for their respective owners.
- Home businesses employ over 13 million people.
- Approximately 35% of home businesses generate more than \$125,000 in annual revenue (8% generate more than \$500,000 annually).¹²⁰

APPLICABLE TAX RULES

For more information on the simplified option for claiming a home office deduction, which is effective for the 2013 tax year, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues and www.irs.gov/uac/Newsroom/Simplified-Option-for-Claiming-Home-Office-Deduction-Starting-This-Year.

IRC §162 allows the deduction of ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business.¹²¹ In order for an activity to constitute a trade or business, the taxpayer’s predominant purpose for engaging in that activity must be to make a profit.¹²² A taxpayer with a good-faith expectation of profit does not need to demonstrate the reasonableness of that profit expectation,¹²³ but a court generally requires the taxpayer to at least show some basis upon which that profit expectation is made.¹²⁴ The hobby loss rules under IRC §183 provide the necessary guidance on how to determine whether a taxpayer’s activity is engaged in for profit.

Note. For further details on the IRS guidance regarding hobby losses and the factors used to determine whether a taxpayer engages in an activity with a profit motive, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Hobby Losses.

¹¹⁸ The Small Business Success Index was formed in 2008 by Network Solutions and the Robert H. Smith School of Business at the University of Maryland.

¹¹⁹ *Small Business Success Index Research Note — Homepreneurs: A Vital Economic Force*. Fisher, Steven. Oct. 2009. Network Solutions. [www.networksolutions.com/smallbusiness/2009/10/the-rise-of-the-homepreneur-and-network-solutions-report] Accessed on Dec. 18, 2012.

¹²⁰ Ibid.

¹²¹ IRC §162(a).

¹²² *R. Gajewski v. Comm’r*, 723 F.2d 1062 (2nd Cir. 1983), cert. denied 469 US 818 (1984); *International Trading Co. v. Comm’r*, 275 F.2d 578 (7th Cir. 1960); *E.A. Brannen v. Comm’r*, 78 TC 471 (1982), *aff’d* 722 F.2d 695 (11th Cir. 1984).

¹²³ *H.S. Doggett v. D. Burnet*, 65 F.2d 191 (DC Cir. 1933).

¹²⁴ *R.W. Hughes v. Comm’r*, TC Memo 1989-528 (Sep. 27, 1989).

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Although there are several tax rules that may apply to a taxpayer's particular home-based business, the following guidance outlines some of the more common provisions.

Source	Topic
IRC §162	Trade or business and deductible business expenses
IRC §183	Trade or business for profit or hobby
IRC §280A IRS Pub. 587, <i>Business Use of Your Home</i>	Home office deduction
IRC §274 IRS Pub. 463, <i>Travel, Entertainment, Gift, and Car Expenses</i>	Deduction of business travel, meal costs, and business-related automobile expenses
IRS Pub. 334, <i>Tax Guide for Small Businesses (For Individuals Who Use Schedule C or C-EZ)</i>	Various topics including calculation of profit or loss, business credits, and self-employment tax

Note. See the regulations corresponding to the Code sections noted in the preceding table for additional guidance. In addition, see the 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 6: Travel, Meals, and Entertainment, for further details in connection with the tax treatment of business travel, transportation, and meals expenses. Additional information about the home office deduction can be found in the 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 7: Office in Home.

IRS INITIATIVES WITH HOME-BASED BUSINESSES

The IRS is concerned about tax schemes marketed as home-based businesses that cause taxpayers to believe that personal household expenses may be deducted as business expenses. The IRS is aware that, while most business taxpayers accurately report income and expenses, home-based business tax schemes have been aggressively marketed by promoters who sell these schemes as a means to reduce taxes. Consequently, these schemes have become common. The IRS expressed this concern in a former website section on the issue of home-based business tax schemes (which was not included in the new IRS website that was updated in late 2012).¹²⁵ The IRS continues to be concerned about taxpayer involvement with these schemes.

Specifically, the IRS has noted that these home-based business tax shams may involve several misinterpretations of the relevant tax rules on business deductions. In 2005, the IRS issued settlement guidelines under its appeals technical guidance program. This was done to provide IRS staff with additional background and training on how to address the tax issues that commonly arise with home-based business tax shams.¹²⁶ This guidance points out several tax law **misinterpretations** that are used to justify the improper deduction of personal expenses. The IRS has found the following misinterpretations commonly used within these home-based business tax schemes.

¹²⁵ The relevant part of the previous website section was *Abusive Home-Based Business Tax Schemes — Background*. Aug. 2, 2012. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Abusive-Home-Based-Business-Tax-Schemes---Background] Accessed on Dec. 12, 2012. For currently available information, see *Appeals Technical Guidance Program, Appeals Settlement Guidelines*. Mar. 23, 2005. [www.irs.gov/pub/irs-utl/final_hbb_asg_03-11-2005.pdf] Accessed on Apr. 1, 2013.

¹²⁶ *Appeals Technical Guidance Program, Appeals Settlement Guidelines*. Mar. 23, 2005. [www.irs.gov/pub/irs-utl/final_hbb_asg_03-11-2005.pdf] Accessed on Apr. 1, 2013.

- Claiming that the “exclusive use” restriction of the home office deduction rules of IRC §280A can be avoided by placing business-related items in a room of the house, which gives the room business status (The §280A(c)(2) exception for storage space is used as a basis for this interpretation to justify the deduction of additional expenses.)
- Paying children and/or other family members for household duties (such as trash disposal, lawn care, telephone answering, or washing vehicles) and characterizing such payments as necessary and ordinary to a business operation
- Misusing the rules in connection with the Education Assistance Program by deducting education expenses of up to \$5,250 per year per family member characterized as an employee
- Deducting excessive car expenses, justifying most or all use as business use because of the continual potential of obtaining customers or clients on virtually any car trip
- Deducting personal travel, meals, and entertainment because everyone is a potential client, making such expenses deductible business expenses
- Deducting 100% of medical costs by claiming that a family member is an employee covered under a medical reimbursement plan

The IRS has indicated to tax return preparers who assist clients involved with home-based business tax schemes that income tax cannot be avoided by claiming personal living, family, or household expenses as business expenses and that the positions taken to justify such deductions are meritless and frivolous.¹²⁷ The IRS urges taxpayers who have been claiming inappropriate deductions through home-based business schemes to amend their tax returns to show only appropriate deductions.¹²⁸

In addition, the IRS has been very successful in its litigation efforts to combat home-based business tax schemes. The cases litigated include the following.

- In *William C. and Dorothy Smith v. Comm’r*,¹²⁹ the taxpayers participated in direct marketing schemes selling candy and health and wellness products. The taxpayers also marketed a “Tax Relief System” for Renaissance, The Tax People, Inc., that guaranteed at least \$5,000 in federal tax deductions and claimed that opening a home-based business allowed enjoyment of “double deductions” by claiming the standard deduction and itemized deductions on Schedule C. The Tax Court agreed with the IRS and disallowed the personal expense deductions claimed.
- In *Lang Her and Ka Moua v. Comm’r*,¹³⁰ the taxpayers also were involved in selling the “Tax Relief System” for Renaissance, The Tax People, Inc. The deduction of personal expenses was disallowed.
- In *Robert D. and Carol A. Berryman v. Comm’r*,¹³¹ the taxpayers participated in Malaleuca, a direct marketing program that involved the sale of health and wellness products and the recruitment of other salespeople. The Tax Court determined that the taxpayers had no profit objective. The Tax Court agreed with the IRS on the issue of disallowed expenses.

Note. Many other cases involving the disallowance of deductions for personal expenses are cited in *Appeals Technical Guidance Program, Appeals Settlement Guidelines*.¹³²

¹²⁷ Rev. Rul. 2004-32, 2004-12 IRB 621.

¹²⁸ *Appeals Technical Guidance Program, Appeals Settlement Guidelines*. Mar. 23, 2005. [www.irs.gov/pub/irs-utl/final_hbb_asg_03-11-2005.pdf] Accessed on Apr. 1, 2013.

¹²⁹ *William C. and Dorothy Smith v. Comm’r*, TC Memo 2007-154 (Jun. 14, 2007).

¹³⁰ *Lang Her and Ka Moua v. Comm’r*, TC Summ. Op. 2005-187 (Dec. 27, 2005).

¹³¹ *Robert D. and Carol A. Berryman v. Comm’r*, TC Summ. Op. 2007-138 (Aug. 8, 2007).

¹³² *Appeals Technical Guidance Program, Appeals Settlement Guidelines*. Mar. 23, 2005. [www.irs.gov/pub/irs-utl/final_hbb_asg_03-11-2005.pdf] Accessed on Apr. 1, 2013.

The Federal Trade Commission has also initiated more than 70 lawsuits against various home-based business organizations for deceptive practices.¹³³

One home-based business tax sham was Renaissance, The Tax People, Inc., which marketed their “tax relief package” under various company names, including Advantage International Marketing. Its founder, Michael Craig Cooper of Topeka, Kansas, was convicted of 73 criminal counts including mail fraud, wire fraud, money laundering, and conspiracy. He was sentenced to 240 months in federal prison, ordered to pay restitution of \$10 million to the IRS, and is subject to a \$75 million forfeiture money judgment.

Three other defendants associated with Mr. Cooper’s operations pleaded guilty and received sentences as well. Daniel Joel Gleason pleaded guilty to conspiracy to defraud the United States and aiding or assisting in the preparation of a false tax return. He was sentenced to 78 months. Jesse Ayala Cota, a former IRS District Director in California, pleaded guilty to conspiracy to defraud the United States and received a 24-month sentence. Todd Eugene Strand received a 51-month sentence after admitting that customers were defrauded out of more than \$75 million from the scheme, which also caused a tax loss of more than \$20 million.¹³⁴

SALE OF A HOME WITH A HOME OFFICE

A taxpayer can exclude from income up to \$250,000 (\$500,000 for certain joint filers) of the gain arising from the sale or exchange of a principal residence.¹³⁵ To qualify for this exclusion, use and ownership tests in connection with the property must be met. “Use” is satisfied through actual occupancy of the dwelling. Short, temporary absences, such as those for vacation or seasonal absences, still count as periods of use.¹³⁶

The taxpayer must own and use the property for at least two of the five years before the sale. A continuous 24-month period or any total number of days aggregating 730 days during which the use and ownership requirements are met can be used to meet the test.¹³⁷ In addition, the 2-year period of use and the 2-year period of ownership need not be concurrent.¹³⁸ Taxpayers not meeting these tests may still qualify for a partial exclusion.¹³⁹

If part of a home is used for business purposes, the exclusion can still be used for the amount of gain on the sale of the home after adjusting the basis for any allowed or allowable depreciation (discussed in greater detail in the next section). The sale is **not** treated as two separate sales (a sale of the residential portion and a sale of the business-use portion) if both uses occur within the same dwelling unit. However, if the residential and business uses take place in **separate** portions of the property with **separate** entrances, then the exclusion applies only to the residential portion.¹⁴⁰

Depreciation

A depreciation deduction is allowed for the part of the home used for a home office. The home office is considered nonresidential property and is depreciated using the straight-line method over 39 years. The initial basis of the home-office portion of the property is the lower of its cost or fair market value (FMV) on the date that the home-office portion is put into use as business property.

Only the depreciation allowed or allowable after May 6, 1997, is taken into account when adjusting the basis of the home to calculate the gain that can be excluded from income.¹⁴¹

¹³³ *FTC Expands Fight Against Deceptive Business Opportunity Schemes*. Nov. 15, 2012. Federal Trade Commission. [www.ftc.gov/opa/2012/11/lostopp.shtml] Accessed on Dec. 12, 2012.

¹³⁴ *Topeka Promoter Sentenced to 20 Years in \$75 Million Renaissance Tax Fraud*. Apr. 20, 2010. The United States Attorney’s Office, District of Kansas. [www.justice.gov/usao/ks/PressReleases/2010/apr/April20b.html] Accessed on Dec. 13, 2012.

¹³⁵ IRC §121.

¹³⁶ Treas. Reg. §1.121-1(c)(2)(i).

¹³⁷ Treas. Reg. §1.121-1(c)(1).

¹³⁸ *Ibid.*

¹³⁹ IRC §121(c).

¹⁴⁰ Treas. Reg. §1.121-1(e)(1).

¹⁴¹ Treas. Reg. §1.121-1(d)(1).

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Example 27. Craig and Crissy, a married couple, sold their jointly owned principal residence for \$290,000 on January 2, 2012. It was purchased in 2005, and the dual two-out-of-five years' ownership and use tests were met for the personal residential-use portion of the home. Crissy deducted home-office expenses for her consulting business on her 2006–2011 Schedules C. The total depreciation she claimed for the home-office portion of the home for those six years was \$17,000. At the time of the sale, Craig and Crissy had a basis in their home of \$120,000. Their realized gain is \$170,000 (\$290,000 – \$120,000). This gain is taxed as follows.

Amount of gain excludible from income under IRC §121	\$153,000
Amount of gain recognized as unrecaptured §1250 gain	<u>17,000</u>
Total gain recognized on sale	\$170,000

The \$17,000 of unrecaptured gain that results from the depreciation deductions claimed is reported on Form 8949, *Sales and Other Dispositions of Capital Assets*, and subsequently on Schedule D, *Capital Gains and Losses*, as unrecaptured §1250 gain. Unrecaptured §1250 gain is taxed at a maximum 25% tax rate. The relevant portions of Form 8949 and Schedule D follow.

2013 Workbook

For Example 27

Form 8949 (2012)

Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. (Name and SSN or taxpayer identification no. not required if shown on other side.) Craig and Crissy Smith	Social security number or taxpayer identification number 012-34-5678
--	--

Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box A, B, or C below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.

Part II Long-Term. Transactions involving capital assets you held more than one year are long term. For short-term transactions, see page 1.

You must check Box A, B, or C below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- (A) Long-term transactions reported on Form(s) 1099-B showing basis **was** reported to the IRS
- (B) Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
- (C) Long-term transactions not reported to you on Form 1099-B

3	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see <i>Column (e)</i> in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	
	Residence with office	5/22/2005	01/02/2012	290,000	0	H	-273,000	17,000
4 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 8 (if Box A above is checked), line 9 (if Box B above is checked), or line 10 (if Box C above is checked) ►				290,000	0		-273,000	17,000

Note. If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2012)

2013 Workbook

For Example 27

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Schedule D and its separate instructions is at www.irs.gov/form1040.
▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2012

Attachment
Sequence No. 12

Name(s) shown on return

Craig and Crissy Smith

Your social security number

012-34-5678

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price) from Form(s) 8949, Part I, line 2, column (d)	(e) Cost or other basis from Form(s) 8949, Part I, line 2, column (e)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I				
2 Short-term totals from all Forms 8949 with box B checked in Part I				
3 Short-term totals from all Forms 8949 with box C checked in Part I				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824			4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions			6	()
7 Net short-term capital gain or (loss) . Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back			7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price) from Form(s) 8949, Part II, line 4, column (d)	(e) Cost or other basis from Form(s) 8949, Part II, line 4, column (e)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 4, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II				
9 Long-term totals from all Forms 8949 with box B checked in Part II				
10 Long-term totals from all Forms 8949 with box C checked in Part II	290,000	0	(273,000)	17,000
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824			11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			12	
13 Capital gain distributions. See the instructions			13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions			14	()
15 Net long-term capital gain or (loss) . Combine lines 8 through 14 in column (h). Then go to Part III on the back			15	17,000

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2012

2013 Workbook

For Example 27

2012	Federal Worksheets	Page 1
Client 8	Craig and Crissy Smith	- -
4/05/13		08:09AM
Sale of Home - Gain (or Loss), Exclusion, and Taxable Gain		
Part 1 - Gain (or Loss) on Sale		
1. Selling price of home		290,000.
2. Selling expenses		0.
3. Subtract line 2 from line 1.		290,000.
4. Adjusted basis of home sold		0.
5. Gain or (loss) on the sale. Subtract line 4 from line 3.		290,000.
Part 2 - Exclusion and Taxable Gain		
6. Maximum exclusion. If no exclusion, enter 0 and skip lines 8 through 13.		500,000.
7. Enter any depreciation allowed or allowable on the property for periods after May 6, 1997.		17,000.
8. Subtract line 7 from line 5.		273,000.
9. Aggregate number of days of nonqualified use after 12/31/2008		0.
10. Number of days taxpayer owned the property		2,416.
11. Divide the amount on line 9 by the amount on line 10.		0.000000
12. Gain allocated to nonqualified use. (Line 8 multiplied by line 11)		0.
13. Gain eligible for exclusion. Subtract line 12 from line 8.		273,000.
14. Exclusion. Enter the smaller of line 6 or line 13. * If you are reporting gain from the sale on the installment method, enter this amount on line 15 of Form 6252.		273,000.
15. Taxable gain. Subtract line 14 from line 5. Report it on Schedule D (Form 1040). * If the amount on this line is zero, do not report the sale or exclusion on your tax return.		17,000.
16. Enter the smaller of line 7 or line 15. Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet.		<u>17,000.</u>

Note. Further details on the sale of a home with a home office can be found in IRS Pub. 523, *Selling Your Home*.

INDEPENDENT CONTRACTOR HOME-BASED BUSINESSES

Frequently, a taxpayer operating a home-based business is treated as an independent contractor who contracts with a principal firm. The taxpayer is required to report all income received from the business endeavor and can claim all reasonable, necessary, and ordinary business expenses.

Sources of income may include the following.

- Income from sales of products or services
- Commission income from recruiting
- Bonus amounts received
- Awards, incentives, and prizes won by the taxpayer
- The value of an automobile, if provided
- Taxable fringe benefits, such as group term life

For a taxpayer operating a home-based business as an independent contractor, the principal firm generally reports the total amount of compensation, including the amount of taxable fringe benefits, for the year on Form 1099-MISC, *Miscellaneous Income*, in box 7. Although a company is not required to issue a Form 1099-MISC for payments less than \$600, the taxpayer is still required to report compensation amounts of less than \$600 even if no Form 1099-MISC is received.

Note. Fringe benefits are generally valued at FMV and are taxable and subject to self-employment tax unless specifically excluded. For additional guidance on the tax treatment of fringe benefits, see the following.

- 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Employment Issues
- IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*

Automobile Arrangements

One fringe benefit that may be included in the amount reported on Form 1099-MISC, box 7, is the value of an automobile that is provided by the principal firm to the taxpayer (typically as an award or achievement incentive).

The value of the car for the tax year in which it is provided is the amount included on Form 1099-MISC. There are three methods available to calculate the annual taxable benefit to the taxpayer in connection with a vehicle provided by the principal firm.

