

**California
Educational Studies**

**INDIVIDUAL
INCOME TAX**

20-Hour

2010 Edition

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CALIFORNIA EDUCATIONAL STUDIES

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All our study courses are approved by The California Tax Education Council, and the 30-hour courses are also approved by the state of Oregon.

The objective of this course is to provide tax practitioners with:

- A continuing education,
- The most recent tax changes,
- A better ability to prepare accurate tax returns,
- An affordable pricing,
- An opportunity to study at their own pace, time and place,
- The convenience to study at home or office without traveling,
- A concise and easy-to-read study guide for quick reference.

Upon completion of a 20-hour course, you will receive continuing education credit of 15 federal hours and 5 California hours. For a 60-hour course, you will receive 45 federal hours and 15 California hours. For a 30-hour course, you will receive 30 federal hours and no state hours.

For California tax preparers, your examination results will be reported to CTEC electronically online. You will be able to register online in about seven working days upon receipt of your certificate. It does not mean you are registered with CTEC. This is simply for your convenience to complete the registration online rather than by mail.

To register online with www.ctec.org, you will need the following information:

- Personal information (including Social Security Number)
- \$5,000 tax preparer bond
- Visa or MasterCard

To register by mail, please include the following:

- A copy of your course completion certificate
- Complete a current “renewal” or “New preparer” application available on CTEC website: www.ctec.org.
- A copy of your \$5,000 tax preparer bond
- A \$25 check, cashier’s check or money order payable to CTEC.

Registration for new preparers begins November 1st each year. If you register prior November 1st, you will have to complete a 20-hour course by October 31. You have 18 months from the completion date stated on your certificate to register with CTEC, otherwise you will be required to retake the full 60 hours of qualifying education. After your initial registration, you must complete the renewal requirements (including 20 hours of continuing education) by October 31st of each year thereafter.

The State of California authorizes bonded CTEC-registered tax preparers to prepare or assist with preparation of tax returns. CTEC is a non-profit organization required by state law to register tax preparers in the State of California only after they have met and continue to meet the state-mandated education requirements for becoming a tax preparer.

You must successfully complete a CTEC-approved 60-hour, qualifying education course in order to be “registered”, and must successfully complete 20 hours of CTEC-approved continuing education each year thereafter to remain “registered”. At least 12 of those hours must be in Federal taxes, and at least 4 hours in California. The remaining four hours can be in Federal or California taxes. You must be at least 18 years old to become a CTEC-registered tax preparer.

Must Read Before You Call.

(May save you time and money)

- ◆ **There are two tests. Each test has 100 questions.**
- ◆ **Use dark ink pen to mark your answers on the answer sheet provided.**
- ◆ **You must return the original answer sheet. Photocopies are not accepted.**
- ◆ **In order to renew online, CTEC requires your CTEC registration number, and you must write that number on the front cover of this final examination.**
- ◆ **For your own record, make a copy of your answers before mailing.**
- ◆ **Your certificate of completion will be mailed within three working days after your answers are received and if your grade is 70% or better.**
- ◆ **For faster service, enclose a large Priority or Express Mail envelope, pre-stamped and self-addressed.**
- ◆ **We are not allowed to disclose your exam results on the phone for your protection. Do not call.**
- ◆ **We must keep your exam answers for records as required by the State.**
- ◆ **The low, low price of this course does not include Express mail, Priority mail, fax service, or copies of your corrected examination.**
- ◆ **The cost for Express mail (1-2 days) delivery is \$25.**
- ◆ **The service fee to fax your answers to us is \$20.00. Credit card # is needed. Fax # 626-457-8852. If you fax, there is no need to send in your originals.**
- ◆ **The service fee for a copy of your corrected examination is \$10. Credit card # is required.**
- ◆ **The cost of a duplicate certificate, study guide, or exam question booklet is \$10.00 each.**
- ◆ **You may keep the exam question booklet.**
- ◆ **Allow 7 days to register online.**
- ◆ **Write legibly in block letters.**

You must complete this course within six months. You may return this study course in its original condition within three days after receipt for a full refund less shipping and handling fees. You will get your refund within 15 working days. After three days, there will be no refund under any circumstances.

Contents

Federal Section

Important Changes for 2009	6
Important Changes for 2010	10
Important reminders	12
Retirement Plans, Pensions and Annuities	16
Social Security Benefits	18
Other Income	19
Basis of Property	23
Sale of Property	29
Selling Your Home	35
Reporting Gains and Losses	38
Individual Retirement Arrangements (IRAs)	39
Moving Expenses	46
Alimony	49
Student Loan	52
Standard Deduction	55
Who Should Itemize	56
Medical and Dental Expenses	57
Taxes	60
Ethics and Conduct	63

California Section

Who are Residents and Nonresidents	71
Guidelines for Determining Residency	72
Temporary or Transitory Purposes	73
Withholding Services and Compliance Section	76
Specific Professions	77
Residents of or Individuals in Foreign Countries	78
Supplemental Guidelines to California Adjustments	81
California Tax forms and Related Federal Forms	90

Important Changes for Tax Year 2009

Important tax changes that took effect in 2009

Economic recovery payment

Any economic recovery payment you received is not taxable for federal income tax purposes this section summarizes, but it reduces any making work pay credit or government retiree credit.

Making work pay credit

If you have earned income from work, you may be able to take this credit. It is 6.2% of your earned income but cannot be more than \$400 (\$800 if married filing jointly).

Government retiree credit

You may be able to take this credit if you get a government pension or annuity, but it reduces any making work pay credit.

U.S. Savings Bonds

You can now use your refund to buy up to \$5,000 in U.S. Series I savings bonds in multiples of \$50. For more information, see Form 8888, Direct Deposit of Refund to More Than One Account.

Cash for clunkers

A \$3,500 or \$4,500 voucher or payment made for such a voucher under the CARS “cash for clunkers” program to buy or lease a new fuel-efficient automobile is not taxable for federal income tax purposes.

Unemployment compensation

You do not have to pay tax on unemployment compensation up to \$2,400 per person for the year. Amounts over \$2,400 are still taxable.

American opportunity education credit

The maximum Hope education credit is increased to \$2,500. The increased credit has been renamed the American opportunity credit and part of it is refundable.

Deduction for motor vehicle taxes

If you bought a new motor vehicle in 2009 after February 16, you may be able to deduct any state or local sales or excise taxes on the purchase. In states without a sales tax, you may be able to deduct certain other taxes or fees instead. Take the deduction on Schedule A (Form 1040) if you are itemizing deductions and are not electing to deduct state and local general sales taxes. If you are not itemizing deductions, these taxes increase your standard deduction as figured on Schedule L (Form 1040A or 1040).

Publication 17 (2009)

The definitions of a qualifying child apply.

- Your qualifying child must be younger than you unless the child is permanently and totally disabled.
- A child cannot be your qualifying child if he or she files a joint return, unless the return was filed only as a claim for refund.
- If the parents of a child can claim the child as a qualifying child but no parent so claims the child, no one else can claim the child as a qualifying child unless that person's adjusted gross income (AGI) is higher than the highest AGI of any parent of the child who can claim the child.
- Your child is a qualifying child for purposes of the child tax credit only if you can and do claim an exemption for him or her.

Earned income credit (EIC).

The EIC has increased for people with three or more children and for some married couples filing jointly. You may be able to take the EIC if:

- Three or more children lived with you and you earned less than \$43,279 (\$48,279 if married filing jointly),
- Two children lived with you and you earned less than \$40,295 (\$45,295 if married filing jointly),
- One child lived with you and you earned less than \$35,463 (\$40,463 if married filing jointly), or
- A child did not live with you and you earned less than \$13,440 (\$18,440 if married filing jointly).

The maximum AGI you can have and still get the credit also has increased. You may be able to take the credit if your AGI is less than the amount in the above list that applies to you. The maximum investment income you can have and still get the credit has increased to \$3,100.

Divorced or separated parents

A noncustodial parent claiming an exemption for a child can no longer attach certain pages from a divorce decree or separation agreement instead of Form 8332 if the decree or agreement went into effect after 2008. The noncustodial parent must attach Form 8332 or a similar statement signed by the custodial parent and whose only purpose is to release a claim to exemption.

Tax on child's investment income

The amount of taxable investment income a child can have without it being subject to tax at the parent's rate has increased to \$1,900.

Personal casualty and theft loss limit

Generally, a personal casualty or theft loss must be more than \$500 to be allowed. This is in addition to the 10% of AGI limit that generally applies to the net loss.

First-time homebuyer credit

The credit increases to as much as \$8,000 (\$4,000 if married filing separately) for homes bought after 2008 and before May 1, 2010 (before July 1, 2010, if you entered into a written binding contract before May 1, 2010). You can choose to claim the credit on your 2009 return for a home you bought in 2010 that qualifies for the credit. You generally must repay any credit you claimed on your 2008 return if you sold your home in 2009 or the home stopped being your main home during 2009.

Alternative minimum tax (AMT) exemption amount increased

The AMT exemption amount is increased to \$46,700 (\$70,950 if married filing jointly or a qualifying widow(er); \$35,475 if married filing separately).

Standard mileage rates

For 2009, the standard mileage rate for the cost of operating your car for business use is 55 cents per mile.

For 2009, the standard mileage rate for the cost of operating your car for medical reasons is 24 cents per mile.

For 2009, the standard mileage rate for the cost of operating your car for determining moving expenses is 24 cents per mile. See Publication 521, Moving Expenses.

Electric vehicle credits

You may be able to take a credit for:

- A plug-in electric drive motor vehicle placed in service in 2009.
- A plug-in electric vehicle bought after February 17, 2009, or
- Conversion of a vehicle to a plug-in electric drive motor vehicle placed in service after February 17, 2009.

Credit for non-business energy property

You may be able to take this credit for qualifying energy saving items for your home placed in service in 2009.

Retirement savings plans

The following paragraphs highlight changes that affect individual retirement arrangements (IRAs) and pension plans.

Traditional IRA income limits

You may be able to take an IRA deduction if you were covered by a retirement plan and your modified AGI is less than \$65,000 (\$109,000, if you are married filing jointly or a qualifying widow(er)). If your spouse was covered by a retirement plan, but you were not, you may be able to take an IRA deduction if your modified AGI is less than \$176,000.

Roth IRA income limit

You may be able to make a Roth IRA contribution if your modified AGI is less than \$120,000 (\$176,000, if you are married filing jointly or a qualifying widow(er)).