1. The cents-per-mile rule
2. The commuting rule
3. The lease-value rule

The requirements associated with the commuting rule make this method less likely to be used by the principal firm of a home-based business. Either the cents-per-mile rule or the lease-value rule is more likely to be used. If the cents-per-mile rule or the lease-value rule cannot be used, then the value of the vehicle's usage is the amount that the taxpayer would pay in an arm's-length lease transaction on the same or comparable vehicle.¹⁴²

¹⁴² Treas. Reg. §1.61-21(b)(4).

2013 Workbook

Cents-Per-Mile Rule. The cents-per-mile rule can be used if:

- The principal firm reasonably expects the vehicle to be **regularly used** in the taxpayer's home-based business operation throughout the calendar year, or
- The vehicle is driven by the taxpayer at least 10,000 miles, and the vehicle is used primarily by the taxpayer.¹⁴³

“Regular use” of the vehicle in the principal firm's trade or business is determined based on all the facts and circumstances. The vehicle is considered regularly used in the home-based business if at least 50% of the taxpayer's annual mileage is in connection with the business.¹⁴⁴ For 2013, the cents-per-mile method can only be used for a passenger vehicle with a value that does not exceed \$16,000 (\$17,000 for a truck or van).¹⁴⁵ This amount is subject to annual adjustments for inflation.

Note. Additional requirements and details associated with the cents-per-mile rule can be found in Treas. Reg. §1.61-21. The cents-per-mile rule has some consistency requirements that are explained in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

Under the cents-per-mile rule, the value of the vehicle provided to the taxpayer for the year is calculated by multiplying the standard mileage rate by the total number of personal miles the taxpayer drives during the year.

Note. For 2013, the standard mileage rate is 56.5 cents.

Lease-Value Rule. The lease value is generally determined by following three steps.

1. Determine the FMV of the vehicle on the date it is first provided to the taxpayer.
2. Find the range in which the vehicle's FMV falls within the table which follows, and determine the vehicle's **annual lease value**.
3. Calculate the taxable amount to the taxpayer by using the following formula.

$$\text{Taxable amount to taxpayer} = \frac{\text{Personal miles driven during tax year}}{\text{Total miles driven in tax year}} \times \text{Annual lease value}$$

The annual lease value table is shown on the following page.¹⁴⁶

¹⁴³ Treas. Reg. §1.61-21(e)(1).

¹⁴⁴ Treas. Reg. §1.61-21(e)(1)(iv).

¹⁴⁵ IRS Notice 2013-27, 2013-18 IRB 985.

¹⁴⁶ Ibid.

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IRS Annual Lease Value Table

Automobile Fair Market Value	Annual Lease Value	Automobile Fair Market Value	Annual Lease Value
\$ 0-999	\$ 600	\$22,000-22,999	\$ 6,100
1,000-1,999	850	23,000-23,999	6,350
2,000-2,999	1,100	24,000-24,999	6,600
3,000-3,999	1,350	25,000-25,999	6,850
4,000-4,999	1,600	26,000-27,999	7,250
5,000-5,999	1,850	28,000-29,999	7,750
6,000-6,999	2,100	30,000-31,999	8,250
7,000-7,999	2,350	32,000-33,999	8,750
8,000-8,999	2,600	34,000-35,999	9,250
9,000-9,999	2,850	36,000-37,999	9,750
10,000-10,999	3,100	38,000-39,999	10,250
11,000-11,999	3,350	40,000-41,999	10,750
12,000-12,999	3,600	42,000-43,999	11,250
13,000-13,999	3,850	44,000-45,999	11,750
14,000-14,999	4,100	46,000-47,999	12,250
15,000-15,999	4,350	48,000-49,999	12,750
16,000-16,999	4,600	50,000-51,999	13,250
17,000-17,999	4,850	52,000-53,999	13,750
18,000-18,999	5,100	54,000-55,999	14,250
19,000-19,999	5,350	56,000-57,999	14,750
20,000-20,999	5,600	58,000-59,999	15,250
21,000-21,999	5,850	60,000-	^a

^a For Vehicles having a fair market value in excess of \$59,999, the annual lease value = $(0.25 \times \text{the automobile's fair market value}) + \500 .

If the car is provided to the taxpayer for only part of the tax year, the result calculated from the three steps is pro-rated to reflect only the number of days during the tax year in which the taxpayer actually had use of the automobile. In addition, if the principal firm provides fuel to the taxpayer, 5.5 cents for each mile driven by the taxpayer must be added to the amount calculated.¹⁴⁷

¹⁴⁷. Ibid.

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Example 28. Ramona operates a successful home-based business selling women's cosmetics for the Merry Jay Company. Because of her large sales volume, Merry Jay awarded Ramona the use of an automobile. She received the automobile on October 3, 2013, and, accordingly, had the vehicle for the last 90 days of the year. The FMV of the car on October 3, 2013, is \$24,500. Ramona pays for her own fuel and uses the vehicle for both business and personal purposes. She maintains a logbook for her personal mileage. For 2013, she lets Merry Jay know that the car was driven a total of 10,000 miles, of which 2,000 miles were attributable to Ramona's personal use.

Merry Jay calculates the taxable benefit to Ramona using the following steps.

1. The FMV of the car on the date it was made available to Ramona is \$24,500.
2. The \$24,500 FMV for the vehicle falls into the \$24,000–\$24,999 range in the table, which corresponds to an annual lease value of \$6,600.
3. Ramona's taxable benefit is calculated as follows.

$$\begin{aligned}\text{Ramona's taxable benefit} &= \frac{\text{Personal miles driven during tax year}}{\text{Total miles driven in tax year}} \times \text{Annual lease value} \\ &= \frac{2,000 \text{ personal miles}}{10,000 \text{ total miles}} \times \$6,600 \\ &= \$1,320\end{aligned}$$

However, the annual amount of \$1,320 must be pro-rated to reflect only that portion of the year that Ramona had use of the vehicle. Ramona had the vehicle for 90 days of the 2013 tax year. Ramona's taxable benefit, which Merry Jay will include in the amount reported on Ramona's Form 1099-MISC in box 7, is calculated as follows.

$$\begin{aligned}\text{Pro-rated taxable benefit} &= \frac{\text{Days of use}}{\text{Days in year}} \times \text{Taxable benefit} \\ &= \frac{90 \text{ days}}{365 \text{ days}} \times \$1,320 \\ &= \$325\end{aligned}$$

FMV Safe Harbor Rules for Purchases and Leases. If the principal firm purchased the vehicle that is provided to the taxpayer, the company can use its actual cost for the vehicle (including sales tax, title costs, and other purchase expenses) as the vehicle's FMV.

For an automobile that the principal firm leases and subsequently provides to the taxpayer, any of the following amounts may be used as the vehicle's FMV.

- Invoice price plus 4%
- The manufacturer's suggested retail price (including sales tax, title costs, and other purchase expenses) less 8%
- A reasonable retail value for the automobile reported by a nationally recognized pricing source

Observation. If the parent company does not pro rate the amount for partial years or uses the incorrect amount for the taxable benefit, it will be necessary to obtain a corrected Form 1099-MISC. Many home-based business owners find it is best to accept a cash option, if provided, instead of an automobile to avoid potential issues with incorrect taxable benefit amounts.

Note. Further information on how the provision of a vehicle as a fringe benefit is valued and additional requirements and guidance in connection with each of the three allowable methods are available in Treas. Reg. §1.61-21(c)-(f) and IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

TAXATION OF CLERGY

Clergy members are subject to several specific tax provisions under the Code, some of which are covered in this chapter. The ability to “opt out” of social security or the self-employment (SE) tax and the ability to exclude a parsonage or housing allowance from income are a couple of these special tax rules that apply to clergy members.

To take advantage of these special provisions, the taxpayer must be a “minister” and perform “services in the exercise of a ministry.”

A minister is a “duly ordained, commissioned, or licensed minister of a church or a member of a religious order. . . .”¹⁴⁸ Recognizing the stark differences in ordination procedures among various religions, the Tax Court has interpreted the term “minister” broadly and has held as follows.

- A cantor of the Jewish faith was a “duly ordained, commissioned or licensed minister” given the systematic manner in which the cantor was called to his ministry and his ecclesiastical duties.¹⁴⁹
- A licentiate of the Cumberland Presbyterian Church, who held a status that was less than that of a fully ordained minister, was nonetheless held to be a licensed minister because he conducted worship services and was viewed by the congregation as a spiritual leader who preached, performed funerals, visited the sick, and ministered to the needy as part of his church duties.¹⁵⁰

Note. The term “minister” is not specifically defined in the Code but refers to individuals holding various titles within various religions. The main concern with these rules is to prevent a self-appointed minister from obtaining the benefit of the special provisions without being a bona fide religious minister. The terms “minister” or “clergy member” used in this chapter are used to denote all licensed, ordained, or commissioned spiritual leaders of various religions covered by these tax rules. Similarly, the term “churches” is used to refer to all houses of worship of various religions as applicable.

THE WINGO TEST

In *Wingo v. Comm’r*,¹⁵¹ the Tax Court provided a 5-factor test that is used to identify a qualified minister under the Code. A qualified minister is one who:

1. Performs sacerdotal functions;
2. Conducts worship services;
3. Controls or maintains the organization;
4. Is considered a spiritual leader; and
5. Is ordained, licensed, or commissioned.

All five factors must be satisfied to be considered a qualified minister.

¹⁴⁸ Treas. Reg. §1.1402(c)-5(a).

¹⁴⁹ *Salkov v. Comm’r*, 46 TC 190 (1966); *Silverman v. Comm’r*, 57 TC 727 (1972).

¹⁵⁰ *Knight v. Comm’r*, 92 TC 199 (1989).

¹⁵¹ *Wingo v. Comm’r*, 89 TC 911 (1987).

Example 29. Aaron is executive director of a local Jewish temple. He has worked there for 30 years. Although he has always remained in an administrative position, over the years, he has gradually become more involved with religious tasks. However, he never officiated a ceremony. He is not an ordained rabbi or a commissioned cantor but is a fellow of a national synagogue administrators' association. Aaron does not meet any of the five functions outlined by the Tax Court. He is not a minister for tax purposes.¹⁵²

Example 30. Carl, an ordained pastor, is the youth pastor at Main Street Church. The head pastor conducts services and officiates at baptisms, weddings, and funeral ceremonies, and Carl develops and establishes all of the youth programs and events for the children of the families attending the church. Parents and children meet with Carl for advice and counseling. Although Carl is ordained, considered a spiritual leader in the congregation, and performs youth services that control or maintain the church, Carl is not considered a minister for tax purposes because he does not perform sacerdotal functions. If Carl begins to conduct baptisms, weddings, funerals, or other such ceremonies, he may be considered a qualified minister for income tax purposes.

SELF-EMPLOYED OR EMPLOYEE

Determining whether the minister is categorized as either self-employed or an employee is essential because this determines how that minister is taxed.

In common law, a worker is classified as either self-employed or as an employee. An employer-employee relationship exists when the organization for which services are performed has the right to control and direct the worker in how the services are performed.¹⁵³ This common law test is known as the **right-of-control test**. The IRS has developed a 20-factor guideline it uses to determine whether a worker is an employee or independent contractor. The 20 factors focus on the degree of control that the firm has over the worker.¹⁵⁴

The right-of-control test that applies to all taxpayers to determine employee or independent contractor status also applies to **clergy members**. The nature of the clergy member's work and the aspects of control and oversight of the clergy member are taken into account in the application of this test.¹⁵⁵

Note. For additional details and guidance on the definition of "employee" and the right-of-control test, see the 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Employment Issues.

Example 31. Frank is the pastor at Rivergarden Church. The church has no board of directors or other administrative body that oversees the church or its functions. However, Frank serves as church administrator in addition to conducting weekly church services. He officiates at weddings and funerals as needed by the church's followers. Frank's staff consists of a bookkeeper and an assistant that helps with weekly services and Frank's office work.

Frank receives monthly compensation from the church for his services as pastor. The amount of his compensation varies each month. For months when the church's income is higher, Frank's compensation is a larger amount than in other months when the church's income is not as high. Frank and the bookkeeper confer on the amount Frank will get paid each month based on the church's income and the monthly church expenses that must be paid. Arguably, Frank is a self-employed minister. He has little or no oversight in the execution of his ministry work. His income increases and decreases with that of the church, similar to a self-employed business owner.

¹⁵² This example is based on *Haimowitz v. Comm'r*, TC Memo 1997-40 (Feb. 23, 1997).

¹⁵³ Rev. Rul. 87-41, 1987-1 CB 296.

¹⁵⁴ See Rev. Rul. 87-41, 1987-1 CB 296.

¹⁵⁵ IRS, *Minister Audit Technique Guide* (Apr. 2009); *Herman v. Comm'r*, TC Memo 1986-590 (Dec. 18, 1986).

Example 32. Stephanie is the pastor at White Lake Ministry. The board of directors at White Lake Ministry interviewed and hired Stephanie as their pastor as soon as she was officially ordained. The board establishes her pay each year and also establishes her housing allowance. She conducts weekly services and officiates at weddings and funerals. Each week she meets with the board and reports to them about ongoing issues with members of the church and her progress on the church missionary functions and community outreach programs that she heads. Based on these facts, it is very likely that Stephanie will be considered an employee of the church by the IRS.

Requesting IRS Determination

Determining whether a clergy member is an employee or a self-employed independent contractor can be difficult. A clergy member can be an employee with respect to one source of income and a self-employed contractor with respect to other sources of income. If it is unclear whether the minister should be categorized as an employee or as a self-employed taxpayer, the minister or the organization can obtain an IRS determination letter resolving this issue.¹⁵⁶ A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. The request can be made for a determination of the status of a minister or an entire class of ministers or religious workers. There is no fee in connection with this request. Form SS-8 asks questions about the nature of the worker's services and the relationship between the worker and the organization. The focal point of several questions involves the degree of control the organization has over the worker's performance of services.

Note. Further details in connection with filing a Form SS-8 and the procedure used to obtain an IRS determination in this area can be found in the Form SS-8 instructions.

THE "DUAL-STATUS" MINISTER

Ministers who are employed by a church receive "**dual-status**" tax treatment. For income tax reporting purposes, they are considered employees, and they must claim employment-related expenses as itemized deductions subject to the 2%-of-AGI floor.¹⁵⁷ These expenses are reported on Form 2106, *Unreimbursed Employee Business Expenses*, and are carried over to Schedule A. However, for social security and Medicare purposes, they are treated as self-employed taxpayers and must pay SE tax on their earnings (unless exempt).¹⁵⁸

Moreover, ministers are exempt from income tax **withholding**¹⁵⁹ and FICA tax **withholding**¹⁶⁰ with respect to compensation received for services **in the exercise of the ministry**. Ministers not under a vow of poverty are deemed to be engaged in carrying on a trade or business with respect to the services they provide in the exercise of a ministry.¹⁶¹ Therefore, ministers who have not taken a vow of poverty are subject to SE tax.

The special exemption from federal income tax withholding, FICA, and the application of the SE tax exists **only** on income received for services "in the exercise of the ministry" or as "required by the minister's order."¹⁶² The exemption from SE tax on qualifying income is applied for using Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*. This form is discussed later in this chapter. Compensation for services unrelated to the exercise of the ministry is subject to income tax withholding and FICA taxation.¹⁶³

Note. Special tax rules apply to ministers who **have** taken a vow of poverty. This is discussed later in this chapter.

¹⁵⁶ See Instructions for Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

¹⁵⁷ Treas. Reg. §31.3401(c)-1.

¹⁵⁸ IRC §1402(a)(8).

¹⁵⁹ IRC §3401(a)(9).

¹⁶⁰ IRC §3121(b)(8)(A).

¹⁶¹ Treas. Reg. §1.1402(c)-5(a)(2).

¹⁶² IRC §1402(e).

¹⁶³ Treas. Reg. §31.3401(a)(9)-1(c); Treas. Reg. §31.3121(b)(8)-1(c)(3).

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Example 33. Use the same facts as **Example 32**. Stephanie is considered a common law employee of White Lake Ministry, but her pay is not subject to income tax withholding or FICA taxes. Stephanie is treated as if she were self-employed. Stephanie should make estimated income tax payments as if she were self-employed and, absent any exemption, **she is also liable for payment of SE taxes.**

Example 34. Use the same facts as **Example 33**. While employed by White Lake Ministry as pastor, Stephanie decides to keep a part-time student job she had as youth counselor at a local children’s hospital. She works at the hospital three nights per week. Her work for the hospital is not part of her services in the exercise of the ministry she performs for White Lake. When the hospital pays Stephanie, it must withhold income and FICA taxes, and these amounts will be reflected on her Form W-2.

Note. Income received by ministers or members of a religious order who **are** under a vow of poverty is exempt from income taxation and from FICA. They are also exempt from the payment of SE tax. The order can make a special election to participate in FICA taxation (discussed later in this chapter).

Form W-2 Reporting

Wages paid by an organization to a minister who has not taken a vow of poverty are reported on Form W-2, *Wage and Tax Statement*. Box 1 shows gross income, and boxes 3 and 5 for social security and Medicare wages, respectively, are left blank. In addition, the organization does not withhold any FICA taxes, so boxes 4 and 6, which show social security tax and Medicare tax withheld, respectively, are also left blank. The minister can pay income tax using Form 1040-ES, *Estimated Tax for Individuals*.

Example 35. Use the same facts as **Example 34**. Stephanie receives the following Forms W-2 from White Lake Ministry and the hospital that report her compensation for the 2013 tax year.

		a Employee's social security number 456-78-1234	This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.			
		OMB No. 1545-0008				
b Employer identification number (EIN) 38-3333333		1 Wages, tips, other compensation 22500.00	2 Federal income tax withheld			
c Employer's name, address, and ZIP code White Lake Ministry 476 Davista Drive White Lake, MI 48386		3 Social security wages	4 Social security tax withheld			
		5 Medicare wages and tips	6 Medicare tax withheld			
		7 Social security tips	8 Allocated tips			
d Control number		9	10 Dependent care benefits			
e Employee's first name and initial Last name Stephanie K. Behrens 78910 Duck Lake Road North White Lake, MI 48386		Suff.	11 Nonqualified plans		12a See instructions for box 12	
			13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	12b		
			14 Other	12c		
f Employee's address and ZIP code			12d			
15 State Employer's state ID number MI 38-3333333	16 State wages, tips, etc. 22500.00	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

Form W-2 Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

Department of the Treasury—Internal Revenue Service

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Note. Most states have an exemption from state income tax withholding. Illinois has such an exemption for ministers and members of a religious order.¹⁶⁴

¹⁶⁴ Illinois Department of Revenue, Pub. 130, *Who Is Required to Withhold Illinois Income Tax* (Jan. 2012).

For Example 35

		a Employee's social security number 456-78-1234		OMB No. 1545-0008 <small>This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.</small>			
b Employer identification number (EIN) 38-4444444			1 Wages, tips, other compensation 9000.00		2 Federal income tax withheld 2216.00		
c Employer's name, address, and ZIP code Mead Hospital 106 Teggerdine Road White Lake, MI 48386							
			3 Social security wages 9000.00		4 Social security tax withheld 558.00		
			5 Medicare wages and tips 9000.00		6 Medicare tax withheld 131.00		
			7 Social security tips		8 Allocated tips		
d Control number			9		10 Dependent care benefits		
e Employee's first name and initial Stephanie K.		Last name Behrens		11 Nonqualified plans		12a See instructions for box 12	
78910 Duck Lake Road North White Lake, MI 48386				13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12b	
				14 Other		12c	
						12d	
f Employee's address and ZIP code							
15 State MI	Employer's state ID number 38-4444444	16 State wages, tips, etc. 9000.00	17 State income tax 392.00	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

Form **W-2** Wage and Tax Statement
 Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

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5

Optional Income Tax Withholding

The Code provides ministers with some special options regarding the payment of income taxes and SE taxes.

Although ministers are exempt from income tax withholding on their wage payments and are expected to make estimated tax payments instead, they may voluntarily request income tax withholding by the organization.¹⁶⁵ The following steps are taken by the minister to request voluntary withholding.

- Estimate the amount of federal tax liability for the year.
- Provide the employer organization with a Form W-4, *Employee's Withholding Allowance Certificate*, indicating the desired amount of exemptions claimed and tax to be withheld for the year.

The signed Form W-4 serves as the agreement between the minister and the organization for voluntary tax withholding. The agreement can be terminated at any time by the minister's signed written notice. The termination becomes effective on the first payment that is at least 30 days after the next "status determination date" that occurs after the date on which the notice is provided to the organization. The status determination dates are January 1, May 1, July 1, and October 1. However, the minister and the organization can agree on an alternate date if desired.¹⁶⁶

¹⁶⁵ IRC §3402(p).

¹⁶⁶ Treas. Reg. §31.3402(p)-1(b)(2).

Self-Employment Tax

SE status applies to clergy with respect to the performance of services:

- By a duly **ordained, commissioned, or licensed** minister of a church in the **exercise of their ministry**;
- By a member of a religious order in the exercise of duties required by the order; or
- By a person in the exercise of the profession of a Christian Science practitioner.¹⁶⁷

“Ordained, commissioned, or licensed” means that the taxpayer has been vested with ministerial status according to the procedure followed by their church. The minister need not be connected with a particular congregation, and ministerial status continues until revoked by the church.¹⁶⁸

“Exercise of the ministry” includes:

- The conduct of religious worship and sacerdotal functions;
- Directing, managing, or promoting the activities of a religious organization;
- Services done in accordance with a church assignment; or
- Missionary service or work for a missionary organization.¹⁶⁹

Accordingly, qualified ministers are deemed to be engaged in a self-employed trade or business **only** with respect to services performed in the exercise of the ministry¹⁷⁰ and are therefore subject to SE tax on net earnings on these sources of income.

If a clergy member or religious worker performs other services for a nonreligious organization or the services are not pursuant to an assignment by a religious work superior, that work is not “in the exercise of a ministry” and is therefore not part of the SE income under these rules.¹⁷¹ These situations are discussed in greater detail later in this chapter.

Special Rules on Items Excludable from Gross Income. The dual-status minister is able to exclude the following items provided by their employer from gross income.

- The value of meals provided in connection with ministerial services¹⁷²
- The amount of parsonage allowance or rental allowance
- The fair rental value of lodging provided in connection with ministerial services¹⁷³

Even though these items are excluded from gross income for income tax purposes, they **are included for the purposes of calculating SE tax.**

Note. If the church or other employer makes additional payments or allowances to assist with the payment of SE tax or other tax liabilities (other than payments made through withholding), those amounts are considered additional compensation and are subject to federal income tax and SE tax.

¹⁶⁷. IRC §§1402(c)(4), (5).

¹⁶⁸. *Social Security Handbook*, §934.

¹⁶⁹. *Ibid*, §935.

¹⁷⁰. Treas. Reg. §1.1402(c)-5(a)(2).

¹⁷¹. Treas. Reg. §1.1402(c)-5(c)(2).

¹⁷². IRC §119(a).

¹⁷³. *Ibid*.

Opting Out of SE Tax

There are two methods available to opt out of taxes for religious-based reasons.

- A minister who is categorized as a self-employed taxpayer may apply for an exemption from SE tax by filing **Form 4361**, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*.
- A member of a recognized religious sect who objects to insurance may apply for an exemption from both SE tax and FICA tax by filing **Form 4029**, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*.

Religious or conscientious objection grounds are required for an exemption using either Form 4361 or Form 4029.

Self-Employed Minister Opting Out (Form 4361). Form 4361 must be filed by the due date (including extensions) of the tax return for the second year in which the clergy member had SE income of \$400 or more, with any part of that income coming from ministerial services.¹⁷⁴

The applicant must show that the applicable ordaining, commissioning, or licensing body or religious order is:

- Tax-exempt under IRC §501(a) as a religious organization as described in IRC §501(c)(3), and
- A church or similar entity.¹⁷⁵

The application is based on a religious or conscientious opposition to the acceptance of public insurance that makes payments for death, disability, old age, retirement, or medical care. Before the IRS will approve the application, it must verify that the applicant is aware of the grounds for the exemption and wants to obtain the exemption on that basis. Accordingly, upon receiving the completed Form 4361, the IRS forwards a certification letter to the applicant. The certification letter consists of a statement outlining these religious or conscientious objections. The applicant must certify, by signing the letter under penalty of perjury, that the statement was read and that the exemption is sought on these grounds. To prevent a delay in the effective date of the exemption, the signed statement must be returned to the IRS no later than 90 days after the statement was mailed to the applicant.

In addition, Form 4361 requires the applicant to inform their church; order; or other ordaining, commissioning, or licensing body that the exemption from SE tax is being sought on religious or conscientious grounds.¹⁷⁶

Upon IRS approval, the SE exemption is **irrevocable**¹⁷⁷ and is effective for all tax years in which SE income is \$400 or more, with any of that income coming from ministerial services. If the applicant forwards the certification letter to the IRS later than the 90-day deadline, the application may still be approved but will not be effective until the date the signed copy is received by the IRS.¹⁷⁸

Note. The SE tax exemption is effective for ministerial SE income. **The exemption has no effect on other sources of nonministerial income**, which continue to be subject to SE tax for the applicant. Future social security benefits may be received with respect to contributions that were made on nonministerial sources of income.

¹⁷⁴ Form 4361 Instructions.

¹⁷⁵ IRC §170(b)(1)(A)(i) provides the relevant definitions of organizations that qualify.

¹⁷⁶ Ibid.

¹⁷⁷ Treas. Reg. §1.1402(e)-4A(b).

¹⁷⁸ Ibid.

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Example 36. Pastor Otto is an ordained minister. In addition to his ministerial income from his work at the local church, he also owns a bakery, which provides him with nonministerial earnings each year. Also, before his ordination, he was employed in a bakery as a pastry chef for 12 years during which his wages were subject to FICA and income tax withholding. Although Pastor Otto’s ministerial income will be exempt from SE tax if he properly files Form 4361 and the exemption is approved by the IRS, Pastor Otto will still be able to receive social security benefits attributable to his social security contributions during his 12 years of bakery employment. In addition, social security benefits attributable to the contributions made in connection with his bakery SE income will also be available to him.

Note. Once a minister receives an approved copy of the Form 4361 from the IRS, this important document should be retained in the minister’s records for future reference.

Example 37. Cory is a self-employed carpenter. He was ordained on December 1, 2010, and was hired by the local church as an employee to help with weekly services and officiate at weddings, funerals, and other ceremonies. During 2010, he took time away from his carpentry work in order to complete his ministerial course of study. He received a \$50 fee from the church for conducting a wedding on December 28, 2010, the same date he was hired by the church. Corey decides to apply for exemption from SE tax for religious reasons.

Corey has the following income for the most recent tax years.

Tax Year	2009	2010	2011	2012	2013
Carpenter income	\$22,000	\$350	\$24,000	\$20,000	\$16,000
Ministerial income	0	50	1,600	11,000	18,000
Total income	\$22,000	\$400	\$25,600	\$31,000	\$34,000

For the exemption, Corey must file by the due date of his tax return for the second tax year in which he has \$400 or more of SE income, with any amount of that income coming from ministerial services. Because 2011 is the second year in which Corey has at least \$400 of SE income that includes some ministerial income, the normal due date for the filing of his Form 4361 is April 15, 2012, the due date for his 2011 tax return. If Corey files an extension for his 2011 return, he is not required to file his 2011 return or the Form 4361 until October 15, 2012.

If approved, the exemption is effective for the 2010 tax year and all subsequent years. However, the exemption only applies to Corey’s ministerial income. His income from his carpentry business remains subject to SE tax.

Example 38. Assume the same facts as **Example 37**, except Corey does not officiate at the December 28, 2010 wedding and consequently does not receive the \$50 of additional SE income. The second year in which Corey has at least \$400 of SE income with some portion of that income derived from ministerial services is therefore 2012. Corey has until April 15, 2013 (or October 15, 2013, if an extension is filed) to file his Form 4361.

Example 39. Assume the same facts as **Example 37**. Corey conscientiously objects to the acceptance of public insurance that makes payments in connection with death, disability, old age, retirement, or medical care. In 2010, Corey did not pay any SE tax. However, in 2011, Corey paid the following amounts of SE tax on his income.

Type of Income (2011)	Income Amount	Amount of SE Paid
Carpentry	\$24,000	\$3,192
Ministry	1,600	213

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Corey decides to apply for exemption from SE tax. He issues a letter to his ordaining body informing them that he is seeking exemption from SE tax on conscientious grounds. He subsequently completes the following Form 4361 and files the original and two copies of it with the IRS¹⁷⁹ on April 1, 2012.

Form 4361 (Rev. January 2011) Department of the Treasury Internal Revenue Service	Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners	OMB No. 1545-0074 File Original and Two Copies		
File original and two copies and attach supporting documents. This exemption is granted only if the IRS returns a copy to you marked "approved."				
Please type or print	1 Name of taxpayer applying for exemption (as shown on Form 1040) Corey C. Cook Number and street (including apt. no.) 140 Mansfield Ave. City or town, state, and ZIP code Burlington, VT 05401	Social security number 555-55-5555 Telephone number (optional)		
	2 Check one box: <input type="checkbox"/> Christian Science practitioner <input type="checkbox"/> Member of religious order not under a vow of poverty <input checked="" type="checkbox"/> Ordained minister, priest, rabbi <input type="checkbox"/> Commissioned or licensed minister (see line 6)	3 Date ordained, licensed, etc. (Attach supporting document. See instructions.) 12/01/2010		
	4 Legal name of ordaining, licensing, or commissioning body or religious order The United Methodist Church, New England Conference Number, street, and room or suite no. 276 Essex Street City or town, state, and ZIP code Lawrence, MA 01842-0449	Employer identification number 38-5555555		
	5 Enter the first 2 years after the date shown on line 3 that you had net self-employment earnings of \$400 or more, any of which came from services as a minister, priest, rabbi, etc.; member of a religious order; or Christian Science practitioner	<table border="1"> <tr> <td style="width: 50px;">2010</td> <td style="width: 50px;">2011</td> </tr> </table>	2010	2011
2010	2011			
6 If you apply for the exemption as a licensed or commissioned minister and your denomination also ordains ministers, please indicate how your ecclesiastical powers differ from those of an ordained minister of your denomination. Attach a copy of your denomination's bylaws relating to the powers of ordained, commissioned, and licensed ministers.				
7 I certify that I am conscientiously opposed to, or because of my religious principles I am opposed to, the acceptance (for services I perform as a minister, member of a religious order not under a vow of poverty, or Christian Science practitioner) of any public insurance that makes payments in the event of death, disability, old age, or retirement; or that makes payments toward the cost of, or provides services for, medical care. (Public insurance includes insurance systems established by the Social Security Act.) I certify that as a duly ordained, commissioned, or licensed minister of a church or a member of a religious order not under a vow of poverty, I have informed the ordaining, commissioning, or licensing body of my church or order that I am conscientiously opposed to, or because of religious principles I am opposed to, the acceptance (for services I perform as a minister or as a member of a religious order) of any public insurance that makes payments in the event of death, disability, old age, or retirement; or that makes payments toward the cost of, or provides services for, medical care, including the benefits of any insurance system established by the Social Security Act. I certify that I have never filed Form 2031 to revoke a previous exemption from social security coverage on earnings as a minister, member of a religious order not under a vow of poverty, or Christian Science practitioner. I request to be exempted from paying self-employment tax on my earnings from services as a minister, member of a religious order not under a vow of poverty, or Christian Science practitioner, under section 1402(e) of the Internal Revenue Code. I understand that the exemption, if granted, will apply only to these earnings. Under penalties of perjury, I declare that I have examined this application and to the best of my knowledge and belief, it is true and correct.				
Signature ►		Date ►		
Caution: Form 4361 is not proof of the right to an exemption from federal income tax withholding or social security tax, the right to a parsonage allowance exclusion (section 107 of the Internal Revenue Code), assignment by your religious superiors to a particular job, or the exemption or church status of the ordaining, licensing, or commissioning body, or religious order.				
For Internal Revenue Service Use				
<input type="checkbox"/> Approved for exemption from self-employment tax on ministerial earnings <input type="checkbox"/> Disapproved for exemption from self-employment tax on ministerial earnings				
By _____ (Director's signature)		_____ (Date)		
General Instructions				
Section references are to the Internal Revenue Code unless otherwise noted.				
Purpose of form. File Form 4361 to apply for an exemption from self-employment tax if you have ministerial earnings (defined later) and are:				
<ul style="list-style-type: none"> • An ordained, commissioned, or licensed minister of a church; • A member of a religious order who has not taken a vow of poverty; or • A Christian Science practitioner. 				
Note. If you are a commissioned or licensed minister of a religious denomination or church that ordains its ministers, you may be treated in the same manner as an ordained minister if you perform substantially all the religious functions within the scope of the tenets and practices of your religious denomination or church.		death, disability, old age, or retirement; or that makes payments for the cost of, or provides services for, medical care, including any insurance benefits established by the Social Security Act.		
This application must be based on your religious or conscientious opposition to the acceptance (for services performed as a minister, member of a religious order not under a vow of poverty, or Christian Science practitioner) of any public insurance that makes payments for		If you are a duly ordained, commissioned, or licensed minister of a church or a member of a religious order not under a vow of poverty, prior to filing this form you must inform the ordaining, commissioning, or licensing body of your church or order that, on religious or conscientious grounds, you are opposed to the acceptance of public insurance benefits based on ministerial service.		
For Privacy Act and Paperwork Reduction Act Notice, see page 2		Cat. No. 41586H Form 4361 (Rev. 1-2011)		

¹⁷⁹ In accordance with the Form 4361 Instructions, Form 4361 is filed with the Department of the Treasury, Internal Revenue Service Center, Philadelphia, PA 19255-0733.

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Refund of SE Tax. After a Form 4361 is approved by the IRS, a minister can file a refund claim for overpaid SE tax by filing Form 1040X, *Amended U.S. Individual Income Tax Return*, before the end of the applicable limitations period. The limitations period is generally three years from the date the original return was filed or two years from the date the tax was paid, whichever is later. A return filed, or tax paid, before the due date is considered to have been filed or paid on the due date. In addition, if a claim is filed after the 3-year period but within two years of the date the tax was paid, the amount refundable will not be more than the tax paid within the two years immediately before the claim is filed.

Example 40. Assume the same facts as **Example 39**. If Corey’s application for exemption from the payment of SE tax is approved, Corey’s exemption is effective for 2010, 2011, and subsequent years. Corey can file a Form 1040X for the 2011 tax year. He can obtain a refund of the \$213 of SE tax that he paid on his ministerial income. Because the carpentry income is not ministerial in nature, the carpentry income is not exempt from SE tax. Accordingly, Corey cannot obtain a refund of the SE tax of \$3,192 that he paid on his 2011 carpentry income.

Form 1040 Disclosure of the Exemption. Once the minister receives a Form 4361 approval, the exemption may be used each tax year with respect to the ministerial earnings received. The minister indicates to the IRS that an SE exemption exists on a Form 1040, page 2, in the following manner.

household employment taxes from Schedule H	54	\$8,700	54
Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-	55		55
Self-employment tax. Attach Schedule SE	56	Exempt - Form 4361	56
Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	57		57
Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58		58
Household employment taxes from Schedule H	59a		59a
First-time homebuyer credit repayment. Attach Form 5329 if required	59b		59b

Member of Recognized Religious Sect Opting Out (Form 4029)

Employers that are members of **recognized religious sects** that are opposed to public or private insurance may apply for an exemption from the payment of FICA taxes under IRC §3127.

To be eligible for the exemption, a “recognized religious sect” must:

- Be conscientiously opposed to accepting benefits from any public or private insurance;
- Make some provision for the support and care of its dependent members in a manner that appears reasonable to the Commissioner of Social Security;¹⁸⁰ and
- Have been in continual existence since December 31, 1950.¹⁸¹

The employer exemption gives the employer the ability to avoid its FICA obligations for employees — but **only** for those employees who are also similarly approved for a “religious sect” exemption.¹⁸² The exemption also applies to any SE tax otherwise payable by the self-employed individual.

An employee who similarly conscientiously objects to any public or private insurance benefits and who is a member of a recognized religious sect (as defined previously) and follows its teachings can also apply for a religious sect exemption. The employee does not need to be a minister to qualify for this exemption. In order to obtain the religious sect exemption, the employee must waive all rights to receive social security and Medicare benefits, including any benefits that have accrued from contributions on earnings received prior to the effective date of the exemption.¹⁸³

¹⁸⁰ Treas. Reg. §1.1402(h)-1(e)(2)(ii).

¹⁸¹ IRC §1402(g)(1); Treas. Reg. §§1.1402(c)-7, 1.1402(h)-1.

¹⁸² IRC §3127(a).

¹⁸³ IRS Form 4029 Instructions.

Employers and employees who meet the preceding requirements apply for this exemption by filing Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*. This application is filed in triplicate with the Social Security Administration (SSA) and may be **filed at any time**.¹⁸⁴ Although the form is filed with the SSA, a copy is returned to the applicant by the IRS with a notice indicating whether the exemption is approved. If approved, the exemption is effective on the first day of the first quarter after the quarter in which Form 4029 is filed.