Retirement savings contributions credit

The AGI limit for claiming this credit is increased to \$27,750 (\$41,625 if head of household; \$55,500 if married filing jointly).

Military differential pay

For IRA purposes, your compensation includes any military differential pay you receive from your employer while you are serving on active duty for a period of more than 30 days.

Elective salary deferrals

The maximum amount you can defer under all plans is generally limited to \$16,500 (\$11,500 if you have only SIMPLE plans; \$19,500 for section 403(b) plans if you qualify for the 15-year rule). The catch-up contribution limit for individuals age 50 or older at the end of the year is increased to \$5,500 (except for section 401(k)(11) plans and SIMPLE plans, for which this limit remains unchanged).

Temporary waiver of required minimum distribution rules

No minimum distribution is required from your IRA or most defined contribution retirement plans for 2009.

Certain amounts increased

Some tax items that are indexed for inflation increased for 2009.

Standard deduction

The standard deduction for taxpayers who do not itemize deductions on Schedule A (Form 1040) has increased. The amount depends on your filing status.

Exemption amount

You are allowed a \$3,650 deduction for each exemption to which you are entitled. However, you will lose part of your exemption amount if you have high income.

Limit on itemized deductions

Some of your itemized deductions may be limited if your adjusted gross income is more than \$166,800 (\$83,400 if you are married filing separately).

Tax benefits for adoption. The maximum adoption credit and the maximum exclusion from income of benefits under an employer's adoption assistance program are increased to \$12,150.

Important Changes for Tax Year 2010

Earned income credit (EIC).

You may be able to take the EIC if:

- Three or more children lived with you and you earned less than \$43,352 (\$48,362 if married filing jointly),
- Two children lived with you and you earned less than \$40,363 (\$45,373 if married filing jointly),
- One child lived with you and you earned less than \$35,535 (\$40,545 if married filing jointly), or
- A child did not live with you and you earned less than \$13,460 (\$18,470 if married filing jointly).

The maximum AGI you can have and still get the credit also has increased. You may be able to take the credit if your AGI is less than the amount in the above list that applies to you. The maximum investment income you can have and still get the credit is still \$3,100.

Decrease in personal casualty and theft loss limit.

Each personal casualty or theft loss is limited to the excess of the loss over \$100 (instead of \$500). This is in addition to the 10% of AGI limit that generally applies to the net loss.

Disaster losses

The special rules that were in effect in 2008 and 2009 for losses of personal use property attributable to federally declared disasters do not apply to losses occurring in 2010 and later years.

Alternative minimum tax (AMT) exemption amount decreased

The AMT exemption amount is scheduled to decrease to \$33,750 (\$45,000 if married filing jointly or a qualifying widow(er); \$22,500 if married filing separately).

Recapture of first-time homebuyer credit

If you claimed the first-time homebuyer credit for a home you bought in 2008, you must begin repaying the credit in 2010.

IRA deduction expanded

You may be able to take an IRA deduction if you were covered by a retirement plan and your 2010 modified AGI is less than \$66,000 (\$109,000 if married filing jointly or qualifying widow(er)). If your spouse was covered by a retirement plan, but you were not, you may be able to take an IRA deduction if your 2010 modified AGI is less than \$177,000.

Roth IRA income limit

You may be able to make a Roth IRA contribution if your modified AGI is less than \$120,000 (\$177,000 if you are married filing jointly).

Conversions to Roth IRAs

Beginning in 2010, the modified AGI and filing status requirements for conversions to Roth IRAs are eliminated.

Also, for any conversions in 2010, any amounts that would be included as income will be included in income in equal amounts in 2011 and 2012. You can choose to include the entire amount in income in 2010.

Expiring tax benefits

The following benefits are scheduled to expire and will not be available for 2010.

- Deduction for educator expenses in figuring AGI.
- Tuition and fees deduction in figuring AGI.
- Increased standard deduction for real estate taxes or net disaster loss.
- Itemized deduction or increased standard deduction for state or local sales or excise taxes on the purchase of a new motor vehicle.
- Deduction for state and local sales taxes.

- The exclusion from income of up to \$2,400 in unemployment compensation.
- The exclusion from income of qualified charitable distributions made from IRA accounts.
- Government retiree credit.
- District of Columbia first-time homebuyer credit (for homes purchased after 2009).
- Extra \$3,000 IRA deduction for employees of bankrupt companies.
- Certain tax benefits for Midwestern disaster areas, including the additional exemption amount if you provided housing for a person displaced by the Midwestern storms, tornadoes, or flooding.

Personal exemption and itemized deduction phase-out's ended. For 2010, taxpayers with AGI above a certain amount will no longer lose part of their deduction for personal exemptions and itemized deductions.

Reminders

Listed below are important reminders and other items that may help you file your 2009 tax return. Many of these items are explained in more detail later in this publication.

Write in your social security number.

To protect your privacy, social security numbers (SSNs) are not printed on the peel-off label that comes in the mail with your tax instruction booklet. This means you must enter your SSN in the space provided on your tax form. If you filed a joint return for 2008 and are filing a joint return for 2009 with the same spouse, enter your names and SSNs in the same order as on your 2008 return.

Secure your tax records from identity theft.

Identity theft occurs when someone uses your personal information such as your name, SSN, or other identifying information, without your permission, to commit fraud or other crimes. An identity thief may use your SSN to get a job or may file a tax return using your SSN to receive a refund.

To reduce your risk:

- Protect your SSN,
- Ensure your employer is protecting your SSN, and
- Be careful when choosing a tax preparer.

If your tax records are affected by identity theft and you receive a notice from the IRS, respond right away to the name and phone number printed on the IRS notice or letter.

If your tax records are not currently affected by identity theft but you think you are at risk due to a lost or stolen purse or wallet, questionable credit card activity or credit report, etc., contact the IRS Identity Theft Hotline at 1-800-908-4490 or submit Form 14039.

For more information, see Publication 4535, Identity Theft Prevention and Victim Assistance.

Victims of identity theft who are experiencing economic harm or a systemic problem, or are seeking help in resolving tax problems that have not been resolved through normal channels, may be eligible for Taxpayer Advocate Service (TAS) assistance. You can reach TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059.

Protect yourself from suspicious emails or phishing schemes.

Phishing is the creation and use of email and websites designed to mimic legitimate business emails and websites. The

Publication 17 (2009)

Most common form is the act of sending an email to a user falsely claiming to be an established legitimate enterprise in an attempt to scam the user into surrendering private information that will be used for identity theft.

The IRS does not initiate contacts with taxpayers via emails. Also, the IRS does not request detailed personal information through email or ask taxpayers for the PIN numbers, passwords, or similar secret access information for their credit card, bank, or other financial accounts.

If you receive an unsolicited email claiming to be from the IRS, forward the message to: phishing@irs.gov. You may also report misuse of the IRS name, logo, forms or other IRS property to the Treasury Inspector General for Tax Administration toll-free at 1-800-366-4484. You can forward suspicious emails to the Federal Trade Commission at: spam@uce.gov or contact them at www.ftc.gov/idtheft or 1-877-IDTHEFT (1-877-438-4338).

Taxpayer identification numbers

You must provide the taxpayer identification number for each person for whom you claim certain tax benefits. This applies even if the person was born in 2009. Generally, this number is the person's social security number (SSN).

Combat pay is earned income for IRA deductions

For purposes of taking an IRA deduction, earned income includes any non-taxable combat pay received by a member of the U.S. Armed Forces.

Rollovers to Roth IRAs

You can roll over distributions from a qualified retirement plan into a Roth IRA. The rollover is not tax-free.

Tax relief for Kansas disaster area

Temporary tax relief was enacted as a result of the May 4, 2007, storms and tornadoes affecting the Kansas disaster area. See Publication 4492-A, Information for Taxpayers Affected by the May 4, 2007, Kansas Storms and Tornadoes, for more details.

Tax relief for Midwestern disaster areas

Temporary tax relief was enacted as a result of the severe storms, tornadoes, and flooding affecting the Midwestern disaster areas. See Publication 4492-B, Information for Affected Taxpayers in the Midwestern Disaster Areas, for more details.

Mortgage insurance premiums

You may be able to treat mortgage insurance premiums paid in connection with home acquisition debt as home mortgage interest.

Qualified joint venture

A qualified joint venture conducted by you and your spouse may not be treated as a partnership if you file a joint return for the tax year.

Recordkeeping requirements for cash contributions

You cannot deduct a cash contribution, regardless of the amount, unless you keep as a record of the contribution a bank record (such as a canceled check, a blank copy of a canceled check, or a bank statement containing the name of the charity, the date, and amount) or a written communication from the charity. The written communication must include the name of the charity, date of the contribution, and amount of the contribution.

Foreign source income

If you are a U.S. citizen with income from sources outside the United States (foreign income), you must report all such income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form W-2 or Form 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties).

If you reside outside the United States, you may be able to exclude part or your entire foreign source earned income. For details, see Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

Automatic six month extension to file tax return

You can use Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, to obtain an automatic 6-month extension of time to file your tax return.

Advance earned income credit

If a qualifying child lives with you and you expect to qualify for the earned income credit in 2010, you may be able to get part of the credit paid to you in advance throughout the year (by your employer) instead of waiting until you file your tax return.

Tax Computation Worksheet

If your taxable income is \$100,000 or more, figure your tax using the Tax Computation Worksheet. The Tax Computation Worksheet is found near the end of this publication immediately following the Tax Tables.

Joint return responsibility

Generally, both spouses are responsible for the tax and any interest or penalties on a joint tax return. In some cases, one spouse may be relieved of that responsibility for items of the other spouse that were incorrectly reported on the joint return.

Include your phone number on your return. To promptly resolve any questions we have in processing your tax return, we would like to be able to call you. Please enter your daytime telephone number on your tax form next to your signature.

Third-party designee

You can check the “Yes” box in the “Third Party Designee” area of your return to authorize the IRS to discuss your return with your preparer, a friend, a family member, or any other person you choose. This allows the IRS to call the person you identified as your designee to answer any questions that may arise during the processing of your return. It also allows your designee to perform certain actions.

Payment of taxes

Make your check or money order payable to “United States Treasury.” You can pay your taxes by credit or debit card, using the Electronic Federal Tax Payment System (EFTPS), or, if you file electronically, by electronic funds withdrawal.