The exemption applies on an ongoing basis to all tax years in which the applicant continues to meet the exemption requirements. The exemption automatically ends when the applicant no longer meets the requirements. If this happens, the exemption ends on the last day of the calendar quarter before the quarter in which the applicant fails to meet the requirements.¹⁸⁵ The applicant who loses the exemption must notify the IRS by letter. However, if an applicant continues to meet the requirements of the exemption and changes from one recognized religious sect to another, the applicant's exemption continues uninterrupted.¹⁸⁶

Part of the Form 4029 is completed by the religious organization and the remainder of the form is completed by the individual applicant. Exemption from SE tax can be obtained through a Form 4029 exemption application submitted by the employee. However, under FICA, the employee and employer each pay half of the social security and Medicare taxes. For both the employee and employer to be exempt from their respective share of FICA tax obligations, each needs to obtain a Form 4029 exemption approval. Therefore, the employer organization must submit a Form 4029 seeking employer-level exemption.

Note. Although Form 4029 is originally filed with the SSA, the SSA and the IRS both review the application. The applicant receives a copy of Form 4029 from the IRS indicating whether the application has been approved. Once the applicant obtains this approval notification, it should be kept as a permanent record for future reference.

Tax Reporting with a Form 4029 Exemption. The following rules apply with the religious sect exemption.

- If both the employer and employee have obtained approval for the exemption, the employer need not withhold any FICA tax on compensation paid to the exempt employee.
- If the employer is exempt but the employee is not, the employer must withhold FICA taxes (both the employer's and employee's share).

Exempt employers with exempt employees do not need to report the exempt wages on Form 941, *Employer's Quarterly Federal Tax Return*; Form 944, *Employer's Annual Federal Tax Return*; or Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*.

¹⁸⁴. Ibid.

¹⁸⁵. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

¹⁸⁶. Ibid.

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Example 41. The Old Order Furniture Workshop is an Amish business that has obtained a religious sect exemption from FICA taxation. The shop is owned by John Lapp. Amos, an exempt employee, is employed by The Old Order Furniture Workshop. John hired Amos in October 2012 to assist with some furniture production projects before the end of the year. Accordingly, Amos worked for the last quarter of 2012.

For the 2012 tax year, the shop paid Amos \$12,000. Because both The Old Order Furniture Workshop and Amos have obtained religious sect exemptions, the shop only withholds federal income tax and does not withhold or pay any social security or Medicare taxes. Amos' Form W-2 for 2013 and the Workshop's Form 941 for the last quarter of the year follow.

		a Employee's social security number 987-65-4321		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 37-2222222				1 Wages, tips, other compensation 12000.00		2 Federal income tax withheld 1200.00	
c Employer's name, address, and ZIP code The Old Order Furniture Workshop 339 E. Main Street Ephrata, PA 17522				3 Social security wages		4 Social security tax withheld	
				5 Medicare wages and tips		6 Medicare tax withheld	
				7 Social security tips		8 Allocated tips	
d Control number				9		10 Dependent care benefits	
e Employee's first name and initial Amos		Last name Troyer		Suff.		11 Nonqualified plans	
f Employee's address and ZIP code 84 Ridge Avenue Ephrata, PA 17522				13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12a See instructions for box 12	
				14 Other		12b	
				Form 4029		12c	
15 State Employer's state ID number PA 37-2222222		16 State wages, tips, etc. 12000.00		17 State income tax 400.00		18 Local wages, tips, etc.	
						19 Local income tax	
						20 Locality name	

Form **W-2** Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2013

Department of the Treasury—Internal Revenue Service

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For Example 41

Form **941 for 2013: Employer's QUARTERLY Federal Tax Return**
(Rev. January 2013) Department of the Treasury — Internal Revenue Service
950113
OMB No. 1545-0029

Employer identification number (EIN)	3	7	-	2	2	2	2	2	2
Name (not your trade name)	John Lapp								
Trade name (if any)	The Old Order Furniture Workshop								
Address	339 E. Main Street								
	Number	Street								Suite or room number
	Ephrata			PA		17522			
	City	State				ZIP code			

Report for this Quarter of 2013
(Check one.)

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Instructions and prior year forms are available at www.irs.gov/form941.

Read the separate instructions before you complete Form 941. Type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: Mar. 12 (Quarter 1), June 12 (Quarter 2), Sept. 12 (Quarter 3), or Dec. 12 (Quarter 4)	1	1	
2 Wages, tips, and other compensation	2	12,000 . 00	
3 Income tax withheld from wages, tips, and other compensation	3	1,200 . 00	
4 If no wages, tips, and other compensation are subject to social security or Medicare tax			<input checked="" type="checkbox"/> Check and go to line 6.
	Column 1	Column 2	
5a Taxable social security wages	. . . . .	x .124 =	Form 4029
5b Taxable social security tips	. . . . .	x .124 =	
5c Taxable Medicare wages & tips	. . . . .	x .029 =	
5d Taxable wages & tips subject to Additional Medicare Tax withholding	. . . . .	x .009 =	
5e Add Column 2 from lines 5a, 5b, 5c, and 5d		5e	.
5f Section 3121(q) Notice and Demand—Tax due on unreported tips (see instructions)		5f	.
6 Total taxes before adjustments (add lines 3, 5e, and 5f)		6	1,200 . 00
7 Current quarter's adjustment for fractions of cents		7	.
8 Current quarter's adjustment for sick pay		8	.
9 Current quarter's adjustments for tips and group-term life insurance		9	.
10 Total taxes after adjustments. Combine lines 6 through 9		10	1,200 . 00
11 Total deposits for this quarter, including overpayment applied from a prior quarter and overpayment applied from Form 941-X or Form 944-X filed in the current quarter		11	.
12a COBRA premium assistance payments (see instructions)		12a	.
12b Number of individuals provided COBRA premium assistance	. . . . .	
13 Add lines 11 and 12a		13	.
14 Balance due. If line 10 is more than line 13, enter the difference and see instructions		14	1,200 . 00
15 Overpayment. If line 13 is more than line 10, enter the difference	. . . . .	

▶ You MUST complete both pages of Form 941 and SIGN it.

Next ▶

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher.
Cat. No. 17001Z
Form **941** (Rev. 1-2013)

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Parsonages, Parsonage Allowances, and Housing Allowances

If a church or other religious organization, as employer, provides the minister with a parsonage in which to live, the minister is entitled to exclude the fair rental value (FRV) of the home from gross income. The excludable amount includes the cost of furnishings and appurtenances such as a garage.¹⁸⁷ It also includes utilities costs but not food or domestic service staff.¹⁸⁸

There is also an income exclusion for ministers receiving a housing or parsonage allowance.¹⁸⁹ A minister can exclude from income the amount of a parsonage allowance paid by an employing church or religious organization.

Both the FRV exclusion and the parsonage allowance exclusion **require** that the employer provide the minister with the home or parsonage allowance as compensation for services that are ordinarily the duties of a minister, which include any of the following.

- Performance of sacerdotal functions
- Conduct of religious worship
- Administration and maintenance of religious organizations and agencies
- Performance of teaching and administration duties at a seminary¹⁹⁰

Limits on Exclusion. Under this exception, the minister is generally entitled to an income exclusion equal to the **lesser** of the following amounts.

- The FRV of a home (including utilities costs) furnished as part of the minister's compensation
- The amount of the parsonage allowance specifically designated as such by the employer
- The amount of the housing allowance that is **actually used** to pay qualifying housing costs¹⁹¹

Qualifying housing costs include living expenses such as the following.

- Mortgage payment
- Property taxes
- Home insurance premiums
- Structural repairs, renovation, or remodeling costs
- Yard maintenance and landscaping
- Utilities costs
- Furnishings and appliances

Note. Even though a minister may exclude from gross income that portion of a parsonage allowance used to pay mortgage interest and property taxes, the minister may still claim mortgage interest and property taxes as itemized deductions.¹⁹²

¹⁸⁷. IRC §107(2).

¹⁸⁸. Treas. Reg. §1.107-1.

¹⁸⁹. IRC §107(2).

¹⁹⁰. Treas. Reg. §1.107-1(a).

¹⁹¹. IRS Pub. 1828, *Tax Guide For Churches and Religious Organizations*.

¹⁹². IRC §265(a)(6).

SE Tax Treatment. Even though the value of a parsonage or rental allowance is excluded from the clergy member's gross income for income tax purposes, **the amount is still subject to SE tax.**¹⁹³

Designation Requirement. To qualify as an excludable parsonage allowance, the amount must be officially designated as such by the church or other employing organization before any payment is made. The amount may be designated in an employment contract or any written instrument of official action such as in a resolution or minutes of a church meeting or item within the organization's budget.¹⁹⁴

Note. Although no upper limit on the amount that may be designated to the minister as a parsonage allowance is provided, IRS guidance states that the allowance must be reasonable with regard to other compensation the minister receives in order for the parsonage allowance to be excludable.¹⁹⁵

Excess Parsonage Allowance. If the amount of parsonage allowance paid to the minister exceeds the excludable amount, the excess is included in the minister's gross income and is subject to income tax and SE tax.

Example 42. Reverend Lucas is a pastor at Hilltop Family Church. The church held a directors' meeting in late 2011 and, by resolution, designated \$12,000 for the 2012 year as a parsonage allowance for Reverend Lucas. In order to help offset increasing utilities costs, the directors of the church also passed a resolution to designate an additional \$1,200 for the year as a utilities allowance for Reverend Lucas. During 2012, the church controller paid Reverend Lucas additional amounts of \$4,800 to offset utility costs and property taxes that were higher than originally anticipated at the directors' meeting. These additional amounts were not designated as additional parsonage allowance amounts by the church's administrative board, the controller, or other church administrative body. The church actually paid Reverend Lucas a total of \$18,000 for the year (\$12,000 parsonage allowance + \$1,200 utilities allowance + additional amounts of \$4,800). Reverend Lucas provided his tax return preparer, Bernard, with the following list of household expenses for 2012.

Mortgage interest	\$ 7,000
Property taxes	3,300
Utilities	800
Home insurance	1,200
Painting the living room	240
New kitchen stove	560
Flowers for front of house	100
Babysitter for children	1,400
Cleaning supplies, light bulbs	300
Groceries	4,500
Rental of neighbor's garage	600
Total household expenses	\$20,000

Reverend Lucas told Bernard that Hilltop Family Church indicated that the FRV of the house is \$1,400 per month, or \$16,800 per year. Bernard must determine the amount of parsonage allowance that Reverend Lucas can exclude for the year. Because the excludable amount for housing expenses includes utilities costs under IRC §107 and Treas. Reg. §1.107-1, the amount called "parsonage allowance" and "utilities allowance" by the church may be added together as the "parsonage allowance" for tax purposes despite the fact that the church designates these items separately.

¹⁹³. IRC §§3121(a), 3306(a).

¹⁹⁴. Treas. Reg. §1.107-1(b).

¹⁹⁵. Rev. Rul. 78-448, 1978-2 CB 105.

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Bernard reviews Reverend Lucas's list of household expenses. All the costs directly related¹⁹⁶ to the home qualify, including the costs of renovation or remodeling and the cost of appurtenances, such as the garage, which Reverend Lucas rented. However, the cost of domestic servants, such as the babysitter, and the cost of groceries do not qualify. Therefore, after reducing the list of household expenses by the costs of the babysitter and groceries, Bernard determines that Reverend Lucas's actual qualifying housing expenses are \$14,100 (\$20,000 total – \$4,500 groceries – \$1,400 babysitter).

Bernard completes some tax research on excludable parsonage allowances and discovers that Reverend Lucas can exclude from income the lesser of the following items.

Item	Calculation	Result
FRV of the home (including utilities costs)	FRV of \$16,800 + utilities costs of \$800	\$17,600
The amount of parsonage allowance designated by Hilltop Family Church	\$12,000 parsonage allowance + \$1,200 utilities allowance	13,200
The amount that Reverend Lucas actually spent on qualifying housing costs for the year.	\$20,000 – \$4,500 groceries – \$1,400 babysitter costs	14,100

The amount of parsonage allowance that Reverend Lucas may exclude is limited to the \$13,200 that the church actually designated as a parsonage allowance (including the designated utilities allowance). The difference between the \$18,000 that he was actually paid and the \$13,200 actually designated (\$4,800) must be included in Reverend Lucas's gross income for the year. This \$4,800 excess parsonage allowance is included in income and is subject to income tax and SE tax.

Note. Tax software frequently includes the parsonage allowance amount on line 7 automatically. Some churches may include an excess parsonage allowance amount on Form W-2, in box 1. If so, care must be taken to ensure that the excess parsonage amount is reported only once. A statement should be submitted with the return.

Use of Parsonage Allowance for Second Home. The recent *Driscoll* case¹⁹⁷ addressed the ability of a minister to exclude the portion of the parsonage allowance that was used for a second home. Mr. Driscoll, who headed his own ministry, sought to exclude the following amounts that were designated as a parsonage allowance for his second lakefront home in addition to the parsonage allowance for his primary residence.

Tax Year	Parsonage Allowance for Second Home
1996	\$ 25,843
1997	70,708
1998	116,309
1999	195,779

¹⁹⁶ Treas. Reg. §1.107-1(c).

¹⁹⁷ *Driscoll v. Comm'r*, 135 TC 27 (Dec. 14, 2010), *rev'd and rem'd Comm'r v. Driscoll*, 669 F.3d 1309 (11th Cir. 2012).

IRC §107 allows the exclusion of a parsonage allowance for amounts spent on a “home.” The Tax Court held in favor of Mr. Driscoll, stating that the term “home” was intended to differentiate between an amount spent on residential property (which is excludable) from an amount expended on a farm or business (which a minister cannot exclude). “Home” was not meant to limit a parsonage allowance to only one residence. However, the U.S. Court of Appeals for the 11th Circuit disagreed with the Tax Court and Mr. Driscoll, interpreting “home” to mean that a minister can deduct a parsonage allowance on only one home.

Observation. Had Mr. Driscoll’s exclusion amounts not been so large, the IRS may not have been as aggressive as it was in pursuing a favorable judgment.

Pending Constitutional Challenge to Parsonage Allowances. *Freedom From Religion Foundation v. Geithner*, filed in U.S. District Court, Western District of Wisconsin,¹⁹⁸ on September 13, 2011, represents a pending constitutional challenge to the parsonage allowance for ministers. The Freedom From Religion Foundation (FFRF) is seeking declaratory judgment that the parsonage allowance violates the Establishment Clause of the First Amendment by providing preferential tax benefits to ministers while denying similar tax benefits to FFRF directors who are promoting nonbelief, rather than religion. One such director was formerly a church minister who claimed a parsonage allowance exclusion before becoming an FFRF official. On August 29, 2012, the U.S. District Court issued an opinion that cleared existing procedural challenges to the case and held that the FFRF case can proceed. The outcome of the case is pending.

The *Deason* Rule

Under IRC §265(a)(1), an otherwise deductible business or employment expense that is allocable to a tax-exempt source of income is not deductible. This Code section was the basis for the Tax Court’s decision in *Deason v. Comm’r*.¹⁹⁹ In the *Deason* case, the Tax Court disallowed the portion of a minister’s unreimbursed automobile expense that was allocable to his tax-exempt parsonage allowance. The most recent IRS Ministers Audit Techniques Guide states:²⁰⁰

A minister may deduct ordinary and necessary business expenses. However, if a minister’s compensation includes a parsonage or housing allowance which is exempt from income under IRC §107, the prorated portion of the expenses allocable to the tax exempt income is not deductible, per IRC §265, Deason v. Commissioner . . .

However, the *Deason* rule does not affect the amounts the minister can otherwise deduct for mortgage interest or property taxes on a home.²⁰¹

The *Deason* rule is applied as follows.

- Step 1.** Determine the minister’s total ministry income (TMI). TMI includes the minister’s salary, fees, expense allowances provided under any nonaccountable plans **and** any excludable parsonage or housing allowance.
- Step 2.** Calculate the nontaxable income percentage (NTIP) using the following formula.

$$\text{NTIP} = \frac{\text{Excludable parsonage or housing allowance}}{\text{TMI}}$$

¹⁹⁸. *Freedom From Religion Foundation, Inc. et al. v. U.S.*, No. 3:11-cv-00626-bbc (W.D. Wis. Aug. 29, 2012).

¹⁹⁹. *Deason v. Comm’r*, 41 TC 465 (1964).

²⁰⁰. See IRS, *Ministers Audit Techniques Guide* (Apr. 2009).

²⁰¹. IRC §265(a)(6).

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Step 3. Calculate the amount of nondeductible expenses (NDE) by multiplying the minister's total employment expenses (TEE) by the NTIP. NDE is the amount of business expenses that are allocable to the tax-exempt parsonage or housing allowance that cannot be deducted. This is shown by the following formula.

$$\text{NDE} = \text{TEE} \times \text{NTIP}$$

Step 4. Determine the amount of deductible expenses (DE). This is found by taking the minister's TEE and subtracting the NDE. This is shown by the following formula.

$$\text{DE} = \text{TEE} - \text{NDE}$$

Example 43. The following amounts apply to Pastor Ryan for the 2012 tax year.

Salary (exclusive of housing allowance)	\$40,000
Excludable housing allowance	10,000
Income from officiating weddings	6,000
Gas allowance from nonaccountable plan	4,000
Unreimbursed business expenses	10,000

Although Pastor Ryan is entitled to deduct his unreimbursed business expenses, he cannot deduct that portion of the unreimbursed business expenses attributable to his tax-free housing allowance. The *Deason* rule applies to Pastor Ryan, and the following calculations are completed to determine how much of the \$10,000 of unreimbursed business expenses are deductible for 2012.

Step 1. Determine Pastor Ryan's TMI for 2012 as follows.

Salary (exclusive of housing allowance)	\$40,000
Excludable housing allowance	10,000
Income from officiating weddings	6,000
Gas allowance from nonaccountable plan	4,000
Total ministry income	\$60,000

Step 2. Calculate the nontaxable income percentage (NTIP).

$$\begin{aligned}\text{NTIP} &= \frac{\text{Excludable parsonage or housing allowance}}{\text{TMI}} \\ &= \frac{\$10,000}{\$60,000} \\ &= 16.67\%\end{aligned}$$

Step 3. Calculate the amount of nondeductible expenses (NDE).

$$\begin{aligned}\text{NDE} &= \text{TEE} \times \text{NTIP} \\ &= \$10,000 \times 16.67\% \\ &= \$1,667\end{aligned}$$

Step 4. Determine the amount of deductible expenses (DE).

$$\begin{aligned} \text{DE} &= \text{TEE} - \text{NDE} \\ &= \$10,000 - \$1,667 \\ &= \$8,333 \end{aligned}$$

After applying the *Deason* rule, Pastor Ryan may deduct \$8,333 of his \$10,000 unreimbursed business expenses for the 2012 tax year.