Faster ways to file your return

The IRS offers fast, accurate ways to file your tax return information without filing a paper tax return. You can use IRS *e-file* (electronic filing).

Free electronic filing

You may be able to file your 2009 taxes online for free thanks to an electronic filing agreement.

Retirement Plans, Pensions, & Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable.

Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors, partnerships (but not a partner), and corporations. They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Rollovers

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA. For this purpose, a qualified retirement plan generally is:

- 1) A qualified employee plan, or
- 2) A qualified employee annuity.

Withholding Tax

If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you.

Tax on Early Distributions

Most distributions (both periodic and no periodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59 1/2 are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income. For this purpose, a qualified retirement plan is:

- 1) A qualified employee plan,
- 2) A qualified employee annuity plan, or
- 3) A tax-sheltered annuity plan.
- 4) A state or local government section 457 deferred compensation plan.

The tax does not apply to distributions that are:

- ◆ Made as part of a series of substantially equal periodic payments for your life or the joint lives of you and your designated beneficiary,
- ◆ Made because you are totally and permanently disabled, or
- ◆ Made on or after the death of the plan participant or contract holder.

- ◆ From a qualified retirement plan after your separation from service in or after the year you reached age 55,
- ◆ From a qualified retirement plan to an alternate payee under a qualified domestic relations order,
- ◆ From a qualified retirement plan to the extent you have deductible medical expenses (medical expenses that exceed 7.5% of your adjusted gross income), whether or not you itemize your deductions for the year,
- ◆ From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had separated from service and had begun receiving payments under the election,
- ◆ From an employee stock ownership plan for dividends on employer securities held by the plan, or
- ◆ From a qualified retirement plan due to an IRS levy of the plan.

Special Additional Taxes

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- ◆ Early distributions, and
- ◆ Excess accumulation (not receiving minimum distributions).

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your required beginning date.

Unless the rule for 5% owners applies, you must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the later of:

- 1) The calendar year in which you reach age 70 1/2, or
- 2) The calendar year in which you retire.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 70 1/2, even if you have not retired. For this purpose, a qualified retirement plan includes a:

- 1) Qualified employee plan,
- 2) Qualified employee annuity plan,
- 3) Section 457 deferred compensation plan, or
- 4) Tax-sheltered annuity plans (for benefits accruing after 1986).

You reach age 70 1/2 on the date that is 6 calendar months after the date of your 70th birthday.

Social Security Benefits & Equivalent Railroad Retirement.

To find out whether any of your benefits are taxable, compare the base amount for your filing status with the total of:

- 1) One-half of your benefits, plus
- 2) All your other income, including tax-exempt interest.

When making this comparison, do not reduce your other income by any exclusions for:

- ◆ Interest from qualified U.S. savings bonds,
- ◆ Employer-provided adoption benefits,
- ◆ Foreign earned income or foreign housing, or
- ◆ Income earned in American Samoa or Puerto Rico by bona fide residents.

If you are married and file a joint return, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.

If the only income you received was your social security or the SSEB portion of tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. If you have income in addition to your benefits, you may have to file a return even if none of your benefits are taxable. Your base amount is:

- ◆ \$25,000 if single, head of household, or qualifying widow(er),
- ◆ \$25,000 if married filing separately and lived apart from your spouse for all of the tax year,
- ◆ \$32,000 if married filing jointly, or
- ◆ \$-0- if you are married filing separately and lived with your spouse at any time during 2001.

The person who has the legal right to receive the benefits must determine whether the benefits are taxable. If parts of your benefits are taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ. If none of your benefits are taxable, do not report any of them on your tax return.

Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations applies to you:

- 1) The total of one-half of your benefits and all your other income is more than \$34,000 (\$44,000 if you are married filing jointly).
- 2) You are married filing separately and lived with your spouse at any time during the tax year.

You can usually deduct legal expenses that you pay or incur to produce or collect taxable income or in connection with the determination, collection, or refund of any tax. Legal expenses for collecting the taxable part of your benefits are deductible as a miscellaneous itemized deduction on Schedule A (Form 1040).

Other Income

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, which value will be accepted as fair market value unless the value can be shown to be otherwise? Generally, you report this income on Schedule C, Profit or Loss from Business, or Schedule C-EZ, Net Profit From Business (Form 1040).

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, Cancellation of Debt.

If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is dividend income to you. If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Accelerated Death Benefits

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the individual's death is excluded from income if the insured is terminally or chronically ill.

Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

Partnership Income

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items. Although a partnership generally pays no tax, it must file an information return on Form 1065, U.S. Return of Partnership Income, and send Schedule K-1 (Form 1065) to each partner. Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040.

Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you generally must include the full amount of the recovery in your income in the year you receive it.

State Tax Refund

If you received a state or local income tax refund (or credit or offset) in tax year, you generally must include it in income if you deducted the tax in an earlier year.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income. You generally report royalties in Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C or Schedule C-EZ (Form 1040).

Unemployment Benefits

You must include in your income all unemployment compensation you receive. You should receive a Form 1099-G, Certain Government and Qualified State Tuition Program Payments, showing the amount paid to you. Generally, you enter unemployment compensation on Form 1040, Form 1040A, or Form 1040EZ.

Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits:

- ◆ Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- ◆ State unemployment insurance benefits.
- ◆ Railroad unemployment compensation benefits.
- ◆ Disability payments from a government program paid as a substitute for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are not unemployment compensation. See chapter 6 for more information.)
- ◆ Trade readjustment allowances under the Trade Act of 1974.

- ◆ Unemployment assistance under the Disaster Relief Act Amendments.

If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax and social security and Medicare taxes. Report these payments on Form 1040 or Form 1040A or on Form 1040EZ.

Other Income

Include in your income on Form 1040 any alimony payments you receive. Amounts you receive for child support are not taxable.

To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. Include the following as ordinary income:

- 1) Interest on any award.
- 2) Compensation for lost wages or lost profits in most cases.
- 3) Punitive damages. It does not matter if they relate to a physical injury or physical sickness.
- 4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
- 5) Damages for:
 - a) Patent or copyright infringement,
 - b) Breach of contract, or
 - c) Interference with business operations.
- 6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
- 7) Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income.

If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Jury Duty

Jury duty pay you receive must be included in your income on Form 1040, or Form 1040A. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income.

Welfare and Other Public Assistance Benefits

Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare payments obtained fraudulently

Basis of Property

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items:

- ◆ Sales tax. Freight. Excise taxes.
- ◆ Installation and testing.
- ◆ Legal and accounting fees (when they must be capitalized).
- ◆ Revenue stamps. Recording fees.
- ◆ Real estate taxes (if assumed for the seller).

Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land. If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

If you buy buildings and the land on which they stand for a lump sum, allocate the basis among the land and the buildings so you can figure the allowable depreciation on the buildings. Land is not depreciable. Allocate the cost according to the fair market values of the land and buildings at the time of purchase.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, who both have reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

The following are some of the settlement fees or closing costs you can include in the basis of your property:

- ◆ Abstract fees (abstract of title fees).
- ◆ Charges for installing utility services.
- ◆ Legal fees (including title search and preparation of the sales contract and deed).
- ◆ Recording fees. Surveys.
- ◆ Transfer taxes. Owner's title insurance.
- ◆ Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Costs You Cannot Include

The following are some of the settlement fees and closing costs you cannot include in the basis of property:

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services related to occupancy of the property before closing.
- 4) Fees for refinancing a mortgage.
- 5) Charges connected with getting a loan. The following are examples of these charges.
 - a) Points (discount points, loan origination fees).
 - b) Mortgage insurance premiums.
 - c) Loan assumption fees.
 - d) Cost of a credit report.
 - e) Fees for an appraisal required by a lender.

If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as taxes.

Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

Add assessments for improvements such as streets and sidewalks to the basis of the property if they increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes assessments for maintenance, repairs, or interest charges on the improvements.

Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis.

Decreases to Basis

The following items reduce the basis of your property:

- ◆ The section 179 deduction.

- ◆ The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- ◆ Nontaxable corporate distributions.
- ◆ Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
- ◆ Exclusion of subsidies for energy conservation measures.
- ◆ Credit for qualified electric vehicles.
- ◆ Postponed gain from the sale of your home.
- ◆ Casualty and theft losses and insurance reimbursements.
- ◆ Certain canceled debt excluded from income.
- ◆ Rebates received from a manufacturer or seller.
- ◆ Easements. Adoption tax benefits.

If you have a casualty or theft loss, decrease the basis of your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance. You must increase your basis in the property by the amount you spend on repairs that restore the property to its pre-casualty condition.

If you receive property for your services, include its FMV in income. The amount you include in income becomes your basis.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Involuntary Conversions

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you can figure the basis of the replacement property using the basis of the converted property. If you receive property similar or related in service or use to the converted property, the replacement property's basis is the same as the converted property's basis on the date of the conversion, with the following adjustments:

- 1) Decrease the basis by the following.
 - a) Any loss you recognize on the conversion.
 - b) Any money you receive that you do not spend on similar property.
- 2) Increase the basis by the following.
 - a) Any gain you recognize on the conversion.
 - b) Any cost of acquiring the replacement property.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To qualify as a like-kind exchange, the property traded and the property received must be both of the following:

- 1) Qualifying property.
- 2) Like-kind property.

The basis of the property you receive is generally the same as the basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the basis of the property you gave up increased by the money you paid.

In a like-kind exchange, you must hold for investment or for productive use in your trade or business both the property you give up and the property you receive.

There must be an exchange of like property. The exchange of real estate for real estate or personal property for similar personal property is an exchange of like property.

Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the basis of the property you gave up, with the following adjustments:

- 1) Decrease the basis by the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.
- 2) Increase the basis by the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.

Allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like property.

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse that is incident to divorce. However, adjust your basis for any gain recognized by your spouse or former spouse on property transferred in trust. This rule applies only to a transfer of property in trust in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property.

If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property.

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following:

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
- 3) The value under the special-use valuation method for real property used in farming or another closely held business, if chosen for estate tax purposes.
- 4) The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former personal residence.

The basis for depreciation is the lesser of the following amounts:

- 1) The FMV of the property on the date of the change.
- 2) Your adjusted basis on the date of the change.

The basis for figuring a gain is your adjusted basis when you sell the property. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use.

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees.

Sale of Property

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker. Use Form 1099-B (or an equivalent statement received from your broker) to complete Schedule D of Form 1040.

Redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Whether redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- 1) The redemption is not essentially equivalent to a dividend,
- 2) There is a substantially disproportionate redemption of stock,
- 3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 4) The redemption is a distribution in partial liquidation of a corporation.

A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year.

How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

Nontaxable Trades

If you trade business or investment property for other business or investment property of a like-kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions:

- 1) The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
- 2) The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
- 3) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule.
- 4) There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property is a trade of like property. Real property located in the United States and real property located outside the United States are not like property.
- 5) The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
- 6) The property to be received must be received by the earlier of:
 - a) The 180th day after the date on which you transfer the property given up in the trade, or
 - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

Partially Nontaxable Exchange

If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value. If conditions (1) - (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This no recognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Related Party Transactions

Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it.

Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties:

- 1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- 3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock.
- 4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties:

- 1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- 2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
- 4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- 5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

- 6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
- 8) Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
- 9) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are:

- ◆ Stocks or bonds held in your personal account,
- ◆ A house owned and used by you and your family,
- ◆ Household furnishings,
- ◆ A car used for pleasure or commuting,
- ◆ Coin or stamp collections,
- ◆ Gems and jewelry, and
- ◆ Gold, silver, or any other metal.

Any property you own is a capital asset, except the following non-capital assets:

- 1) Property held mainly for sale to customers or property that will physically become a part of the merchandise that is for sale to customers.
- 2) Depreciable property used in your trade or business, even if fully depreciated.
- 3) Real property used in your trade or business.
- 4) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property:
 - a) Created by your personal efforts,
 - b) Prepared or produced for you as a letter, memorandum, or similar property, or
 - c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
- 5) Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).
- 6) U.S. Government publications that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.
- 7) Certain commodities derivative financial instruments held by commodities derivatives dealers.

- 8) Hedging transactions, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into.
- 9) Supplies of a type you regularly use or consume in the ordinary course of your trade or business.

Corporate reorganizations

In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation

You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

If you hold investment property more than 1 year, any capital gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any capital gain or loss is a short-term capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.

Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.

If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

If you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

Schedule F

Report your farm income on Schedule F (Form 1040). Use this schedule to figure the net profit or loss from regular farming operations.

Income from farming reported on Schedule F (Form 1040) includes amounts you receive from cultivating, operating, or managing a farm for gain or profit, either as owner or tenant. This includes income from operating a stock, dairy, poultry, fish, fruit, or truck farm and income from operating a plantation, ranch, range, or orchard. It also includes income from the sale of crop shares if you materially participate in producing the crop.

Income received from operating a nursery, which specializes in growing ornamental plants, is considered to be income from farming.

Income reported on Schedule F does not include gains or losses from sales or other dispositions of the following farm assets: Land, depreciable farm equipment, building and structures, livestock held for draft, breeding, sport or dairy purposes.

Selling Your Home

Usually, the home you live in most of the time is your main home and can be a:

- ◆ House • Houseboat • Mobile home.
- ◆ Cooperative apartment or Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land. However, if you sell vacant land used as part of your main home and that is adjacent to it, you may be able to exclude the gain from the sale under certain circumstances.

If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income the gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time. You own a house, but you live in another house that you rent. The rented house is your main home.

How To Figure Gain or Loss

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis.

The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

The amount realized is the selling price minus selling expenses. Selling expenses include:

- ◆ Commissions,
- ◆ Advertising fees,
- ◆ Legal fees, and
- ◆ Loan charges paid by the seller, such as loan placement fees or "points."

If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

If your home was foreclosed on or repossessed, you have a sale. If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which

you are personally liable and the debt is canceled, you have ordinary income equal to the amount of the canceled debt.

Ownership and Use Tests

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

- 1) Owned the home for at least 2 years (the ownership test), and
- 2) Lived in the home as your main home for at least 2 years (the use test).

Adjusted Basis

Adjusted basis is your basis increased or decreased by certain amounts. Increases to basis. These include any:

- 1) Additions and other improvements that have a useful life of more than 1 year,
- 2) Special assessments for local improvements, and
- 3) Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

- 1) Gain you postponed from the sale of a previous home before May 7, 1997,
- 2) General sales taxes claimed as an itemized deduction on Schedule A (Form 1040) that were imposed on the purchase of personal property, such as a houseboat used as your home or a mobile home,
- 3) Deductible casualty losses,
- 4) Insurance payments you received or expect to receive for casualty losses,
- 5) Payments you received for granting an easement or right-of-way,
- 6) Depreciation allowed or allowable if you used your home for business or rental purposes,
- 7) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
- 8) Adoption credit you claimed for improvements added to the basis of your home,
- 9) Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
- 10) First-time homebuyer credit (allowed to certain first-time buyers of a home in the District of Columbia), and
- 11) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure.

Maximum Amount of Exclusion

You can exclude the entire gain on the sale of your main home up to:

- 1) \$250,000, or
- 2) \$500,000 if all of the following are true.
 - a) You are married and file a joint return for the year.
 - b) Either you or your spouse meets the ownership test.
 - c) Both you and your spouse meet the use test.

- d) During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

You may be able to exclude up to \$500,000 of the gain on the sale of your main home if you are married and file a joint return and meet other requirements.

Special Rules for Joint Returns

You can exclude up to \$500,000 of the gain on the sale of your main home if all of the following are true.

1. You are married and file a joint return for the year.
2. Either you or your spouse meets the ownership test.
3. Both you and your spouse meet the use test.
4. During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

If either spouse does not satisfy all these requirements, the maximum exclusion that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

Reporting Gains & Losses

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or Form 1099-S, Proceeds From Real Estate Transactions (or substitute statement). You can use Schedule D-1 as a continuation schedule to report more transactions.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses. Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or
- 2) Your total net loss as shown on line 16 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit. If you have a total net loss on line 16 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates. The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

Adjustment to Income

Traditional IRAs

Here, the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA." Two advantages of a traditional IRA are:

- 1) You may be able to deduct some or all of your contributions to it, depending on your circumstances, and,
- 2) Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA. You can set up and make contributions to a traditional IRA if:

- 1) You (or, if you file a joint return, your spouse) received taxable compensation during the year, and
- 2) You were not age 70 1/2 by the end of the year.

Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services. If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the total of:

- 1) The deduction for contributions made on your behalf to retirement plans, and
- 2) The deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs. Compensation does not include any of the following items:

- ◆ Earnings and profits from property, such as rental income, interest income, and dividend income.
- ◆ Pension or annuity income.
- ◆ Deferred compensation received (compensation payments postponed from a past year).
- ◆ Income from a partnership for which you do not provide services that are a material income-producing factor.
- ◆ Any amounts you exclude from income, such as foreign earned income and housing costs.

When and How Can a Traditional IRA Be Set Up?

You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Your traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

How Much Can Be Contributed?

The most that can be contributed to your traditional IRA is the smaller of the following amounts:

- 1) Your compensation that you must include in income for the year, or
- 2) \$5,000 or \$6,000 if you are 50 or older).

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions is nondeductible.

If you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

- 1) \$5,000 or \$6,000 if you are 50 or older), or
- 2) The total compensation of both you and your spouse for the year, reduced by the following two amounts:
 - a) Your spouse's contribution for the year to a traditional IRA.
 - b) Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as \$10,000 or \$11,000 if only one of you is 50 or older, or \$12,000 if both of you are 50 or older.

When Can Contributions Be Made?

As soon as you set up your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, not including extensions.

Contributions cannot be made to your traditional IRA for the year in which you reach age 70 1/2 or for any later year.

How Much Can You Deduct?

Generally, you can deduct the lesser of:

- ◆ The contributions to your traditional IRA for the year, or
- ◆ The general limit (or the spousal IRA limit, if it applies).

Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they may be

deductible as a miscellaneous itemized deduction on Schedule A (Form 1040). Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of:

- 1) \$5,000 or \$6,000 if you are 50 or older, or
- 2) 100% of your compensation.

Form 8606

To designate contributions as nondeductible, you must file Form 8606. You do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible. You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Inherited IRAs

If you inherit a traditional IRA from your deceased spouse, you can choose to treat it as your own by making contributions (including rollover contributions) to it. If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that contributions (including rollover contributions) cannot be made to the IRA and you cannot roll over any amounts out of the inherited IRA.

If you inherit a traditional IRA from your deceased spouse, you can generally roll it over into another traditional IRA established for you or you can choose to treat the inherited IRA as your own.

Can You Move Retirement Plan Assets?

Traditional IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. The rules permit the following kinds of transfers:

- ◆ Transfers from one trustee to another.
- ◆ Rollovers.
- ◆ Transfers incident to a divorce.

Under certain conditions, you can move assets from a traditional IRA to a Roth IRA.

Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

The amount you roll over tax free is generally taxable when the new plan distributes that amount to you or your beneficiary. You can roll over amounts from the following plans into a traditional IRA:

1. A Traditional IRA,
2. An employer's qualified retirement plan for its employees,
3. A deferred compensation plan of a state or local government (section 457 plan),
or
4. A tax-sheltered annuity (section 403(b)).

You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return.

Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

If you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

When Can You Withdraw or Use IRA Assets?

There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of violation.

Generally, if you are under age 59 1/2, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59 1/2 are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Exceptions to the 59 1/2 Rule

There are several exceptions to the age 59 1/2 rule. Even if you receive a distribution before you are age 59 1/2, you may not have to pay the 10% additional tax if you are in one of the following situations:

- ◆ You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- ◆ The distributions are not more than the cost of your medical insurance.
- ◆ You are disabled.
- ◆ You are the beneficiary of a deceased IRA owner.
- ◆ You are receiving distributions in the form of an annuity.
- ◆ The distributions are not more than your qualified higher education expenses.
- ◆ You use the distributions to buy, build, or rebuild a first home.
- ◆ The distribution is due to an IRS levy of the qualified plan.
- ◆ The distribution is a qualified reservist distribution.

When Must You Withdraw IRA Assets?

Amounts that must be distributed (required distributions) during a particular year are not eligible for rollover treatment. If you are the owner of a traditional IRA, by April 1 of the year following the year in which you reach age 70 1/2, you must start receiving distributions from your IRA. April 1 of the year following the year in which you reach age 70 1/2 is referred to as the required beginning date.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person. Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendent, and any spouse of a lineal descendent). The following are examples of prohibited transactions with a traditional IRA:

- ◆ Borrowing money from it.
- ◆ Selling property to it.
- ◆ Receiving unreasonable compensation for managing it.
- ◆ Using it as security for a loan.
- ◆ Buying property for personal use (present or future) with IRA funds.