Observation. Although no direct IRS guidance exists on the matter, IRC §265(a)(6) indicates that ministers affected by the *Deason* rule may take full deductions for mortgage interest and property taxes. This suggests that the amounts for mortgage interest and property taxes should never be included as part of total employment expenses (TEE) in the preceding calculations.

The *Deason* rule is only implicated for ministers who receive a tax-exempt parsonage or housing allowance **and** who itemize unreimbursed employment expenses. If the minister is in this situation, there is a **special statement** that must be filed with the minister's tax return showing details regarding sources and amounts of taxable ministerial income, the tax-exempt parsonage allowance, and the *Deason* rule calculations.²⁰²

If the minister is reimbursed for expenses only under an **accountable plan** for the year, the *Deason* rule is irrelevant.

Employee Expenses and Reimbursements

Generally, expense reimbursement amounts paid to an employee-minister are included in the minister's gross income. Such payments are treated as paid under a **"nonaccountable plan"** and are therefore included as wages. The reimbursement amounts are thus subject to income tax withholding and payroll taxes.²⁰³

Because the amounts included in an employee's wages reported on Form W-2 are not considered reimbursements, the employee-minister receiving such payments can claim **unreimbursed employee expenses** as a miscellaneous itemized deduction on Schedule A. This amount represents the minister's expenses in connection with the trade or business of being an employee. These expenses are subject to the 2%-of-AGI threshold and are deductible only if they are:

- Paid or incurred during the tax year,
- For carrying on the minister's trade or business of being an employee, and
- Are ordinary and necessary.²⁰⁴

An "ordinary" expense is one that is common and accepted in the minister's profession. An expense is "necessary" if it is appropriate and helpful to the minister's profession. An expense does not have to be required to be considered necessary.

²⁰² See IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*, for additional details on the special statement required.

²⁰³ Treas. Reg. §1.62-2(c)(5).

²⁰⁴ Treas. Reg. §1.162-1(a); IRS Pub. 529, *Miscellaneous Deductions*.

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There are also **other expenses** related to income or property²⁰⁵ that an **employee-minister** can claim. These other expenses are deductible if they are ordinary, necessary, reasonable, and closely related to one of the following purposes.

- To produce or collect taxable income
- To manage, conserve, or maintain property held for producing taxable income²⁰⁶

Both unreimbursed employee expenses and the other expenses are claimed as miscellaneous itemized deductions and are subject to the 2%-of-AGI floor.

Examples of the types of **unreimbursed employee expenses** an employee-minister can deduct include the following.

- Professional dues and malpractice insurance costs
- Home office expenses
- Employment-related computer costs and depreciation
- Job search expenses related to current minister position
- Job-related legal fees
- Travel, transportation, meals, entertainment, and lodging related to ministerial work
- Work-related clothing, uniform, and education costs

Examples of the types of **other expenses related to income or property** that an employee-minister can deduct include the following.

- Appraisal costs for a charitable or casualty loss claim
- Cost of clerical help, office rent, or depreciation for carrying investments
- Costs incurred to collect interest or dividends
- Legal fees incurred to produce or collect taxable income
- Legal fees for tax advice
- Safe deposit box rental charges
- IRA trustee fees if separately invoiced and paid

Note. Further guidance and special rules applicable to the above deductions can be found in IRS Pub. 529, *Miscellaneous Deductions*.

Accountable Expense Reimbursement Plans. Instead of the minister including reimbursement amounts from the employer in gross income, paying income tax and payroll taxes on those amounts, and facing the limited prospect of itemizing those expenses as deductions, there is an alternative approach.

The church or other employer organization can establish an **accountable plan** through which the minister's employment expenses are administered. Amounts paid to the employee-minister through an accountable plan **are not reported to the minister as wages** and therefore are not shown on Form W-2 or included on Form 941, *Employer's Quarterly Federal Tax Return*. Moreover, no income tax withholding or payroll taxes apply to these reimbursement amounts.²⁰⁷

²⁰⁵. IRC §212.

²⁰⁶. Treas. Reg. §1.212-1.

²⁰⁷. Treas. Reg. §1.62-2(c)(4).

Use of an accountable plan eliminates the following disadvantages associated with unreimbursed employment expenses.

- None of the employment expenses can be claimed if the standard deduction is taken.
- A tax benefit is received only on the amount of itemized employment expenses that exceed the 2%-of-AGI floor.
- Only the allowable 50% portion of meals and entertainment can be claimed.

A plan to reimburse the minister for expenses must meet three requirements in order to be an accountable plan.

1. The expenses reimbursed must have a business connection.
2. The reimbursement amounts paid to the minister must be substantiated.
3. The minister must return amounts paid that exceed actual expenses.

Note. For further guidance on the accountable plan requirements, see Treas. Reg. §1.62-2.

An accountable plan may provide the minister with advances and allowances in addition to reimbursements. For travel, meals, and lodging expenses, the minister must adequately substantiate the employment expense with evidence of the dollar amount of the expense, the time and place the expense was incurred, and the business purpose of the expense.²⁰⁸

Tax Preparation Fees

An employee-minister may deduct the cost of income tax preparation. Fees are deducted on the return for the year in which they are paid. The cost of preparing Schedules C, E, or F is deducted on that schedule. The cost of preparing the remainder of the return is deducted on Schedule A, line 22, and is subject to the 2%-of-AGI floor. The costs of tax software and tax publications are likewise deductible.²⁰⁹

Hobby Expenses

Under the “hobby loss” rule, the extent to which a minister may deduct hobby expenses depends on whether the minister engages in the activity with a profit-seeking motive.

Note. See the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Hobby Losses, for a detailed discussion on the hobby loss rules and their application to activities engaged in by a taxpayer to determine whether expenses and/or losses may be deducted.

Improper Documentation from Employer

The Ministers Audit Techniques Guide²¹⁰ states: “Even though a minister may receive a Form 1099-MISC for the performance of services, he or she may be a common law employee and should in fact be receiving a Form W-2.” Tax return preparers should ensure that a minister has received the proper type of documentation based on the nature of the work the minister does with due regard to the right-of-control test.

²⁰⁸. Treas. Reg. §1.62-2(e); IRC §274(d).

²⁰⁹. IRS Pub. 529, *Miscellaneous Deductions*.

²¹⁰. IRS, *Ministers Audit Techniques Guide* (Apr. 2009).

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If an employee-minister receives a Form 1099-MISC in error from an employer instead of a Form W-2, the following steps must be taken by the minister's employer before the minister files their tax return for the year.

- Prepare a **corrected** Form 1099-MISC showing no income (and no tax withholding if an amount was previously shown in box 4). This will serve to “zero out” the erroneous Form 1099-MISC that was originally issued.
- A Form W-2 should be issued showing the appropriate amount of compensation in box 1 and the amount of tax withholding, if applicable, in box 2.

Tax Reporting for the Dual-Status Minister

Tax return preparation and tax reporting for dual-status ministers reflect the “hybrid” tax treatment they receive under the Code.

Example 44. Pastor Brad is employed by Tremont Street Church as head pastor. Under the right-of-control test, Brad is classified as a common law employee based on the degree of control the church has over the performance of his duties. In addition to his wages, the church designated and paid Brad a housing allowance and a separate utilities allowance. The church also provides Brad with a social security allowance of \$200 per month (\$2,400 for the year) to assist Brad with the payment of his SE tax. Pastor Brad owns his own home near the church.

Throughout 2012, Pastor Brad had travel, meals, and other employment expenses for which he received reimbursement under the church's accountable plan. However, he had some out-of-town travel expenses attributable to a conference he attended for which the church reimbursed him outside of the accountable plan. This was done because these expenses were not reimbursable expenses under the terms of the plan.

Pastor Brad received the following amounts from the church for the 2012 tax year.

Pastor wages	\$41,000
Social security allowance	2,400
Parsonage allowance designated and paid	5,500
Utilities allowance designated and paid	500
Expenses reimbursed under accountable plan	2,000
Nonaccountable expense reimbursement	1,500

Pastor Brad is subject to SE tax because he did not file a Form 4361 before the required deadline. Pastor Brad owns his own home. He paid the following homeowner expenses and estimated taxes for 2012.

Deductible mortgage interest	\$ 5,200
Residential property taxes paid	3,200
Estimated taxes paid for 2012	10,000

He pays no state income tax, so he will opt to claim state and local general sales tax (using the IRS tables provided in the Schedule A instructions) on his Schedule A.

Brad received the following Form W-2 from the Tremont Street Church in connection with his compensation for 2012.

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For Example 44

a Employee's social security number 777-77-7777		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.			
b Employer identification number (EIN) 37-2222222			1 Wages, tips, other compensation 44900.00	2 Federal income tax withheld			
c Employer's name, address, and ZIP code Tremont Street Church 346 Tremont Street Portsmouth, NH 03801			3 Social security wages	4 Social security tax withheld			
			5 Medicare wages and tips	6 Medicare tax withheld			
			7 Social security tips	8 Allocated tips			
d Control number			9	10 Dependent care benefits			
e Employee's first name and initial Brad		Last name Morrissey		Suff.		11 Nonqualified plans	12a See instructions for box 12
f Employee's address and ZIP code 786 Boylston Street Portsmouth, NH 03803			13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>	12b		12c	
			14 Other Housing \$6000.00	12d			
			15 State Employer's state ID number NH 37-2222222			16 State wages, tips, etc. 44900.00	17 State income tax .00	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

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

2012

Department of the Treasury—Internal Revenue Service

Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

Safe, accurate FAST! Use



Note. While the church in this example used Form W-2, box 14, to disclose the total of Brad's parsonage and utilities allowances (\$5,500 + \$500 = \$6,000), there is no requirement that the church do so. Accordingly, the amount of a parsonage or utilities allowance is not always entered on Form W-2 in this manner for a minister.

Although Pastor Brad is a common law employee, the church does not withhold income tax, social security, or Medicare taxes. Instead, Brad is treated as a self-employed taxpayer and must pay his own income tax through estimated payments (unless he wishes to voluntarily have the church withhold income tax from his pay, which can be accomplished by agreement). Pastor Brad also must pay his own social security tax and Medicare tax.

Brad furnishes his tax return preparer, Clarissa, with all of the following relevant details and information.

The \$44,900 reported on Brad's Form W-2, box 1, consists of the following.

Wages from the church	\$41,000
Social security allowance	2,400
Nonaccountable expense reimbursement	1,500
Compensation	<u>\$44,900</u>

Although the reimbursements Brad received under the church's accountable plan are excluded from gross income, Brad must include the amount of the reimbursement for the travel that was made outside of the accountable plan (and therefore treated as a nonaccountable plan reimbursement). Because Brad is classified as a common law employee, he can claim a deduction for the out-of-town travel expenses to offset the income inclusion. However, he must claim these expenses as part of his itemized deductions subject to the 2%-of-AGI floor.

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The social security allowance that the church pays Brad is also part of his taxable compensation and must be included in his gross income.

Brad's income for SE tax purposes includes the following amounts.

Compensation	\$44,900
Parsonage allowance	5,500
Utilities allowance	500
Subtotal	\$50,900
Less: unreimbursed travel expenses	(1,500)
Income for SE tax purposes	\$49,400

For income tax purposes, the parsonage allowance and utilities allowance are excluded.

Because Brad is making a claim for the nonaccountable reimbursement amount of \$1,500 on his return, it is subject to the *Deason* rule. Brad therefore cannot deduct the portion of this \$1,500 that is allocable to his tax-exempt parsonage and utilities allowance.

Clarissa contacts Brad regarding the parsonage and utility allowance to obtain some relevant information in connection with the possible limitation of the excludable amount. She knows that the excludable parsonage allowance includes the amount for home utilities. However, she must check to ensure that Brad's exclusion is not limited. Brad can claim the lesser of the following.

- The FRV of Brad's home, plus the actual utilities costs²¹¹
- The amount the church designated to Brad as an allowance
- The amount Brad actually spent for housing costs

Brad provides her with the following amounts in connection with his residential expenses for 2012.

Fair rental value	\$ 7,200
Actual utilities costs	950
Actual housing costs (excluding utilities)	10,000

Clarissa determines that the amount of parsonage allowance and utilities allowance that Brad can exclude is the lesser of the following.

- The FRV plus actual utility costs, or **\$8,150** (\$7,200 + \$950)
- The parsonage allowance designated to Brad, or **\$6,000** (\$5,500 parsonage allowance + \$500 utilities allowance)
- The amount Brad actually spent on housing and utilities, which is **\$10,950** (\$10,000 housing costs + \$950 utilities)

Clarissa concludes that Brad can exclude the \$6,000 that the church designated and paid to Brad for a parsonage and utilities allowance.

Clarissa prepares Brad's 2012 tax return. The following pages show the relevant schedules of Brad's 2012 tax return.

²¹¹. Treas. Reg. §1.107-1(a); IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

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Because Brad's employment expenses were limited by the *Deason* rule, he must attach a **special statement** to his return as indicated by IRS Pub. 517.

2012	Federal Statements	Page 1
Client 6	Brad Morrissey	777-77-7777
4/03/13		02:08PM
Statement 1		
Minister's Parsonage Allowance		
Adapted from IRS Publication 517		
<u>Percentage of Tax-Free Income</u>		
1. Wages.....	\$	44,900.
2. Schedule C Gross Income.....		
3. Fair Rental Value of Parsonage Provided by Church.....		
4a. Parsonage Allowance.....		5,500.
4b. Utility Allowance.....		500.
4c. Total Allowance.....		6,000.
4d. Actual Parsonage Expense.....		10,000.
4e. Actual Utility Expense.....		950.
4f. Total Actual Expenses.....		10,950.
4g. Fair Rental Value of Parsonage, Plus the Cost of Utilities.....		8,150.
4h. Smaller of 4c, 4f, or 4g.....		6,000.
4i. Excess Allowance (line 4c - line 4h).....		
5a. Taxable Ministerial Income (lines 1 + 2 + 4i).....		44,900.
5b. Nontaxable Ministerial Income (line 3 + line 4h).....		6,000.
5c. Total Ministerial Income (lines 1 + 2 + 3 + 4h + 4i).....		50,900.
6. Ratio of Tax-free to Total Income (line 5b / line 5c).....		11.79%
<u>Allowable Schedule C Expenses</u>		
1. Total Schedule C Expenses.....		
2. Nondeductible Expenses (line 1 * ratio).....		
3. Allowable Schedule C Expenses.....		
<u>Allowable Form 2106 Expenses</u>		
1. Total Unreimbursed Form 2106 Expenses.....	\$	1,500.
2. Nondeductible Expenses (line 1 * ratio).....		-177.
3. Allowable Form 2106 Expenses.....		1,323.
<u>Net Self-Employment Income</u>		
1. Wages.....	\$	44,900.
2. Schedule C Net Income.....		
3a. Parsonage Allowance (or FRV of parsonage if church provided).....		5,500.
3b. Utility Allowance.....		500.
3c. Total Allowance (line 3a + line 3b).....		6,000.
4. Income (lines 1 + 2 + 3c).....		50,900.
5. Disallowed Schedule C Expenses.....		
6. Unreimbursed Form 2106 Expenses.....		1,500.
7. Total Expenses not Deducted (line 5 + line 6).....		1,500.
8. Net Self-Employment Income (line 4 - line 7).....		49,400.
Statement 2 - Minister		
Form 2106-EZ, Line 6		
Total Expenses		
Total unreimbursed Form 2106 or 2106-EZ expenses.....	\$	1,500.
Nondeductible part of Form 2106 or 2106-EZ expenses.....		177.
Ministerial employee business expense deduction allowed.....	\$	1,323.

5

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The Form 2106-EZ shows the application of the *Deason* rule in connection with Brad's \$1,500 of nonaccountable expenses. Brad's **nontaxable income percentage** is calculated as follows.

$$\begin{aligned}\text{NTIP} &= \frac{\text{Excludable parsonage allowance and utilities allowance}}{\text{Total ministerial income}} \\ &= \frac{\$6,000}{\$50,900} \\ &= 11.79\%\end{aligned}$$

Therefore, 11.79% of Brad's nonaccountable expenses of \$1,500 is attributable to his tax-exempt parsonage and utilities allowances. He cannot deduct \$177 ($\$1,500 \times 11.79\%$) of the \$1,500. He can deduct the remaining \$1,323 ($\$1,500 - \177).

Note. If Pastor Brad resided in a church-provided parsonage, the FRV would be subject to SE tax. In addition, the FRV would be part of the excludable income in the numerator and also part of "total ministerial income" in the denominator of the calculation used to obtain his nontaxable income percentage (NTIP) for *Deason* rule purposes.

2013 Workbook

For Example 44

Form 2106-EZ Department of the Treasury Internal Revenue Service (99)	<h3 style="margin: 0;">Unreimbursed Employee Business Expenses</h3> <p style="margin: 0;">▶ Attach to Form 1040 or Form 1040NR. ▶ Information about Form 2106 and its separate instructions is available at www.irs.gov/form2106.</p>	OMB No. 1545-0074 <div style="text-align: center; font-size: 24pt; font-weight: bold;">2012</div> Attachment Sequence No. 129A
Your name	Occupation in which you incurred expenses	Social security number
Brad Morrissey	Minister	777 | 77 | 7777

You Can Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements for this purpose).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2012.

Caution: You can use the standard mileage rate for 2012 **only if:** (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service, or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1 Complete Part II. Multiply line 8a by 55.5¢ (.555). Enter the result here	1		
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	1,500	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		
5 Meals and entertainment expenses: \$ _____ × 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	5		
6 Total expenses. Add lines 1 through 5. Enter here and on Schedule A (Form 1040), line 21 (or on Schedule A (Form 1040NR), line 7). (Armed Forces reservists, fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	6	1,323	

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ _____ / _____ / _____

8 Of the total number of miles you drove your vehicle during 2012, enter the number of miles you used your vehicle for:

a Business _____ b Commuting (see instructions) _____ c Other _____

9 Was your vehicle available for personal use during off-duty hours? Yes No

10 Do you (or your spouse) have another vehicle available for personal use? Yes No

11a Do you have evidence to support your deduction? Yes No

b If "Yes," is the evidence written? Yes No

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 20604Q Form **2106-EZ** (2012)

Note. Some tax preparation software packages may not perform this calculation. Thus, a manual calculation may be necessary. The \$1,323 amount shown on line 6 of Brad's Form 2106-EZ is correct. It reflects the application of the *Deason* rule.