If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA. You can make contributions by the due date (not including extensions) for filing your tax return. This means that most people can make contributions by April 15 of the tax year. You do not have to report Roth IRA contributions on your return.

A Roth IRA is an individual retirement plan that is subject to the rules that apply to a traditional IRA. It can be either an account or an annuity. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions are tax free. Contributions can be made to your Roth IRA after you reach age 70 1/2 and you can leave amounts in your Roth IRA as long as you live.

Can You Contribute to a Roth IRA?

Generally, you can contribute to a Roth IRA if you have taxable compensation and your modified AGI is less than:

- ◆ \$169,000 for married filing jointly,
- ◆ \$10,000 for married filing separately and you lived with your spouse at any time during the year, and
- ◆ \$116,000 for single, head of household, qualifying widow(er) or married filing separately and you did not live with your spouse at any time during the year.

Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return modified as follows:

- 1) Subtract any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA (conversion income), and minimum required distributions from IRAs (for conversions only).
- 2) Add the following deductions and exclusions:
 - a) Traditional IRA deduction,
 - b) Student loan interest deduction,
 - c) Foreign earned income exclusion,
 - d) Foreign housing exclusion or deduction,
 - e) Exclusion of qualified savings bond interest shown on Form 8815, and
 - f) Exclusion of employer-paid adoption expenses shown on Form 8839.
 - g) Tuition and fees deduction,
 - h) Domestic production activities deduction.

How Much Can Be Contributed?

If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of:

- ◆ \$5,000 or \$6,000 if you are 50 or older, or
- ◆ Your taxable compensation.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit

would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs. Employer contributions under a SEP or SIMPLE IRA plan do not affect this limit.

Catch-up contributions in employer bankruptcies

If you participated in a 401(k) plan and the employer who maintained the plan went into bankruptcy in an earlier year, you may be able to contribute an additional \$3,000 to your IRA. If you qualify and choose to make these catch-up contributions, the higher contribution and deduction limits for individuals who are age 50 or older do not apply. The most that you can contribute to your Roth IRA is \$8,000.

Can I Move Amounts Into a Roth IRA?

You may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from one Roth IRA to another Roth IRA.

You can convert a traditional IRA or a SIMPLE IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used.

Conversion Methods

1. You can convert amounts from a traditional IRA to a Roth IRA in any of the following three ways:
 - a. Rollover. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
 - b. Trustee-to-trustee transfer. You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
 - c. Same trustee transfer. If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Generally, you can convert an amount in your SIMPLE IRA to Roth IRA under the same rules as converting from any traditional IRA to Roth IRA.

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA.

Am I required to take distributions when I reach age 70 1/2? You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive.

Moving Expenses

You can deduct your allowable moving expenses if your move is closely related to the start of work. You also must meet the distance test and the time test. You can generally consider moving expenses incurred within 1 year from the date you first reported to work at the new location as closely related in time to the start of work. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

You can generally consider your move closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement may qualify if you can show that:

- 1) You are required to live at that home as a condition of your employment, or
- 2) You will spend less time or money commuting from your new home to your new job location.

Distance Test

Your move will meet the distance test if your new main job location is at least 50 miles farther from your former home than your old main job location was from your former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not take into account the location of your new home.

Time Test

To deduct your moving expenses, you also must meet one of the following two time tests:

- 1) The time test for employees.
- 2) The time test for self-employed persons.

If you are an employee, you must work full time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. Full-time employment depends on what is usual for your type of work in your area. For purposes of this test, the following four rules apply:

- 1) You count only your full-time work as an employee, not any work you do as a self-employed.
- 2) You do not have to work for the same employer for all 39 weeks.
- 3) You do not have to work 39 weeks in a row.
- 4) You must work full time within the same general commuting area for all 39 weeks.

If you are self-employed, you must work full time for at least 39 weeks during the first 12 months AND for a total of at least 78 weeks during the first 24 months after you arrive in your new job location. For purposes of this test, the following three rules apply:

- 1) You count any full-time work you do either as an employee or as a self-employed person.
- 2) You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.
- 3) You must work within the same general commuting area for all 78 weeks.

Deductible Moving Expenses

If you meet the requirements, you can deduct the reasonable expenses of:

- 1) Moving your household goods and personal effects (including in-transit or foreign-move storage expenses), and
- 2) Traveling (including lodging but not meals) to your new home.

You cannot deduct any expenses for meals.

If you use your car to take yourself, members of your household, or your personal effects to your new home, you can figure your expenses by deducting either:

- 1) Your actual expenses, such as gas and oil for your car, if you keep an accurate record of each expense, or
- 2) The standard mileage rate.

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects. You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving your household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.

Nondeductible Expenses

You cannot deduct any expenses for meals. You cannot deduct the cost of moving furniture you buy on the way to your new home. You cannot deduct the following items as moving expenses:

- ◆ Any part of the purchase price of your new home.
- ◆ Car tags. Driver's license. Expenses of buying or selling a home.
- ◆ Expenses of getting or breaking a lease. Loss on the sale of your home.
- ◆ Home improvements to help sell your home.
- ◆ Losses from disposing of memberships in clubs.
- ◆ Meal expenses. Mortgage penalties. Pre-move househunting expenses.

- ◆ Real estate taxes. Refitting of carpets and draperies.
- ◆ Security deposits (including any given up due to the move).
- ◆ Storage charges except those incurred in transit and for foreign moves.
- ◆ Temporary living expenses.

You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must decide if your expenses are deductible as moving expenses or as business expenses. Use Form 3903 to report your moving expenses. If you were not reimbursed, deduct your allowable moving expenses either in the year you incurred them or in the year you paid them.

Alimony

Not all payments under a divorce or separation instrument are alimony. Alimony does not include any of the following:

- 1) Child support.
- 2) Noncash property settlements.
- 3) Payments that are your spouse's part of community income.
- 4) Payments to keep up the payer's property.
- 5) Use of property.

Cash payments (including checks and money orders) to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony.

If you must pay all the real estate taxes or insurance on a home held as tenants in common, you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as tenants by the entirety or joint tenants, none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

Alimony Requirements

A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met:

- 1) The payment is in cash.
- 2) The instrument does not designate the payment as not alimony.
- 3) The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a decree of divorce or separate maintenance.

- 4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
- 5) The payment is not treated as child support.

Payment Must Be In Cash

Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony:

- ◆ Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- ◆ Execution of a debt instrument by the payer.
- ◆ The use of the payer's property.

Payments to a Third Party

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if all the following requirements are met:

- 1) The payments are in lieu of payments of alimony directly to your spouse.
- 2) The written request states that both spouses intend the payments to be treated as alimony.
- 3) You receive the written request from your spouse before you file your return for the year you made the payments.

Other Rules

You and your spouse can designate that otherwise qualifying payments are not alimony. You do this by including a provision in your divorce or separation instrument that states the payments are not deductible as alimony by you and are excludable from your spouse's income.

Payments to your spouse while you are members of the same household are not alimony if you are legally separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony. The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. Child support payments are neither deductible by the payer nor taxable to the payee. You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040. You cannot use Form 1040A or Form 1040EZ.

If you do not provide your spouse's social security number, you may have to pay a \$50 penalty and your deduction may be disallowed. You must give the person who paid the alimony your social security number. If you do not, you may have to pay a \$50 penalty.

Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- ◆ A change in your divorce or separation instrument,
- ◆ A failure to make timely payments,
- ◆ A reduction in your ability to provide support, or
- ◆ A reduction in your spouse's support needs.

You are subject to the recapture rule in the third year if the alimony you pay in the third year decreases by more than \$15,000 from the second year or the alimony you pay in the second and third years decreases significantly from the alimony you pay in the first year.

When you figure a decrease in alimony, do not include the following amounts:

- 1) Payments made under a temporary support order.
- 2) Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
- 3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments.

Student Loan Interest Deduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible. However, if your modified adjusted gross income (MAGI) is less than \$70,000 (\$145,000 if filing a joint return) you may be able to take a deduction for interest paid on a student loan (also known as an education loan) used for higher education. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of your income subject to tax by up to \$2,500 in tax year.

Student Loan Interest Defined

Student loan interest is interest you paid during the year on a qualified student loan. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay qualified education expenses that were:

- For you, your spouse, or a person who was your dependent when you took out the loan,
- Paid or incurred within a reasonable period of time before or after you took out the loan, and
- For education provided during an academic period for an eligible student.

Loans from the following sources are not qualified student loans.

- A related person.
- A qualified employer plan.

Loan from a related person

You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grand-children, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items.

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

The cost of room and board qualifies only to the extent that it is not more than the greater of:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student, or
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible educational institution

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

For purposes of the student loan interest deduction, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

An educational institution must meet the above criteria only during the academic period(s) for which the student loan was incurred. The deductibility of interest on the loan is not affected by the institution's subsequent loss of eligibility. The educational institution should be able to tell you if it is an eligible educational institution.

You cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (for example, home mortgage interest).

How Much Can You Deduct

Your student loan interest deduction for the tax year is generally the smaller of:

- \$2,500, or
- The interest you paid in the tax year.

The amount determined above is phased out (gradually reduced) if your MAGI is between \$55,000 and \$70,000 (\$115,000 and \$145,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is \$70,000 or more (\$140,000 or more if you file a joint return).

Tuition and Fees Deduction

You may be able to deduct qualified education expenses paid during the year for yourself, your spouse, or a dependent. You cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return. The qualified expenses must be for higher education. The tuition and fees deduction can reduce the amount of your income subject to tax by up to \$4,000.

Standard Deduction

Before figuring the amount of your standard deduction, you must determine if you are eligible to take it. Your standard deduction is zero and you should itemize any deductions you have if:

- 1) You are married and filing a separate return, and your spouse itemizes deductions,
- 2) You are filing a tax return for a short tax year because of a change in your annual accounting period, or
- 3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

Standard Deduction Amount

Generally, the standard deduction amounts are adjusted each year for inflation. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

Higher Standard Deduction for Age (65 or Older)

If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday.

Higher Standard Deduction for Blindness

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction. You qualify for this benefit if you are totally or partly blind. If you are partly blind, you must get a certified statement from an eye doctor or registered optometrist that:

- 1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- 2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, the statement should include this fact. You must keep the statement in your records. If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of:

- 1) \$900, or
- 2) The individual's earned income for the year plus \$300 (but not more than the regular standard deduction amount, generally \$5,450).