2013 Workbook

For Example 44

SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Information about Schedule SE and its separate instructions is at www.irs.gov/form1040.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2012
Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040)

Brad Morrissey

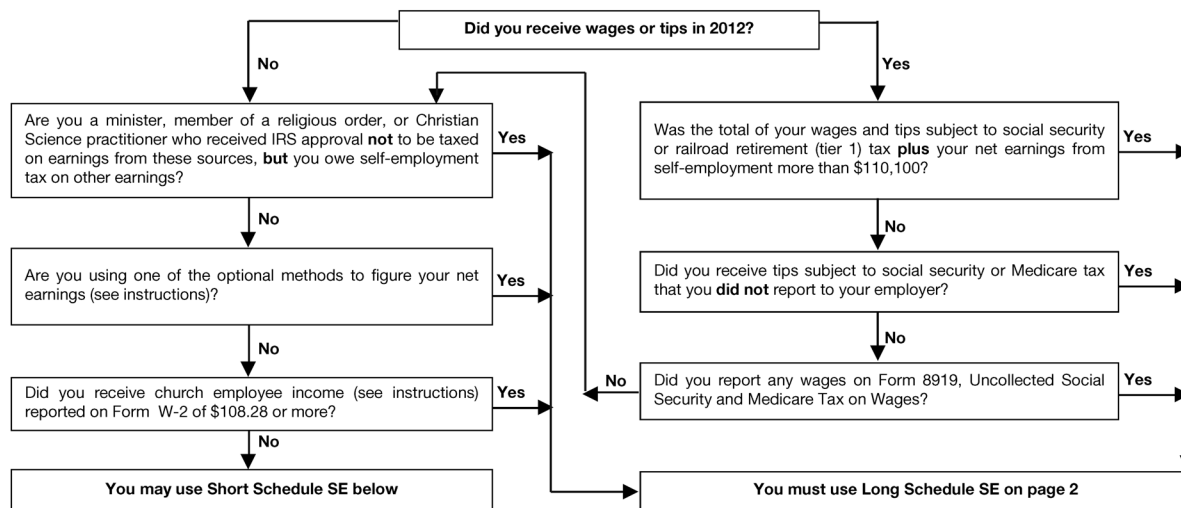
Social security number of person with self-employment income ▶

777-77-7777

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. **Caution.** Read above to see if you can use Short Schedule SE.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	()
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	49,400	
3 Combine lines 1a, 1b, and 2	3	49,400	
4 Multiply line 3 by 92.35% (.9235). If less than \$400, you do not owe self-employment tax; do not file this schedule unless you have an amount on line 1b ▶	4	45,621	
5 Self-employment tax. If the amount on line 4 is: • \$110,100 or less, multiply line 4 by 13.3% (.133). Enter the result here and on Form 1040, line 56, or Form 1040NR, line 54 • More than \$110,100, multiply line 4 by 2.9% (.029). Then, add \$11,450.40 to the result. Enter the total here and on Form 1040, line 56, or Form 1040NR, line 54	5	6,068	
6 Deduction for employer-equivalent portion of self-employment tax. If the amount on line 5 is: • \$14,643.30 or less, multiply line 5 by 57.51% (.5751) • More than \$14,643.30, multiply line 5 by 50% (.50) and add \$1,100 to the result. Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27	6	3,489	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2012

2013 Workbook

For Example 44

Form 1040	Department of the Treasury—Internal Revenue Service (99)	2012	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
For the year Jan. 1–Dec. 31, 2012, or other tax year beginning _____, 2012, ending _____, 20____				See separate instructions.
Your first name and initial Brad		Last name Morrissey		Your social security number 7 7 7 7 7 7 7 7
If a joint return, spouse's first name and initial		Last name		Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions. 786 Boylston Street			Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Portsmouth, NH 03803			Foreign country name	
Foreign province/state/country		Foreign postal code		Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse				
Filing Status	1 <input checked="" type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶ 4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child			
Check only one box.				
Exemptions	6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a b <input type="checkbox"/> Spouse			Boxes checked on 6a and 6b 1
If more than four dependents, see instructions and check here ▶ <input type="checkbox"/>	c Dependents:		(2) Dependent's social security number	(3) Dependent's relationship to you
	(1) First name	Last name		(4) <input type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
d Total number of exemptions claimed				1
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2 8a Taxable interest. Attach Schedule B if required b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required b Qualified dividends 9b 10 Taxable refunds, credits, or offsets of state and local income taxes 11 Alimony received 12 Business income or (loss). Attach Schedule C or C-EZ 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/> 14 Other gains or (losses). Attach Form 4797 15a IRA distributions 15a b Taxable amount 15b 16a Pensions and annuities 16a b Taxable amount 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 18 Farm income or (loss). Attach Schedule F 19 Unemployment compensation 20a Social security benefits 20a b Taxable amount 20b 21 Other income. List type and amount _____ 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶			7 44,900 8a 9a 10 11 12 13 14 15b 16b 17 18 19 20b 21 22 44,900
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.				
If you did not get a W-2, see instructions.				
Enclose, but do not attach, any payment. Also, please use Form 1040-V.				
Adjusted Gross Income	23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 3,489 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN ▶ 31a 32 IRA deduction 32 33 Student loan interest deduction 33 34 Tuition and fees. Attach Form 8917 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 3,489 37 Subtract line 36 from line 22. This is your adjusted gross income ▶			36 3,489 37 41,411
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.				Cat. No. 11320B Form 1040 (2012)

2013 Workbook

For Example 44

Form 1040 (2012)		Page 2
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38 41,411
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$5,950 Married filing jointly or Qualifying widow(er), \$11,900 Head of household, \$8,700	39a Check <input type="checkbox"/> You were born before January 2, 1948, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1948, <input type="checkbox"/> Blind. } checked ▶ 39a	
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>	
	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 9,426
	41 Subtract line 40 from line 38	41 31,985
	42 Exemptions. Multiply \$3,800 by the number on line 6d.	42 3,800
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43 28,185
	44 Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election	44 3,791
	45 Alternative minimum tax (see instructions). Attach Form 6251	45
	46 Add lines 44 and 45 ▶	46 3,791
	47 Foreign tax credit. Attach Form 1116 if required	47
	48 Credit for child and dependent care expenses. Attach Form 2441	48
	49 Education credits from Form 8863, line 19	49
	50 Retirement savings contributions credit. Attach Form 8880	50
	51 Child tax credit. Attach Schedule 8812, if required	51
	52 Residential energy credits. Attach Form 5695	52
53 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53	
54 Add lines 47 through 53. These are your total credits	54	
55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶	55 3,791	
Other Taxes	56 Self-employment tax. Attach Schedule SE	56 6,068
	57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 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	60
	61 Add lines 55 through 60. This is your total tax ▶	61 9,859
Payments	62 Federal income tax withheld from Forms W-2 and 1099	62
If you have a qualifying child, attach Schedule EIC.	63 2012 estimated tax payments and amount applied from 2011 return	63 10,000
	64a Earned income credit (EIC)	64a
	b Nontaxable combat pay election 64b	64b
	65 Additional child tax credit. Attach Schedule 8812	65
	66 American opportunity credit from Form 8863, line 8	66
	67 Reserved	67
	68 Amount paid with request for extension to file	68
	69 Excess social security and tier 1 RRTA tax withheld	69
	70 Credit for federal tax on fuels. Attach Form 4136	70
	71 Credits from Form: a <input type="checkbox"/> 2439 b <input checked="" type="checkbox"/> Reserved c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885	71
72 Add lines 62, 63, 64a, and 65 through 71. These are your total payments ▶	72 10,000	
Refund	73 If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid	73 141
	74a Amount of line 73 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/>	74a 141
Direct deposit? See instructions.	b Routing number ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	d Account number	
	75 Amount of line 73 you want applied to your 2013 estimated tax ▶ 75	75
Amount You Owe	76 Amount you owe. Subtract line 72 from line 61. For details on how to pay, see instructions ▶	76
	77 Estimated tax penalty (see instructions)	77
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No	
	Designee's name ▶	Phone no. ▶
	Personal identification number (PIN) ▶	
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	
Joint return? See instructions. Keep a copy for your records.	Your signature	Date
	Spouse's signature. If a joint return, both must sign.	Date
	Your occupation Minister	Daytime phone number 603-544-4321
	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)	
Paid Preparer Use Only	Print/Type preparer's name Clarissa Covington	Preparer's signature
	Date	Check <input type="checkbox"/> if self-employed
	PTIN P12345678	
	Firm's name ▶ Clarissa's Tax Service	Firm's EIN ▶ 38-1234567
	Firm's address ▶ 381 Strawberry Bank Drive, Portsmouth, NH 03803	Phone no. 603-555-5555

2013 Workbook

For Example 44

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at www.irs.gov/form1040.
▶ Attach to Form 1040.

OMB No. 1545-0074

2012

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

Brad Morrissey

777-77-7777

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see instructions)	1		
2	Enter amount from Form 1040, line 38 2	2		
3	Multiply line 2 by 7.5% (.075)	3		
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		0
Taxes You Paid	5 State and local (check only one box):			
	a <input type="checkbox"/> Income taxes, or	5	531	
	b <input checked="" type="checkbox"/> General sales taxes			
6	Real estate taxes (see instructions)	6	3,200	
7	Personal property taxes	7		
8	Other taxes. List type and amount ▶	8		
9	Add lines 5 through 8	9		3,731
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10	5,200	
	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11		
	12 Points not reported to you on Form 1098. See instructions for special rules	12		
	13 Mortgage insurance premiums (see instructions)	13		
	14 Investment interest. Attach Form 4952 if required. (See instructions.)	14		
	15 Add lines 10 through 14	15		5,200
Gifts to Charity	16 Gifts by cash or check. If you made any gift of \$250 or more, see instructions.	16		
	17 Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500	17		
	18 Carryover from prior year	18		
	19 Add lines 16 through 18	19		0
Casualty and Theft Losses	20 Casualty or theft loss(es). Attach Form 4684. (See instructions.)	20		0
Job Expenses and Certain Miscellaneous Deductions	21 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶	21	1,323	
	22 Tax preparation fees	22		
	23 Other expenses—investment, safe deposit box, etc. List type and amount ▶	23		
	24 Add lines 21 through 23	24	1,323	
	25 Enter amount from Form 1040, line 38 25 41,411	25		
	26 Multiply line 25 by 2% (.02)	26	828	
	27 Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-	27		495
Other Miscellaneous Deductions	28 Other—from list in instructions. List type and amount ▶	28		0
Total Itemized Deductions	29 Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40	29		9,426
	30 If you elect to itemize deductions even though they are less than your standard deduction, check here <input type="checkbox"/>	30		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 17145C

Schedule A (Form 1040) 2012

5

SELF-EMPLOYED MINISTERS

Ministers who are categorized as **self-employed independent contractors** under the right-of-control test may have various sources and types of SE income that are subject to SE tax. Compensation for self-employed ministers includes the following.

- Fees and payments made to the clergy member for ministerial services, such as offerings for the performance of marriages, baptisms, funerals, and masses (**but not such payments made to a church or religious organization**)
- Payments received from churches or other parties for speaking engagements
- Royalties from the sale of books or the writing of articles

Amounts that are **not** considered compensation for SE tax purposes include the following.

- Amounts contributed by the clergy member to a church retirement annuity plan that are not included in income
- Pension payments or retirement allowances for past services, even if part of the pension or allowance is for housing or utilities
- Gifts from individual congregation members that are not fees for performing ministerial services unless it is understood that these gifts are part of the clergy member's compensation

Tax Reporting for Self-Employed Ministers

Generally, a minister is self-employed if the minister is not in any common law employment relationship with an employing organization and receives fees or payments for services.

Example 45. Reverend Norma, an ordained minister, works out of her home. Throughout the year, she receives fees from persons who hire her to officiate weddings and conduct funerals. Because Norma is also educated and licensed in social work, she maintains her own marriage counseling practice. She also earns fee income from freelance writing, which includes a regular monthly article she writes for a magazine published by a large local church. She receives Forms 1099-MISC from parties who pay her over \$600.

Norma is a self-employed taxpayer. She reports her income on Schedule C, on which she claims her business expenses, such as travel, lodging, advertising, and depreciation on business assets. As a self-employed taxpayer, she also files Form 8829, *Expenses for Business Use of Your Home*, to claim her deductible home office expenses.

The deductions of self-employed ministers are not subject to the limitations that exist on deductions for dual-status ministers. The dual-status minister must file as a common law employee and is limited to deducting only those expenses that qualify as employment business expenses. The dual-status minister is also required to itemize such expenses on Schedule A, and these expenses are generally subject to the 2%-of-AGI floor.

If the IRS has approved an SE tax exemption for the self-employed minister, the SE exemption applies on income from any activity in the exercise of a ministry.

Example 46. Use the same facts as **Example 45**. Although Norma's income from writing church magazine articles and from officiating weddings and conducting funerals constitutes work "in the exercise of a ministry," it can be argued that her marriage counseling practice and perhaps other freelance writing projects are activities that do not fall into this category. Therefore, these other activities are not exempt from SE tax.

Note. A minister may be treated as a dual-status minister with respect to their work for a church or other organization **and** as a self-employed independent contractor in connection with other sources of income earned outside that common-law employment arrangement. These other sources of income may include fees for speaking and royalties from book sales and writing articles.

TAX REPORTING SUMMARY FOR SELF-EMPLOYED AND DUAL-STATUS MINISTERS

The following table summarizes the differences in reporting for dual-status and self-employed clergy members.

	Dual-Status Minister	Self-Employed Clergy Member
Church or organization reporting of payments	Form W-2 with nothing in boxes 3,4,5, or 6 due to the application of SE tax on the minister Nothing in box 2 for income tax withholding unless the minister has agreed to voluntary tax withholding by the employer	Schedule 1099-MISC (for payments received over \$600)
Clergy member reporting	Form 1040 with W-2 Must pay SE tax on net earnings if not exempt from SE tax	Form 1040 with Schedule C Must pay SE tax on net earnings if not exempt from SE tax
Clergy member expense deductions	Limited to expenses incurred in carrying on the trade or business of being employed Reported on Form 2106 or 2106-EZ and itemized on Schedule A, subject to the 2%-of-AGI floor Total amount allowed against income subject to SE tax	Any ordinary, reasonable, and necessary expense incurred in connection with the trade or business of ministry work Reported on Schedule C and deducted against SE income
Tax Payments	Estimated tax payments made unless employer withholds tax due to voluntary election by minister ²¹²	Estimated tax payments if necessary

MINISTERS IN NON-MINISTRY WORK

Some ministers perform work activities that are not considered “in the exercise of a ministry.” Their remuneration is therefore not considered SE income. If the minister is working within a common law employment situation, income tax and FICA withholding apply to their remuneration. Some specific common law employee situations for ministers have been addressed by the IRS through revenue rulings.

Note. There are countless fact patterns and circumstances within which a minister can perform work services. The following represents a brief summary of the existing IRS guidance in connection with situations in which a minister’s remuneration does not constitute SE earnings and therefore the minister cannot “opt out” of the applicable SE tax.

²¹² IRC §3402(p)(3).

Ministers as Teachers and Administrators

Universities that are not religious organizations may have a seminary that operates as a department of the university. A minister working as a teacher or administrator with duties not involving any ecclesiastical functions and who has not been assigned to their post by religious superiors is not performing services in the exercise of a ministry. This remuneration is subject to income tax and FICA withholding.²¹³ The same tax treatment applies to ministers who teach in other subject areas at schools, universities, and colleges.

Example 47. Pastor Steve teaches organic chemistry at Greater Midland University. Greater Midland University is not a religious organization. Pastor Steve is hired by the university and is not posted there by a church superior. Pastor Steve also conducts weddings and funerals for friends and relatives and receives income for these services.

Pastor Steve's income from university teaching is not considered SE income because the teaching is not a service in the exercise of his ministry. His university remuneration is subject to income tax and FICA withholding. However, the income Pastor Steve earns from conducting weddings and funerals is income from services in the exercise of his ministry and constitutes SE income. Pastor Steve can opt out of paying SE tax on this income if he files the application for exemption (Form 4361) within the required time.

Ministers as Government Employees

Even if a minister's actual work activity involves conducting religious worship and sacerdotal functions, that minister's work activity is not considered in the exercise of their ministry if they are employed by one of the following.

- The United States, any state, or the District of Columbia
- A U.S. territory or possession
- A foreign government

The remuneration of such ministers is subject to income tax and FICA withholding.²¹⁴

Example 48. Maura is a member of a religious order. She has taken a vow of poverty and works as a chaplain in the U.S. Army. Her order requires her to serve in the Army and she is required to turn over her earnings to the order. Her Army pay is subject to income tax and FICA withholding, and she cannot opt out.²¹⁵

Ministers Working in Industry

A minister who works in private industry as a counselor to a firm's employees to assist them with personal problems is not working in the exercise of a ministry. Income tax and FICA withholding apply to the minister's remuneration.

Example 49. Pastor Bob is an ordained minister who resigned from his position as minister of South End Church in order to pursue full-time work at Diversified Plastics and Plasma Cutting, Inc. Bob works at Diversified Plastics as Human Relations Director. He serves as employee counselor and provides assistance and advice to employees on their personal problems and work-related issues. Bob was hired by Diversified Plastics and was not posted there by any church superior. Bob's work is not in the exercise of his ministry and therefore his remuneration is not considered SE income. He cannot opt out of social security and Medicare. His paychecks have income, social security, and Medicare taxes deducted.²¹⁶

²¹³ Rev. Rul. 58-550, 1958-2 CB 274.

²¹⁴ Treas. Reg. §31.3401(a)(9)-1(c)(3).

²¹⁵ Based on Rev. Rul. 79-132, 1979-1 CB 62, amplifying Rev. Rul. 77-290, 1977-2 CB 26.

²¹⁶ Based on Rev. Rul. 71-337, 1971-2 CB 342.

Ministers Working Overseas

Ministers who work outside the United States may exclude their compensation from foreign sources if they meet the requirements of the **foreign earned income exclusion (FEIE)**.²¹⁷ However, even if they can exclude this foreign income, they must still include that income for SE tax purposes.²¹⁸

Note. For further details on the FEIE, see the International Taxation chapter in the 2011 *University of Illinois Federal Tax Workbook*.

Therefore, ministers working outside the United States and performing services in the exercise of a ministry are normally subject to SE tax on their earnings. However, the United States currently has in place several totalization agreements with various foreign countries. This makes the minister subject only to either U.S. social security or the prevailing similar social security program of the foreign country. Accordingly, the minister working overseas may not be subject to SE tax under an applicable totalization agreement.

Note. For further information on the totalization agreements in effect between the United States and various foreign countries, see IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

MINISTERS WHO HAVE TAKEN A VOW OF POVERTY

Religious order members who have taken a vow of poverty are automatically exempt from SE and FICA taxes in connection with services performed in the exercise of any duties required by the order.²¹⁹ As long as the services are directed or required by an ecclesiastical superior, those duties fall within this exemption regardless of their nature or extent.²²⁰ If the member performs services outside those required by the order or directed by a superior, the member's earnings are subject to either SE taxes (if the earnings are from self-employment) or FICA taxes (if the earnings are from a common law employee situation). The member may be entitled to a charitable deduction for the wages turned over to the order.²²¹

Note. Religious order members who have not taken a vow of poverty are subject to SE tax on remuneration for services performed in the exercise of a ministry.²²² Form 4361 may be filed to provide an exemption from the SE tax, as discussed earlier.

The member's earnings from the performance of duties required by the order are considered to be earnings of the order, not the member.

²¹⁷ IRC §911.

²¹⁸ IRC §1402(a)(8).

²¹⁹ IRC §§1402(c), 3121(b)(8)(A).

²²⁰ Treas. Reg. §§31.3121(b)(8)-1(d), 31.3401(a)(9)-1(d).

²²¹ IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

²²² *Ibid.*

Special Election Available to Religious Orders

An order may elect to have its members who have taken the vow of poverty covered by FICA in order to participate in the social security program. The order makes this election by filing Form SS-16, *Certificate of Election of Coverage Under the Federal Contributions Act*. This election provides social security and Medicare participation for members of the religious order who:

- Are under a vow of poverty,
- Perform services usually required of an active member of the order, and
- Are not considered retired due to age or total disability.²²³

Note. Further details on the procedure and requirements for this election are found in Treas. Reg. §31.3121(r)-1.

RETIRED MINISTERS

Several special tax rules continue to apply to a minister after retirement, particularly in connection with the receipt of a post-retirement parsonage allowance and the calculation of SE tax with respect to retirement income.

Post-Retirement Parsonage Allowance

A retired minister may continue to exclude either the FRV (plus utilities costs) of a furnished residence or a rental allowance paid by a church as part of compensation for past duties as a minister.²²⁴ These exclusions are subject to the same limitations and rules as those applicable to working ministers.

In addition, a retired minister may exclude from income that portion of a pension payment designated as a rental allowance by the religious denomination's national governing body that has complete control over the pension fund.²²⁵ However, this amount is not excludable from income as a rental allowance if paid to the minister's widow.²²⁶

Pension Payments and SE Tax Liability

Pension payments from a church plan or retirement allowance payments made to a retired minister do not form a part of earnings for SE tax purposes and are therefore exempt from SE tax.²²⁷ Similarly, the IRS has ruled that although IRA contributions made by a minister are tax deductible, the amount of the contribution does not reduce SE earnings.²²⁸

SE Tax and Retirement Funding. Employer contributions to an annuity plan for a minister are excluded from the minister's SE earnings and are therefore exempt from SE tax to the extent that the amount is excludable from income under IRC §403(b). This exclusion applies even if the minister agrees to a salary reduction in exchange for the annuity contribution.²²⁹

²²³ Form SS-16 Instructions.

²²⁴ Rev. Rul. 63-156, 1963-2 CB 79.

²²⁵ Rev. Rul. 62-117, 1962-1 CB 87.

²²⁶ Rev. Rul. 72-249, 1972-1 CB 36.

²²⁷ IRC §1402(a)(8).

²²⁸ Rev. Rul. 78-6, 1978-1 CB 273.

²²⁹ Rev. Rul. 68-395, 1968-2 CB 375.

TRANSPORTATION WORKERS

This section describes several special rules that apply to workers in the transportation industry. A taxpayer is in the transportation industry if that taxpayer's work:

- Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck; and
- Regularly requires the individual to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal rates.²³⁰

Example 50. Kelly is a certified marine engineer. Kelly is licensed by the U.S. Coast Guard and is employed by Oceanic Enterprises Maritime Company (OEMC) as chief engineer aboard its tugboats. All work she performs for OEMC is done while she is away from her residence. Her work includes training, sailing from port to port, and performing repairs and maintenance on OEMC ships while they are docked in various ports. The most frequent port-to-port routes she travels for OEMC involve several ports that are within 90 miles of her residence. However, she also sails routes involving far more distant U.S. ports. For a more distant departure port, she arrives the day before departure and lodges in a hotel before departing the next morning. Kelly is a transportation worker and is entitled to use the special transportation worker tax rules for which she qualifies.²³¹

5

GENERAL TAX RULES FOR DEDUCTIBLE TRAVEL EXPENSES

Generally, tax rules allow any employee or self-employed taxpayer to deduct ordinary and necessary business-related expenses, including expenses for travel and transportation. Temporary **travel away from home** for business purposes may result in deductible travel expenses.

“Travel away from home” occurs if:

- The taxpayer has job duties that require them to be away from the general area of the taxpayer's “**tax home**” substantially longer than an ordinary day's work, and
- The taxpayer needs to sleep or rest to meet the job demands of assigned work while away from home.

For a travel expense to be deductible, the taxpayer need not be away from home for an entire day, or even from dawn to dusk, as long as relief from job duty is long enough to obtain necessary rest or sleep.

Tax Home

“Tax home” is the regular post of duty or regular place of business, without regard to the location of the taxpayer's family home. Typically, it is easy to determine the location of the taxpayer's tax home for travel expense deduction purposes. However, this determination can be difficult if there is more than one place of business or if there is no main place where the taxpayer executes job or business duties.

More Than One Post of Duty. If more than one place of business exists, the tax home is the main place of business. If more than one post of duty or place of business exists, the following three factors are considered in order to determine which is the main place of business and therefore the taxpayer's tax home.

1. The total time ordinarily spent in each location
2. The level of business or job activity in each location
3. Whether a significant amount of income is earned at each location

²³⁰ IRS Pub. 17, *Your Federal Income Tax*.

²³¹ Based on *Kelly Lynn Madsen v. Comm'r*, TC Summ. Op. 2010-151 (Oct. 7, 2010).

No Main Place of Job or Business. If the taxpayer has no main place of business, it is necessary to determine which of the following three factors applies to the taxpayer.

1. All business or job duties are performed in the area of the taxpayer's main home and the taxpayer uses that home for lodging while conducting business in that area.
2. The taxpayer has living expenses that are duplicated due to being away from that home on business.
3. The taxpayer:
 - a. Has not abandoned the area which is the taxpayer's historical place of lodging and claimed main home,
 - b. Has family members living at the main home, **or**
 - c. Often uses that home for lodging.

If all three factors apply to the taxpayer, the tax home is the taxpayer's residence. If no more than any two of the three factors apply, additional facts and circumstances of the taxpayer's situation must be considered to determine whether the taxpayer has a tax home. If only one of the three factors exists, the taxpayer is itinerant. The tax home of an itinerant taxpayer is wherever the taxpayer works, and travel expenses are not deductible.

Temporary or Permanent Job Assignment. Whether a taxpayer is away from the tax home may depend on whether a job assignment is temporary or permanent. If the taxpayer receives a new, permanent job assignment, the location of the permanent assignment becomes the taxpayer's new tax home. The taxpayer therefore cannot deduct any travel expenses while at that location. However, if the job assignment is **temporary**, the taxpayer maintains the original tax home location while away at the temporary job assignment. Travel expenses while at the temporary job post, which is away from the original tax home, may be deductible if they otherwise qualify.

A "temporary" job assignment is one that is expected to last (and in fact lasts) for a period of one year or less.

Tax Home for Transportation Workers. Because transportation workers often travel continuously and do not spend a significant period of time in a home office, determining the tax home of a transportation worker can be difficult. For transportation workers, the tax home is typically the terminal where the worker usually begins and ends trips. The IRS and the Tax Court have applied this notion to specific cases. Consider the following.

- A home terminal and surrounding vicinity was deemed to be the tax home for a long-haul truck driver.²³²
- The tax home of a train crew member is deemed to be where the crew member's trips begin and end.²³³
- The airport of departure is the tax home for airline employees.²³⁴

Example 51. Roger is an airline pilot employed with Airguide Airlines. His residence is in New York City, but all of his flights in connection with his employment with Airguide Airlines originate from Miami. Because Miami is Roger's regular post of duty, Miami is Roger's tax home. Roger's travel expenses incurred in the Miami area are not deductible because these expenses are not considered to be incurred in connection with travel away from home.²³⁵

Example 52. Assume the same facts as **Example 51**, except that, during the year, Airguide Airlines gives Roger a 1-month job assignment to handle flights from Tampa. The 1-month job assignment actually lasts 38 days, after which Roger returns to his regular post in Miami. Travel expenses incurred by Roger to remain in Tampa for the temporary job assignment are deductible because, during the temporary job assignment, Miami is still Roger's tax home.

²³² Rev. Rul. 55-236, 1955-1 CB 274.

²³³ Rev. Rul. 75-432, 1975-2 CB 60.

²³⁴ *R.E. Kennedy v. Comm'r*, TC Memo 1970-58 (Mar. 5, 1970).

²³⁵ See *R.O. Lagrone v. Comm'r*, TC Memo 1988-451 (Sep. 20, 1988).

Example 53. Assume the same facts as **Example 52**, except the temporary job assignment in Tampa ends up lasting for 14 months. Roger realistically expects the job assignment to last more than one year. Tampa becomes Roger's new tax home. His travel expenses incurred to remain in Tampa are not deductible because they are not considered to be expenses incurred "away from home."

Example 54. Use the same facts as **Example 53**, except Roger realistically expects the temporary job assignment to last 11 months. After 11 months, his employer advises him that he will remain on the temporary job assignment in Tampa for another five months before returning to his regular post in Miami. Because Roger realistically expected the temporary job assignment to last less than one year and he believed this for an 11-month period, his travel expenses for those 11 months are deductible.

A transportation worker without a home terminal who is working at a series of temporary job assignments may be able to establish a residence as a tax home if the residence is a regular place of abode in a real and substantial manner.

Example 55. Owen owns and maintains a residence where he resides with his wife and his adopted son. He is a locomotive engineer employed by MKT Railroad. Because Owen has a very junior position on the union seniority list, he does not work on one permanent route with the railroad. Instead, he obtains temporary route assignments lasting about one month each. He typically receives one day off per week, which he spends at his residence. In addition, any time off between job assignments is also spent at home. The job assignments are temporary in nature and Owen's residence is his tax home. He is therefore entitled to claim employment expenses incurred while away from his tax home working on these temporary route assignments.²³⁶

However, a transportation worker without a home terminal may be deemed an itinerant worker with no tax home and no ability to deduct employment travel expenses.²³⁷ Itinerant workers do not meet the "away from home" requirement because the place where they are working is always their tax home. Taxpayers who may fall in this category generally claim some place as their residence and tax home in an attempt to deduct expenses away from that tax home. However, the IRS indicates that a taxpayer who has no ascertainable place of employment or business is itinerant if they do not meet at least two of the three following tests.

1. The taxpayer performs a part of employment or business activity in the vicinity of the residence claimed and that residence is used for lodging during the performance of business or employment activities at that location.
2. The taxpayer's living expenses at the claimed residence are duplicated because of the performance of business or employment services while away from that claimed residence.
3. The taxpayer:
 - a. Has not abandoned the vicinity where a place of lodging and claimed residence have historically been located for the taxpayer,
 - b. Has one or more family members presently residing at the claimed residence, **or**
 - c. Uses the claimed residence for lodging.²³⁸

A taxpayer meeting all three of these tests is deemed to have a tax home. A facts and circumstances analysis is used for taxpayers meeting any two of the three tests. Taxpayers meeting none or only one of the tests are deemed itinerant.²³⁹

Example 56. A licensed minister travels across the United States in his recreational vehicle, conducting religious services during his journey across the country. He has no permanent home while traveling. He is not entitled to deduct travel expenses because he does not meet the "away-from-home" requirement.²⁴⁰

²³⁶ Based on *C.W. Todd v. Comm'r*, 3 TCM 1221 (Nov. 20, 1944).

²³⁷ *E. Barone v. Comm'r*, 85 TC 462 (1986); *W.J. McNeill v. Comm'r*, TC Memo 2003-65 (Mar. 6, 2003).

²³⁸ Rev. Rul. 73-529, 1973-2 CB 37.

²³⁹ *Ibid.*

²⁴⁰ *Boyd v. Comm'r*, TC Summ. Op. 2006-36 (Mar. 2, 2006).

TRAVEL AND MEAL EXPENSES

Taxpayers, including transportation workers, must adequately substantiate all travel expenses, including expenses for meals, before deducting them. Generally, the taxpayer is required to substantiate the following aspects of travel expenses.

- The **amount** of each separate travel expense (However, the cost of meals and other incidental expenses such as gas and oil or taxi fares can be aggregated if reasonably identified.)
- The **date** of the expense, including trip departure and return dates and number of days away from the tax home spent on job or business activities
- The **place** of travel (the name of the city or town or other similar designation will suffice)
- The **business purpose** of the trip or the nature of the business benefit expected as a result of the trip²⁴¹

Note. For more details on the substantiation requirements that apply to travel expenses and entertainment expenses, see Temp. Treas. Reg. §1.274-5T.

Limitations on Deduction of Meals

In order to be deductible, the cost of a meal must:

- Be incurred under circumstances when it is necessary to stop for substantial sleep or rest in order to perform job or business duties while traveling away from the taxpayer's tax home, or
- Be business-related entertainment.

In addition, the meal cannot be lavish or extravagant, and the taxpayer is limited to a deduction of 50% of the cost of the meal.

Special Limit for Transportation Workers. Certain transportation workers who are drivers are subject to the Department of Transportation's "hours of service" (HOS) limits.

Note. The HOS limits are rules promulgated by the Department of Transportation regulating the number of hours of work and rest for certain transportation workers for safety purposes. An up-to-date summary of the current rules and regulations and a summary of which drivers are subject to the HOS limits may be found at www.fmcsa.dot.gov/rules-regulations/topics/hos/index.htm.

For meal costs incurred during or incident to any period subject to these HOS limits, the transportation worker is entitled to claim **80%** of the cost of the meals instead of the usual 50% as noted in the previous section.

Options for Calculating the Deduction

To calculate the amount of the deduction for qualifying meals, the taxpayer can use either of the following methods.

- Actual cost method
- Standard meal allowance²⁴²

²⁴¹. Temp. Treas. Reg. §1.274-5T(b)(2).

²⁴². Treas. Reg. §1.274-5(j).

Under the **actual cost method**, the taxpayer bases the amount of the deduction on the actual amount expended for qualifying meals. The taxpayer must be able to substantiate the amount of that cost in addition to the other substantiation requirements noted earlier. The actual cost method can be used for meals and for **incidental expenses**. “Incidental expenses” include ancillary costs associated with travel, such as fees and tips and the costs of mailing receipts or other expense documentation. Incidental expenses do not include costs incurred for laundry, cleaning or pressing of clothing, lodging taxes, or telephone calls.

Under the **standard meal allowance method**, the taxpayer uses established, per diem rates (known as the “federal per diem rates”) for meals for travel within the contiguous United States (or “CONUS”). These rates are promulgated by the IRS as an alternative to using actual costs as shown on receipts or other documentation. Every October, the IRS issues a notice of the applicable rates that become effective October 1 and remain effective for one year after that date. There are meals and incidental expenses (M&IE) rates and rates for M&IE plus lodging. To the extent that the standard allowances are used, the taxpayer is deemed to have met the substantiation requirement as to the amount, but the taxpayer is still obligated to substantiate other factors such as the date, place, and business purpose as required by Temp. Treas. Reg. §1.274-5T.

Note. If the employee receives a per diem allowance that exceeds the standard rates, the excess must be included in the employee’s gross income. This excess amount is subject to federal income, social security, and Medicare taxation.

To assist the taxpayer with calculating appropriate deductions for meals and/or lodging, the IRS publishes tables for the taxpayer to use to find the proper per diem rates. These tables are found at www.gsa.gov/perdiem.

Note. Effective May 2012, IRS Pub. 1542, *Per Diem Rates*, has been discontinued. The website indicated above must be used to obtain updated amounts for 2013 onward.

The taxpayer using the tables may use either:

- The federal per diem rate method, or
- The high-low method.

Under the federal per diem rate method, the effective standard rates for the year commencing October 1, 2011, are \$77 per day for M&IE (\$123 per day for M&IE plus lodging) for those localities **not** specifically listed in the actual table. These amounts remain unchanged for the subsequent year commencing October 1, 2012.²⁴³ Locations specifically listed generally have higher applicable amounts.

Under the high-low method, the taxpayer can use rates in tables that divide localities into high cost and low cost areas. Under the high-low method, the standard high cost area rates for those localities listed in the IRS tables are \$65 for M&IE (\$242 for M&IE plus lodging). Areas not listed in the tables are the low cost areas for which a \$52 M&IE rate (\$163 for M&IE plus lodging) applies. These rates, effective for 2011, are also applicable for the year commencing October 1, 2012.²⁴⁴

In addition, the Department of Defense promulgates the federal per diem rates for travel outside the contiguous United States (OCONUS). This includes Alaska, Hawaii, and foreign travel.

Note. Updated CONUS rates are published each year and may be found at www.gsa.gov/portal/content/103168. OCONUS rates may be found at www.defensetravel.dod.mil/site/perdiemCalc.cfm.

²⁴³ IRS Notice 2012-63, 2012-42 IRB 496.

²⁴⁴ IRS Notice 2012-63, 2012-42 IRB 496. For the applicable rates for the previous year, see IRS Notice 2011-81, 2011-42 IRB 513.

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Because updated rates for the year are effective from October 1 to September 30 of the following year, the rates for the final three months of each year may differ from those that were in effect for the first nine months (January through September) of the year. There are special **transition rules** that must be used for taxpayers who have used the January-to-September rates for expense reimbursement purposes.

Note. Other rules on the use of the standard rates for meals and lodging may be found in Rev. Proc. 2011-47 and Rev. Proc. 2010-39.

The transition rules are discussed in IRS Pub. 1542. In addition, for the **departure date** and **return date**, the taxpayer may either:

- Deduct 75% of the standard meal allowance, or
- Prorate the standard meal allowance using any method that comports with reasonable business practice that is consistently applied.

Special Meal Rates for Transportation Workers

Transportation workers can use a special M&IE rate. The rates effective October 1, 2011, for the subsequent 12-month period, are as follows.²⁴⁵

CONUS meals	\$59 per day
OCONUS meals	\$65 per day

These rates remain unchanged for the 12-month period commencing October 1, 2012.²⁴⁶

Instead of using the IRS tables and determining the applicable standard rates for the various locations to which the transportation worker traveled, these special rates can be used by the transportation worker to simplify the calculation of a deduction. An employer that uses either of these special rates for an employee must use these rates for that employee consistently throughout the entire tax year.