However, if the individual is 65 or older or blind, the standard deduction may be higher. Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform. For purposes of the standard deduction, earned income also includes any part of a scholarship or fellowship grant that you must include in your gross income.

Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. Also, you should itemize if you do not qualify for the standard deduction. You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit. You may benefit from itemizing your deductions on Schedule A (Form 1040) if you:

- 1) Do not qualify for the standard deduction, or the amount you can claim is limited,
- 2) Had large uninsured medical and dental expenses during the year,
- 3) Paid interest and taxes on your home,
- 4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
- 5) Had large uninsured casualty or theft losses,
- 6) Made large contributions to qualified charities, or
- 7) Have total itemized deductions that are more than the standard deduction to which you otherwise are entitled.

Medical & Dental Expenses

Medical care means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness.

Medical care expenses include the premiums you pay for insurance that covers the expenses of medical care, and the amounts you pay for transportation to get medical care. Medical care expenses also include limited amounts paid for any qualified long-term care insurance contract.

You can include only the medical and dental expenses you paid during the tax year year, regardless of when the services were provided. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a "pay-by-phone" or "on-line" account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

Medical expenses for a decedent that are paid from his or her estate are treated as paid at the time the medical services were provided if they are paid within the 1-year period beginning with the day after the date of death. Medical expenses paid before death by the decedent are included in figuring any deduction for medical and dental expenses on the decedent's final income tax return. This includes expenses for the decedent's spouse and dependents as well as for the decedent. You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income.

Whose Medical Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals like your spouse and your dependents. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

- 1) That person lived with you for the entire year as a member of your household or is related to you,
- 2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which your tax year began, and
- 3) You provided over half of that person's total support for the calendar year.

You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return.

You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical services were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses provided you clearly substantiate that the payment is directly attributable to the medical care of the child.

But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

What Medical Expenses Are Deductible?

Deductible medical expenses include birth control pills prescribed by your doctor, cost of fertility enhancement procedures, and cost of lead-based paint removal, but surgery for purely cosmetic reasons is not deductible.

Insurance Premiums

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for:

- ◆ Hospitalization, surgical fees, X-rays, etc.,
- ◆ Prescription drugs,
- ◆ Dental care.
- ◆ Replacement of lost or damaged contact lenses,
- ◆ Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care, or
- ◆ Qualified long-term care insurance contracts (subject to additional limitations).

Medicare

The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense on your tax return.

Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65 or after you became disabled, you can deduct the monthly premiums you paid.

Meals and Lodging

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements:

- 1) The lodging is primarily for and essential to medical care.
- 2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
- 3) The lodging is not lavish or extravagant under the circumstances.
- 4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses for lodging cannot be more than \$50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care.

You can include in medical expenses the cost of medical care in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

Transportation

You can include in medical expenses amounts paid for transportation primarily for, and essential to, medical care. You can include:

- ◆ Bus, taxi, train, or plane fares, or ambulance service,
- ◆ Transportation expenses of a parent who must go with a child who needs medical care,
- ◆ Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- ◆ Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, were a general partner (or a limited partner receiving guaranteed payments), or received wages from an S corporation in which you were a more than 2% shareholder (who is treated as a partner), you may be able to deduct, as an adjustment to income, all of the amount paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, and dependents.

Taxes

Tests To Deduct Any Tax

The following two tests must be met for any tax to be deductible by you:

- 1) The tax must be imposed on you.
- 2) The tax must be paid during your tax year.

Generally, you can deduct property taxes only if you are the property owner. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes actually paid during your tax year. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and are a cash basis taxpayer, you can deduct the tax only in the year it is actually paid.

State and Local Income Taxes

You can deduct state and local income taxes. However, you can elect to deduct state and local general sales taxes instead of state and local income taxes. But you cannot deduct both taxes in the same year.

Income Taxes

You can deduct state, local and foreign income taxes, but not federal income taxes. You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

Deduct state and local income taxes withheld from your salary in the year they are withheld.

Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible.

If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority.

If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Real Estate-Related Items You Cannot Deduct

Payments for the following items generally are not deductible as real estate taxes:

- ◆ Taxes for local benefits. Transfer taxes (or stamp taxes).
- ◆ Itemized charges for services (such as trash and garbage pickup fees).
- ◆ Rent increases due to higher real estate taxes. Homeowners' association charges.

Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

- 1) Charged on personal property,
- 2) Based only on the value of the personal property, and
- 3) Charged on a yearly basis, even if collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

Taxes and Fees You Cannot Deduct

Taxes and fees that are generally not deductible include the following items:

- ◆ Estate, inheritance, legacy, or succession taxes. Gift taxes.
- ◆ Employment taxes. This includes social security, Medicare and railroad retirement taxes withheld from your pay. However, one-half of self-employment tax you pay is deductible. In addition, the social security and other employment taxes you pay on the wages of a household worker may be included in medical expenses that you can deduct or child care expenses that allow you to claim the child and dependent care credit.
- ◆ Federal income taxes. This includes taxes withheld from your pay.

- ◆ Fines. You cannot deduct penalties for violation of any law, including forfeiture of related collateral deposits.
- ◆ License fees. You cannot deduct license fees for personal purposes (such as marriage, driver's, and dog license fees).
- ◆ Social security. This includes social security, Medicare, or railroad retirement taxes withheld from your pay. Social security and other employment taxes for household workers.

Where to Deduct

State and local income taxes are deducted on Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties. Foreign income taxes you pay to a foreign country can be claimed as an itemized deduction on Schedule A (Form 1040).

Real estate taxes and personal property taxes are deducted on Schedule A (Form 1040), unless they are paid on property used in your business in which case they are deducted on Schedule C (Form 1040).

Taxes on property that produces rent or royalty income are deducted on Schedule E (Form 1040). Deduct one-half of your self-employment tax on Form 1040. All other deductible taxes are deducted on Schedule A (Form 1040).

Ethics & Conduct

Who Can Practice Before the IRS?

Any individual who is recognized to practice (a recognized representative) must file a written declaration with the IRS stating that he or she is authorized and qualified to represent a particular taxpayer. Part II of Form 2848 is a declaration that can be used for this purpose.

Attorneys

Any attorney who is not currently under suspension or disbarment from practice before the IRS and who is a member in good standing of the bar of the highest court of any state, possession, territory, commonwealth, or of the District of Columbia may practice before the IRS.

Certified public accountants (CPAs)

Any CPA who is not currently under suspension or disbarment from practice before the IRS and who is duly qualified to practice as a CPA in any state, possession, territory, commonwealth, or in the District of Columbia may practice before the IRS.

Enrolled agents

Any enrolled agent in active status may practice before the IRS.

Enrolled actuaries

Any individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries may practice before the IRS. The practice of enrolled actuaries is limited to certain Internal Revenue Code sections that relate to their area of expertise, principally those sections governing employee retirement plans.

Un-enrolled return preparers

An unenrolled return preparer is an individual other than an attorney, CPA, enrolled agent, or enrolled actuary who prepares and signs a taxpayer's return as the preparer, or who prepares a return but is not required to sign the return.

An unenrolled return preparer is permitted to appear as your representative only before customer service representatives, revenue agents, and examination officers, with respect to an examination regarding the return he or she prepared. An unenrolled return preparer cannot:

- Represent a taxpayer before other offices of the IRS, such as Collection or Appeals. This includes the Automated Collection System (ACS) unit.
- Execute closing agreements.
- Extend the statutory period for tax assessments or collection of tax.
- Execute waivers.

- Execute claims for refund.
- Receive refund checks.

What Are the Rules of Practice?

An attorney, CPA, enrolled agent, or enrolled actuary authorized to practice before the IRS (referred to hereafter as a practitioner) has the duty to perform certain acts and is restricted from performing other acts. In addition, a practitioner cannot engage in disreputable conduct. Any practitioner who does not comply with the rules of practice or engages in disreputable conduct is subject to disciplinary action. Also, un-enrolled preparers must comply with most of these rules of practice and conduct to exercise the privilege of limited practice before the IRS.

Duties

Practitioners must promptly submit records or information requested by officers or employees of the IRS. When the Director of Practice requests information concerning possible violations of the regulations by other parties, the practitioner must provide the information and be prepared to testify in disbarment or suspension proceedings. A practitioner can be exempted from these rules if he or she believes in good faith and on reasonable grounds that the information requested is privileged or that the request is of doubtful legality.

Confidentiality privilege

The confidentiality protection for certain communications between a taxpayer and an attorney (privileged communications) applies to similar communications between a taxpayer and any federally authorized tax practitioner.

Federally authorized tax practitioners include attorneys, certified public accountants, enrolled agents, enrolled actuaries, and certain other individuals allowed to practice before the IRS.

This confidentiality privilege cannot be used in any administrative proceeding with an agency other than the IRS.

Communications that are protected

The protection of this privilege applies only to tax advice given to the taxpayer by any individual who is a federally authorized tax practitioner. Tax advice is advice in regard to a matter that is within the scope of the practitioner's authority to practice. The confidentiality protection applies to communications that would be considered privileged if they were between the taxpayer and an attorney and that relate to noncriminal:

- ◆ Tax matters before the IRS, or
- ◆ Tax proceedings brought in federal court by or against the United States.

Communications regarding corporate tax shelters

This protection of tax advice communications does not apply to any written communications between a federally authorized tax practitioner and a director, shareholder, officer, employee, agent, or representative of a corporation. It also does not apply if the communication involves the promotion of the direct or indirect participation of the corporation in any tax shelter.

Duty to advise

A practitioner who knows that his or her client has not complied with the revenue laws or has made an error or omission in any return, document, affidavit, or other required paper, has the responsibility to advise the client promptly of the noncompliance, error, or omission.

Due diligence

A practitioner must exercise due diligence when performing the following duties.

- ◆ Preparing or assisting in the preparing, approving, and filing of returns, documents, affidavits, and other papers relating to IRS matters.
- ◆ Determining the correctness of oral or written representations made by him or her to the Department of the Treasury.
- ◆ Determining the correctness of oral or written representations made by him or her to clients with reference to any matter administered by the IRS.

Restrictions

Practitioners are restricted from engaging in certain practices. The following paragraphs discuss some of these restricted practices. A practitioner must not unreasonably delay the prompt disposition of any matter before the IRS.