Note. For further details on the deduction of travel expenses, including the special rules for transportation workers discussed in this section, see IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

MILITARY PERSONNEL

Several special tax rules apply to military personnel. This section covers special rules for military personnel applicable to the following issues.

- The combat pay income exclusion
- Other income exclusions
- The principal residence exemption
- Filing deadlines for returns and refund claims
- Combat zone tax forgiveness

Note. Other special tax rules applicable to military personnel may be found in the International Taxation chapter in the 2011 *University of Illinois Federal Tax Workbook*. In addition, some state tax benefits are available to military spouses under the Military Spouse Residency Relief Act.²⁴⁷

²⁴⁵ IRS Notice 2011-81, 2011-42 IRB 513.

²⁴⁶ IRS Notice 2012-63, 2012-42 IRB 496.

²⁴⁷ PL 111-97.

INCOME EXCLUSION FOR COMBAT PAY

Enlisted members, warrant officers, and commissioned warrant officers who serve in a combat zone can exclude the full amount of their compensation for the month if any part of that month was spent in a combat zone or qualified hazardous duty area.²⁴⁸ This exclusion applies even to those on active duty within a combat zone as noncombatants.

In addition to active duty pay for any month or part of a month served in a combat zone, enlisted members, warrant officers, and commissioned warrant officers may also exclude the following types of pay.

- Imminent danger or hostile fire pay
- A reenlistment bonus earned in a month served in a combat zone
- Accrued leave pay earned in any month served in a combat zone
- Pay received during a month in a combat zone for duties as an armed forces member in clubs, messes, and theaters
- Awards for suggestions, inventions, or scientific achievements from submissions made by the servicemember during a month served in a combat zone
- A student loan repayment if the entire year was served in a combat zone in order to earn the repayment amount (However, a partial year qualifies for a prorated exclusion based on the number of full or partial months in a combat zone.)

A **commissioned officer** is also entitled to an exclusion but the amount of income that can be excluded is limited to the maximum amount of income for an enlisted member. This maximum is the total of:

- The highest rate of basic pay for the month to any enlisted member of the armed forces at the highest pay grade applicable to enlisted members, plus
- Any hostile fire or imminent danger pay, if any, that is payable for the month to the commissioned officer.²⁴⁹

Combat Zone

A “combat zone” is an area designated by a presidential executive order as an area in which U.S. forces are engaging or have engaged in combat. The following areas are presently designated as combat zones.

Executive Order	Combat Zone Area
No. 13239	Afghanistan
No. 13119	Kosovo area, including Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and part of the Ionian Sea
No. 12744	Persian Gulf, including the Red Sea, Gulfs of Oman and Aden, part of the Arabian Sea and Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates

²⁴⁸. IRC §112.

²⁴⁹. IRC §112(b).

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Periods of Hospitalization. Income earned for any month or part of a month during which the servicemember is hospitalized as a result of wounds or disease from service in a combat zone also qualifies for the exclusion. The first two years of such hospitalization after combat zone activity ceases qualify under this rule.²⁵⁰ Hospitalization in either a U.S. or foreign hospital qualifies.

Note. For further details on current combat zones, see IRS Pub. 3, *Armed Forces' Tax Guide*, or www.irs.gov/newsroom/article/0,,id=108331,00.html. Taxpayers in a combat zone can email the IRS with filing or payment issues at combatzone@irs.gov.

Tax Reporting

Servicemembers receive a Form W-2, *Wage and Tax Statement*, in connection with the year's compensation. The military paymaster typically calculates the amount of exclusion, but it is advisable to confirm with the servicemember that the appropriate amount has been excluded.

The excludable combat pay amount is not reported as income on Form W-2, box 1. However, it is subject to social security and Medicare taxes. Accordingly, the amount is included in boxes 3 and 5. The amount of combat pay also is reported in box 12, designated with code "Q."

Note. If Form W-2, box 1, includes combat pay that should have been excluded, it is necessary to obtain a **corrected** Form W-2 from the appropriate finance office.

²⁵⁰ IRC §112(a)(2); Treas. Reg. §1.112-1(a)(2).

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Example 57. Corporal Robert Brigham is enlisted in the U.S. Army. He is married and has three dependent children. His family resides in Boston. During 2012, Robert was deployed in Afghanistan for the months of May and June as well as for the first two days of July. For the remainder of the year, he was in Boston. While in Afghanistan, he officially reenlisted with the Army and earned a \$500 reenlistment bonus. During the time he was deployed in Afghanistan, his monthly pay was \$2,500. Corporal Brigham's Form W-2 from Defense Finance and Accounting Services (DFAS) follows.

a Employee's social security number 345-67-8910		OMB No. 1545-0008 This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.				
b Employer identification number (EIN) 37-5656565		1 Wages, tips, other compensation 22000.00	2 Federal income tax withheld 2000.00			
c Employer's name, address, and ZIP code Defense Finance and Accounting Services 123 Main Street Cleveland, OH 44115		3 Social security wages 30000.00	4 Social security tax withheld 1260.00			
		5 Medicare wages and tips 30000.00	6 Medicare tax withheld 435.00			
		7 Social security tips	8 Allocated tips			
d Control number		9	10 Dependent care benefits			
e Employee's first name and initial Last name Suff. Robert Brigham 458 St. Botolph Street Boston, MA 02116		11 Nonqualified plans		12a See instructions for box 12 Q 8000.00		
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b		
		14 Other		12c		
				12d		
f Employee's address and ZIP code						
15 State MA	Employer's state ID number 37-5656565	16 State wages, tips, etc. 22000.00	17 State income tax 840.00	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2 Wage and Tax Statement**
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2012

Department of the Treasury—Internal Revenue Service

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Corporal Brigham's nontaxable combat pay consists of his monthly pay for each full or part month he spent in a combat zone. He was deployed in Afghanistan for the months of May and June. In addition, because he was in Afghanistan for the first two days of July, his pay for the entire month of July can likewise be excluded. He can also exclude from income the reenlistment bonus he earned because he reenlisted while in a combat zone. Therefore, his excludable combat pay is calculated as follows.

Compensation for May	\$2,500
Compensation for June	2,500
Compensation for July	2,500
Reenlistment bonus	<u>500</u>
Total excludable compensation	\$8,000

This excludable amount is shown on Corporal Brigham's Form W-2, box 12, with the code "Q" denoting this \$8,000 as nontaxable combat pay. Because this \$8,000 is not subject to federal income tax, it is not included in box 1. However, the \$8,000 nontaxable combat pay is subject to social security and Medicare tax and, accordingly, it is included in boxes 3 and 5.

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Special EIC Election

Even though combat pay is excluded for income tax purposes, the servicemember may elect to include combat pay as part of earned income for the year for earned income credit (EIC) purposes.²⁵¹ All nontaxable combat pay received in the year must be treated as earned income under this election. Spouses who each receive combat pay may make their own individual election.

Note. Treating nontaxable combat pay as earned income for EIC purposes can have the effect of either increasing or decreasing the taxpayer's EIC. Dual calculations should always be completed to determine whether it is beneficial to make the election.

Combat Pay and the Child Tax Credit

Nontaxable combat pay is included as earned income for purposes of computing the child tax credit (CTC).²⁵²

Example 58. Assume the same facts as **Example 57**. Corporal Brigham elects to include his nontaxable combat pay of \$8,000 as part of his earned income for the EIC. This \$8,000 is also taken into account as earned income for CTC purposes on Form 8812, *Child Tax Credit*. The following is the relevant portion of Corporal Brigham's Form 1040, page 2, indicating the election to include combat pay as earned income for the EIC.

Payments	62	Federal income tax withheld from Forms W-2 and 1099	62	2,000	01	
	63	2012 estimated tax payments and amount applied from 2011 return	63			
If you have a qualifying child, attach Schedule EIC.	64a	Earned income credit (EIC)	64a	4,012		
	b	Nontaxable combat pay election	64b	8,000		
	65	Additional child tax credit. Attach Schedule 8812	65	3,000		
	66	American opportunity credit from Form 8863	66			

The following portion of Form 8812 specifically indicates that the nontaxable combat pay is being taken into account as earned income for purposes of the additional child tax credit.

2	Enter the amount from Form 1040, line 62; Form 1040-EZ, line 33; or Form 1040-ES, line 40	2	3,000
3	Subtract line 2 from line 1. If zero, stop ; you cannot take this credit	3	3,000
4a	Earned income (see separate instructions)	4a	30,000
b	Nontaxable combat pay (see separate instructions)	4b	8,000
5	Is the amount on line 4a more than \$3,000? <input type="checkbox"/> No. Leave line 5 blank and enter -0- on line 6. <input checked="" type="checkbox"/> Yes. Subtract \$3,000 from the amount on line 4a. Enter the result	5	27,000
6	Multiply the amount on line 5 by 15% (.15) and enter the result Next. Do you have three or more qualifying children? <input type="checkbox"/> No. If line 6 is zero, stop; you cannot take this credit. Otherwise, skip Part III and enter the smaller of line 3 or line 6 on line 13. <input checked="" type="checkbox"/> Yes. If line 6 is equal to or more than line 3, skip Part III and enter the amount from line 3 on line 13. Otherwise, go to line 7.	6	4,050

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59761M

Schedule 8812 (Form 1040A or 1040) 2012

²⁵¹ IRC §32(c)(2)(B)(vi).

²⁵² IRC §24(d)(1).

OTHER INCOME EXCLUSIONS

Military personnel receive various types of income in the form of allowances or reimbursements that also qualify for exclusion from gross income for federal tax purposes.²⁵³ If the servicemember receives an in-kind benefit instead of receiving an allowance or reimbursement, the value of the in-kind benefit is similarly excludable. Some examples follow.

Description of Allowance or Reimbursement	Example
Living allowances	<ul style="list-style-type: none"> • Basic allowance for housing (BAH) • Basic allowance for subsistence (BAS) • Overseas housing allowance (OHA)
Moving expense allowances or reimbursements	<ul style="list-style-type: none"> • Moving household and personal items • Moving trailers or mobile homes • Storage costs • Temporary lodging and temporary lodging expenses
Death allowances	<ul style="list-style-type: none"> • Burial costs • Death gratuity payments • Travel costs of dependents to burial site
Other	<ul style="list-style-type: none"> • Uniform allowances • Standby travel on government aircraft • Legal services • Commissary and exchange discounts

Note. Further details on the types of allowances or reimbursements that are excludable can be found in IRS Pub. 3, *Armed Forces' Tax Guide*.

PRINCIPAL RESIDENCE EXEMPTION

The principal residence rules are modified for military personnel. Generally, the rules regarding the exclusion of gain from the sale of a principal residence provide for exclusion of the full amount of gain up to a maximum amount of \$250,000 for a single taxpayer or \$500,000 for MFJ taxpayers. To qualify, the taxpayer must meet the following ownership and use tests.

- The taxpayer must **own** the residence for a period (or aggregate periods) of two years out of the past five years.
- The taxpayer must **use** the residence for a period (or aggregate periods) of two years out of the past five years.²⁵⁴

The 5-year period used in these tests is the 5-year period that ends on the sale date of the principal residence.

Note. For additional guidance on the ownership and use tests, see Treas. Reg. §1.121-1. For guidance on taxpayers who do not meet the ownership and use tests but nevertheless may qualify to exclude part of the gain on the sale of a principal residence, see Treas. Reg. §1.121-3.

²⁵³ IRC §134.

²⁵⁴ IRC §121(a).

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These rules are modified for military personnel. Military personnel can elect to suspend the 5-year period during which the 2-year ownership and use tests must be met.²⁵⁵ The suspension is only available while either the servicemember or spouse is on **qualified extended duty. The maximum extension period is 10 years.**²⁵⁶ “Extended duty” exists when the taxpayer is called to active duty for a period of more than 90 days or for an indefinite period.²⁵⁷ “Qualified extended duty” means any extended duty while either:

- Serving at a duty station at least 50 miles away from the taxpayer’s residence, **or**
- Living in government quarters under government orders.

Example 59. Captain Adamson purchased a home in Vermont on January 1, 1999. She lives in the home for all of 1999, 2000, and 2001. From January 1, 2002, through 2010, she is on qualified extended duty in South Korea. She sells her home in Vermont in 2011. Captain Adamson can make an election so that the nine years in South Korea are not counted as part of the 5-year period in connection with the use test. With the election, the applicable 5-year period is 1997 through 2001. During this 5-year period, Captain Adamson meets the ownership and use tests for more than two years. She can use up to the maximum \$250,000 exclusion of gain on the sale of her home in 2011.

FILING DEADLINES

The normal April 15 filing deadline for military personal is extended by at least 180 days beyond any of the following periods, if applicable.

- Any period of service in a combat zone
- Any period of hospitalization outside the United States as a result of combat zone service
- Any period of hospitalization in the United States due to combat zone service up to a maximum of five years

If there was unexpired time before the normal filing deadline when the taxpayer entered the combat zone, the filing deadline is extended by the unexpired time.²⁵⁸

Note. This filing extension applies to the filing of tax returns, the payment of income tax, and the filing of a claim for refund or credit.²⁵⁹

The spouse of a combat zone servicemember is also granted an extension. The spousal extension, however, does not apply to tax years beginning more than two years after the date that combat ceased in the zone where the servicemember was stationed.²⁶⁰ The period of U.S. hospitalization of the servicemember does not add to the spousal extension.²⁶¹

Servicemembers who are missing, missing in action, detained in a foreign country against their will, or captured at the time a tax return is due are also provided with other, separate filing deadlines.²⁶²

²⁵⁵ IRC §121(d)(9).

²⁵⁶ IRC §121(d)(9)(B).

²⁵⁷ IRS Pub. 3, *Armed Forces’ Tax Guide* (2012), p. 12.

²⁵⁸ Rev. Rul. 76-425, 1976-2 CB 447.

²⁵⁹ IRC §7508.

²⁶⁰ IRC §7508(c).

²⁶¹ IRC §7508(g).

²⁶² 5 USC §5568.

COMBAT ZONE TAX FORGIVENESS

The full amount of federal tax liability is forgiven for military personnel who die while serving in a **combat zone** or if death occurs as a result of wounds, disease, or injury incurred while serving in a combat zone.²⁶³ This forgiveness further applies to all tax liability in connection with the year of death.²⁶⁴ Forgiveness also extends to all tax liability for any prior year that ends on or after the first day of combat zone service.²⁶⁵ Furthermore, any amounts of tax liability that remain unpaid for any prior tax year ending before the commencement of combat service are canceled.²⁶⁶

Example 60. Sergeant Colburn owes \$3,600 of income taxes in arrears. Of this amount, \$2,000 is attributable to the 2007 tax year and the remaining \$1,600 is attributable to 2008. The last tax return he filed was for the 2009 tax year on which he reported his military pay and the amount of tax withheld. There was no amount owed or refundable for 2009.

Sergeant Colburn begins serving in the Iraq combat zone on December 28, 2010. He served continuously in Iraq until his death in the line of duty on March 19, 2012. The tax forgiveness rule applies to the 2010, 2011, and 2012 tax years due to Sergeant Colburn's combat zone activity. Sergeant Colburn's surviving spouse, personal representative, or administrator must file returns for 2010, 2011, and 2012 to claim tax forgiveness for those years. In addition, although his 2009 return and corresponding tax paid will stand, the amounts owed for 2007 and 2008 in the total amount of \$3,600 will be forgiven.

Tax forgiveness also is provided on amounts that would have been included in the decedent's gross income in the year of death but that are received after death by another person or the servicemember's estate.²⁶⁷

Tax forgiveness is also available for military personnel who die from wounds or injury in a **terrorist action**. In the case of death from terrorist action, tax forgiveness extends to:

- The tax year of death, and
- Any earlier tax year in the period beginning with the year immediately prior to the year in which the wounds or injury occurred.

Example 61. Chief Warrant Officer Kelsey died in 2012 from wounds he incurred in a terrorist attack in 2011. His full income tax liability is forgiven for 2010, 2011, and 2012.

Returns and claims for refunds must be properly identified. On Forms 1040 and 1040X, this is done by indicating the appropriate identifier at the top of page 1 of the return or refund claim and on the line for total tax. Identifiers include "Iraqi Freedom — KIA" or "Enduring Freedom — KIA." The identifier for death from a terrorist act is "KITA."

²⁶³ Treas. Reg. §1.692-1(a)(ii).

²⁶⁴ IRC §692(a)(1).

²⁶⁵ Ibid.

²⁶⁶ Treas. Reg. §1.692-1(a)(3).

²⁶⁷ Treas. Reg. §1.692-1(a)(2)(ii).

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Generally, the following documents must accompany all returns and refund claims.

- Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer* (However, this form is not required if the surviving spouse is filing an original or amended joint return or if a personal representative is filing an original return.)
- A copy of the court certificate of appointment of a personal representative, if such a representative exists
- A Department of Defense certification (DD Form 1300) of the decedent's name, social security number, date of injury, date of death, and a statement that death occurred as a result of military or terrorist action

Note. The required documents to be attached to a return or refund claim may vary depending on the particular circumstances. Rev. Proc. 2004-26²⁶⁸ outlines the procedures, which are more generally outlined in IRS Pub. 3, *Armed Forces' Tax Guide*.

Limitations Period

A refund claim should be filed in connection with prior tax years in which tax has been paid and the forgiveness rule applies. As a general rule, a refund claim must be filed within three years from the date the return is filed or two years from the time the tax is paid, whichever is later.²⁶⁹ Although this general limitations rule applies to tax forgiveness, the deadline for filing a refund claim may be extended by service in a combat zone as discussed earlier in this section.²⁷⁰

If a representative of a decedent who died in a combat or terrorist act does not have enough tax information to file a timely claim for refund, the limitations period can be stopped by filing Form 1040X along with Form 1310 and any other required documentation. A statement must accompany the filing indicating that an amended claim will be filed as soon as the additional required information becomes available. This must be sent to the appropriate IRS address.

Joint Tax Liability

If a joint return has been filed, only the deceased servicemember's taxes are forgiven and not those of the spouse. Treas. Reg. §1.692-1(b) provides the method for allocating the tax liability between spouses. Separate tax liability is calculated for each spouse. The amount of tax liability attributable to the decedent spouse is calculated according to the following formula.

$$\text{Tax liability attributable to decedent spouse} = \text{Joint tax liability} \times \frac{\text{Decedent's separate tax liability}}{\text{Total of separate tax liabilities of each spouse}}$$

²⁶⁸ Rev. Proc. 2004-26, 2004-1 CB 890.

²⁶⁹ IRC §6511(a).

²⁷⁰ IRC §7508(a)(1)(E).