Assistance from disbarred or suspended persons and former IRS employees. A practitioner must not knowingly, directly or indirectly, do the following.

- ◆ Employ or accept assistance from any person who is under disbarment or suspension from practice before the IRS.
- ◆ Accept assistance from any former government employee where provisions of Treasury Department Circular No. 230 or any federal law would be violated.

A practitioner who is a notary public and is employed as counsel, attorney, or agent in a matter before the IRS, or has a material interest in the matter, cannot engage in any notary activities related to that matter. Practitioners who are income tax return preparers must not endorse or otherwise negotiate (cash) any refund check issued to the taxpayer.

Disreputable Conduct

Any practitioner or un-enrolled return preparer may be disbarred or suspended from practice before the IRS for disreputable conduct. The following list contains examples of conduct that is considered disreputable.

- ◆ Committing any criminal offense under the revenue laws or committing any offense involving dishonesty or breach of trust.
- ◆ Knowingly giving false or misleading information in connection with federal tax matters, or participating in such activity.
- ◆ Soliciting employment by prohibited means as discussed in section 10.30 of Treasury Department Circular No. 230.
- ◆ Willfully failing to file a tax return, evading or attempting to evade any federal tax or payment, or participating in such actions.
- ◆ Misappropriating, or failing to properly and promptly remit, funds received from clients for payment of taxes.
- ◆ Directly or indirectly attempting to influence the official action of IRS employees by the use of threats, false accusations, duress, or coercion, or by offering gifts, favors, or any special inducements.
- ◆ Being disbarred or suspended from practice as an attorney, CPA, public accountant, or actuary, by the District of Columbia or any state, possession, territory, commonwealth, or any federal court, or any body or board of any federal agency.
- ◆ Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility (maintaining a partnership so that a disbarred person can continue to practice before the IRS is presumed to be a violation of this provision).
- ◆ Using abusive language, making false accusations and statements knowing them to be false, circulating or publishing malicious or libelous matter, or engaging in any contemptuous conduct in connection with practice before the IRS.
- ◆ Giving a false opinion knowingly, recklessly, or through gross incompetence; or following a pattern of providing incompetent opinions in questions arising under the federal tax laws.

Reprimands, Disbarments, and Suspensions

The Director of Practice may reprimand or institute proceedings to suspend or disbar any attorney, CPA, or enrolled agent who the Director of Practice has reason to believe violated the rules of practice. Except in certain unusual circumstances, the Director will not institute a proceeding for suspension or disbarment against a practitioner until the facts (or conduct) which may warrant such action have been given in writing to that practitioner and the practitioner has been given the opportunity to demonstrate or achieve compliance with the rules.

Endorsing or cashing your refund check

If you want your representative to receive a refund check on your behalf, you must specifically authorize this in your power of attorney. However, if your representative is permitted to practice before the IRS, he or she cannot be authorized to endorse or otherwise cash your check related to income taxes.

Limitation on substitution or delegation

The recognized representative can substitute or delegate authority under the power of attorney to another recognized representative only if the act is specifically authorized under the power of attorney.

After a substitution has been made, only the newly recognized representative will be recognized as the taxpayer's representative. If a delegation of power has been made, both the original and the delegated representative will be recognized by the IRS to represent the taxpayer.

Incapacity or incompetency

A power of attorney is generally terminated if you become incapacitated or incompetent. The power of attorney can continue, however, in the case of your incapacity or incompetency if you authorize this on the Form 2848, or if your non-IRS durable power of attorney meets all the requirements for acceptance by the IRS.

When Is a Power of Attorney Required?

A power of attorney is most often required when you want to authorize another individual to perform at least one of the following acts on your behalf.

- 1) Represent you at a conference with the IRS.
- 2) Prepare and file a written response to the IRS.

When Is a Power of Attorney Not Required?

A power of attorney is not required in some situations when dealing with the IRS. The following situations do not require a power of attorney.

- ◆ Providing information to the IRS.
- ◆ Authorizing the disclosure of tax return information through Form 8821.
- ◆ Allowing the IRS to discuss return information with a third party designee.
- ◆ Allowing a tax matters partner or person (TMP) to perform acts for the partnership.
- ◆ Allowing the IRS to discuss return information with a fiduciary.
- ◆ Representing a taxpayer through a nonwritten consent.

Providing information to the IRS

If you are merely providing information to the IRS at the request of the IRS, a power of attorney is not required.

Disclosure of tax return information

You do not have to file a power of attorney to authorize the IRS to discuss and provide specific confidential tax return information to any individual, corporation, firm, trust, partnership, or organization you designate through the use of Form 8821. You may file your own tax information authorization without using Form 8821, but it must include all the information that is requested on the form.

Form 8821 is strictly a disclosure authorization form and cannot be used to designate an individual to represent you. If you want to name a representative, you should use Form 2848.

Fiduciary

If you are a fiduciary (trustee, executor, administrator, receiver, or guardian) of a taxpayer, you are deemed to be the taxpayer. For this reason you are not required to file a power of attorney. However, a fiduciary should file Form 56, Notice Concerning Fiduciary Relationship, to notify the IRS of the fiduciary relationship.

If you, as a fiduciary, wish to authorize an individual to represent or perform certain acts on your behalf, you must file a power of attorney authorizing that individual to act on your behalf. The individual must complete Form 2848, Part II, and Declaration of Representative.

CTEC Code of Conduct and Responsibilities

CTEC Registered Tax Preparers (CRTPs):

1. Must register as a tax preparer with the California Tax Education Council (CTEC).
2. Must maintain a \$5,000 Tax Preparer Bond issued by a surety company admitted to do business in California. A tax preparer shall provide to the surety company proof that he or she is at least 18 years of age before a bond can be issued.
3. Must identify to the surety company all preparers employed or associated with the tax preparer securing the bond.
4. Must file an amendment to the bond within 30-days of any change in the information provided in the bond.
5. Must not conduct business without having a current surety bond in effect.
6. Must cease doing business as a tax preparer upon cancellation or termination of bond until a new bond is obtained.
7. Must furnish evidence of a current bond upon the request of any state or federal agency or law enforcement agency.
8. Must, prior to rendering any tax preparation services, provide the customer, in writing, with the tax preparer's name, address, telephone number, and evidence of compliance with the bonding requirement.
9. Must not make fraudulent, untrue, or misleading statements or representations which are intended to induce a person to use their tax preparation services.
10. Must not obtain the signature of a customer to a tax return or authorizing document, which contains blank spaces to be filled in after it has been signed.
11. Must not fail or refuse to give a customer, for their own records, a copy of any document requiring the customer's signature, within a reasonable time after the customer signs.
12. Must not fail to maintain a copy of any tax return prepared for a customer for four years from the later of the due date of the return or the completion date of the return.
13. Must not engage in advertising practices, which are fraudulent, untrue, or misleading, including assertions that the tax preparer bond in any way implies licensure or endorsement of a tax preparer by the State of California.
14. Must not violate provisions of Sections 17530.5 or 7216 of Title 26 of the United States Code prohibiting tax preparers from disclosing any information obtained in the business of preparing federal or state income tax returns unless (1) consented to, in writing, by the taxpayer in a separate document; (2) expressly authorized by law; (3) necessary for the preparation of the return; and, (4) pursuant to court order.
15. Must not fail to sign a customer's tax return when payment for services rendered has been made.
16. Must not fail to return, upon the demand by or on behalf of a customer, records or other data provided to the tax preparer by the customer.
17. Must not give false or misleading bond information to a consumer or giving false or misleading information to a surety company in obtaining their tax preparer bond.
18. Must apply for their Certificate of Completion within 18-months after completing their 60-hours of qualifying education from a CTEC approved provider.

19. Must complete, on an annual basis, not less than 20-hours of continuing education from a CTEC approved provider (12 hours federal, 4 hours California, and 4 hours of either federal or California).

When a person prepares a tax return, for a fee, without the appropriate lawful designation, he or she could be cited and fined up to \$5,000 for each illegally prepared tax return. According to California Business and Professions Code 22253.5, The Franchise Tax Board may notify the California Tax Education Council when it identifies an individual who has violated the law.

Violators of other sections of the statute are guilty of a misdemeanor, which offense is punishable by a fine not exceeding \$1,000, or by imprisonment in a county jail for not more than one year, or by both. If a CRTP fails to perform a duty specifically imposed upon him or her pursuant to this statute, any person may maintain an action for enforcement of those duties or to recover a civil penalty in the amount of \$1,000, or for both enforcement and recovery.

The Superior Court in and for the county in which any person acts as a tax preparer in violation of the provisions of this statute, may, upon a petition by any person, issue an injunction or other appropriate order restraining the conduct.

California Income Tax

1. Who Are Residents & Nonresidents

A resident is any individual who is:

- ◆ In California for other than a temporary or transitory purpose;
- ◆ Domiciled in California, but outside California for a temporary or transitory purpose.

A nonresident is any individual who is not a resident. A part-year resident is any individual who is a California resident for part of the year and a nonresident for part of the year.

Safe Harbor

For taxable years beginning on or after January 1, 1994, a safe harbor is available for certain individuals leaving California under employment-related contracts. The safe harbor provides that an individual domiciled in California who is outside California under an employment-related contract for at least 546 consecutive days will be considered a nonresident unless:

- ◆ The individual has intangible income exceeding \$200,000 in any taxable year during which the employment-related contract is in effect;
- ◆ The principal purpose of the absence from California is to avoid personal income tax.

The spouse of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Return visits to California that in the aggregate do not exceed 45 days during any taxable year covered by the employment contract are considered temporary.

Individuals not covered by this safe harbor must determine their residency status based on their facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business, or vocation. Instead, all activities must be considered in the determination of residency status.

For instance, students who are residents of California leaving this state to attend an out-of-state school do not automatically become nonresidents, nor do students who are nonresidents of California coming to this state to attend a California school automatically become residents. In these situations, individuals must determine their residency status based on their facts and circumstances.

Significance of Residency

Residency is significant because it determines how income is taxed by California.

2. Guidelines for Determining Residency

The underlying theory of residency is that you are a resident of the place where you have the closest connections. The following list shows some of the factors you can use to help determine your residency status. Since your residence is usually the place where you have the closest ties, you should compare your ties to California with your ties elsewhere. In using these factors, it is the strength of your ties, not just the number of ties that determines your residency.

Factors to consider:

- ◆ Amount of time you spend in California versus amount of time you spend outside California;
- ◆ Location of your spouse and children;
- ◆ Location of your principal residence;
- ◆ Where your driver's license was issued;
- ◆ Where your vehicles are registered;
- ◆ Where you maintain your professional licenses;
- ◆ Where you are registered to vote;
- ◆ Location of the banks where you maintain accounts;
- ◆ Location of your doctors, dentists, accountants, and attorneys
- ◆ Location of the church, temple or mosque, professional associations, or social and country clubs of which you are a member;
- ◆ Location of your real property and investments;
- ◆ Permanence of your work assignments in California; and
- ◆ Location of your social ties.

Caution: This is only a partial list of the factors to consider. You must consider all the facts of your particular situation to determine residence status.

3. Temporary or Transitory Purposes

Generally, your state of residence is where you have your closest connections. If you leave your state of residence, it is important to determine if your presence in a different location is for a temporary or transitory purpose. You should consider the purpose and length of your stay when determining your residency.

Coming into California

When you are in California for temporary or transitory purposes, you are a nonresident of California. For instance, if you come to California for a vacation, or to complete a transaction, or are simply passing through, your purpose is temporary or transitory. As a nonresident, you are taxed only on your income from California sources.

When you are in California for other than a temporary or transitory purpose, you are a California resident. For instance, if your employer assigns you to an office in California for a long or indefinite period, if you retire and come to California with no specific plans to leave, or if you are ill and are in California for an indefinite recuperation period, your stay is other than temporary or transitory. As a resident, you are taxed on income from all sources.

Note: You will be presumed to be a California resident for any tax year in which you spend more than nine months in this state.

Although you may have connections with another state, if your stay in California is for other than a temporary or transitory purpose, you are a California resident. As a resident, your income from all sources is taxable by California.

Leaving California

Any individual who is a resident of California continues to be a resident when absent from the state for a temporary or transitory purpose.

For taxable years beginning on or after January 1, 1994, an absence from California under an employment-related contract for a period of at least 546 consecutive days may be considered an absence for other than a temporary or transitory purpose. See Section B, Safe Harbor.

Income Taxable by California

Residents of California are taxed on ALL income, including income from sources outside California.

Nonresidents of California are taxed only on income from California sources. Nonresidents of California are not taxed on pensions received after December 31, 1995.

Part-year residents of California are taxed on all income received while a resident and only on income from California sources while a nonresident.

If you use Long Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, you must initially figure your taxable income as if you were a California resident for the entire year. Complete Schedule CA (540NR), California Adjustments — Nonresidents or Part-Year Residents, column A through column D, to figure total adjusted gross income (AGI).

Figure California AGI applicable to a nonresident or part-year resident on Schedule CA (540NR), column E.

If you use Short Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, complete Short Form 540NR, line 17 to figure total adjusted gross income (AGI). Figure California AGI applicable to a nonresident or part-year resident on Short Form 540NR, line 21.

Note: Treat specific types of income as explained below.

Wages and Salaries

Wages and salaries have a source where the services are performed. Neither the location of the employer, where the payment is issued, nor your location when you receive payment affect the source of this income. A resident must include on Schedule CA (540NR), column E or Short Form 540NR, line 21 all wages and salaries earned, regardless of where the services were performed. A nonresident must include the income for services performed in California.

Interest and Dividends

Interest and dividends generally have a source where you are a resident.

Business Income (or Loss)

A nonresident's income from California sources includes income from a business, trade, or profession carried on in California. If the nonresident's business, trade, or profession is carried on both within and outside California and the part outside California is separate and distinct from the part within California, only income from the part conducted within California is California source income.

If, however, there is any business relationship between the parts within and outside California (flow of goods, etc.), the portion of income (or loss) taxable by California is normally determined by using the apportionment formula for corporations engaged in multi-state businesses.

Pensions and Keoghs (HR 10)

Residents: Distributions from employer-sponsored and self-employment (Keogh) pension, profit sharing, stock bonus plans, or other deferred compensation arrangements are taxable by California regardless of where the services were performed.

Nonresidents: Distributions are not taxable by California if received after December 31, 1995.

Lump-Sum Distributions

Residents: Lump-sum distributions are taxable by California. Residents of California are taxed on all income, regardless of source. Therefore, the distribution is taxable even if it is attributable to services performed outside of California and accrued prior to your becoming a California resident.

Nonresidents: Lump-sum distributions from a qualified plan or annuity after December 31, 1995, are not taxable by California. However, lump-sum distributions received from most nonqualified plans after December 31, 1995, continue to be taxable by California. IRA, Roth IRA, SIMPLE IRA, SEP, and Keogh distributions received after becoming a nonresident are not taxable by California if received after December 31, 1995.

Distributions from a SEP from contributions made after 1986 are taxed by California in the same manner as pension and Keogh distributions. Distributions from contributions made before 1987 are taxed by California in the same manner as IRA distributions.

Sale of Real Estate

The gain or loss from the sale of real estate has a source where the property is located. If you sell your California real estate and move out of state, the gain is taxable by California. The gain is taxable by California even if the real estate is sold when you are a nonresident.

4. Withholding Services and Compliance Section

Withholding may be required on sales of California real estate, income allocations or distributions from partnerships, and other payments of California source income paid to nonresidents. For more information, contact:

WITHHOLDING SERVICES AND
COMPLIANCE SECTION
FRANCHISE TAX BOARD
PO BOX 651
SACRAMENTO CA 95812-0651

From within the United States, call (888) 792-4900
From outside the United States, call (916) 845-4900
Fax (916) 845-4831

Partnership, S Corporation, and Trust Income (Loss)

When a partner is a part-year resident during any part of its own or the partnership's taxable year, the part-year resident must divide his or her taxable year into two distinct periods. For the period during which the part-year resident was a resident of this state, all items of income and deductions are to be included in the partner's California taxable income.

For the period during which the part-year resident was a nonresident of this state, only gross income and deductions realized from sources within this state are included in the partner's California taxable income. Therefore, all California-sourced items of income and loss realized by the partnership during the partnership's taxable year when the partner was a nonresident of this state are included in California taxable income. This also applies to shareholders of an S corporation and beneficiaries of a trust.

Sale of Stocks and Bonds

The gain or loss from the sale of stocks or bonds has a source where you are a resident at the time of the sale.

Installment Sales

For taxable years beginning 2002, California taxes installment gains received by a nonresident from the sale of tangible property on a source basis. Real property is sourced and taxed based upon where the property is located. California taxes residents on all income regardless of source.

Reimbursement of Moving Expenses

The source of reimbursed moving expenses is the state to which you move, regardless of your residency at the time the reimbursement is made.

5. Specific Professions

Military

Military personnel should get FTB pub. 1032, Tax Information for Military personnel.

Civilians Working for the Military

The rules for military personnel do not apply to civilians working for the military. You must determine your residency status and the source of your income based on the guidelines previously explained in Sections B through F.

Career Appointees in the U.S. Foreign Service

The rules for military personnel do not apply to career appointees in the U.S. Foreign Service. You must determine your residency status and the source of your income based on the guidelines previously explained in Sections B through F.

Airline Employees

The wages of nonresident flight personnel (e.g. pilot, copilot, flight attendant) are not taxable by California unless more than 50% of the individual's scheduled flight time is in California. If more than 50% of the scheduled flight time is in California, wages are apportioned to California based on the ratio of time spent in California to the total scheduled flight time.

Flight personnel who are California residents are taxed on all wages received regardless of where the flight time is spent.

Interstate Rail and Motor Carrier Employees

The wages of nonresident railroad employees or truck drivers whose regularly assigned duties are performed in two or more states may only be taxed by the individual's state of residence.

Railroad employees or truck drivers who are California residents are taxed on all wages received regardless of where the duties are performed.

Merchant Seamen

A merchant seaman who is in California only because this state is a port-of-call and who maintains no other contact or connections with this state, is a nonresident. However, a seaman who maintains close connections with California remains a California resident while at sea. Under such circumstances, the seaman's absence is for a temporary or transitory purpose.

6. Residents in Foreign Countries

If you are a resident of a foreign country and perform services in California and/or receive income from California sources, you may have a California income tax filing requirement even if you do not have a federal filing requirement.

Tax Treaty

A tax treaty between the U.S. Government and a foreign country may exempt some types of income from federal taxation. Generally, unless the treaty specifically excludes the income from taxation by California, the income is taxable.

Income Tax Clearance

A federal income tax clearance does not affect your California tax liability. The FTB does not issue tax clearance certificates for individuals in this situation.

Foreign Tax Credit or Foreign Earned Income Exclusion

California does not allow a foreign tax credit or a foreign earned income exclusion. If you claimed the foreign earned income exclusion on your federal return, include the amount of your foreign earned income exclusion on Schedule CA (540NR), line 21f, column C.

Married Filing Separate Returns Division of Income

The domicile of the spouse earning the income determines the division of income between spouses when separate returns are filed. Each spouse must follow the laws in his or her state of domicile to determine whether income is separate or community. When separate returns are filed, you and your spouse must each report half of the community income plus all of your separate income on your return. California is a community property state.

Meaning of Domicile

The term “domicile” has a special legal definition that is not the same as residence. While many states consider domicile and residence to be the same, California makes a distinction and views them as two separate concepts, even though they may often overlap. For instance, you may be domiciled in California but not be a California resident or you may be domiciled in another state but be a California resident for income tax purposes.

Domicile is defined for tax purposes as the place where you voluntarily establish yourself and family, not merely for a special or limited purpose, but with a present intention of making it your true, fixed, permanent home and principal establishment. It is the place where, whenever you are absent, you intend to return.

Change of Domicile

You can have only one domicile at a time. Once you acquire a domicile, you retain that domicile until you acquire another.

A change of domicile requires:

- ◆ Abandonment of your prior domicile;
- ◆ Physically moving to and residing in the new locality; and
- ◆ Intent to remain in the new locality permanently or indefinitely.

Community Property

Community property is all of the property that is not separate property acquired by a husband or wife or both while domiciled in a community property state.

Each spouse owns one-half of all community property. If property cannot be specifically identified as separate property, it is considered community property.

The following are community property states (and U.S. territory):

Arizona	New Mexico
California	Puerto Rico
Idaho	Texas
Louisiana	Washington
Nevada	Wisconsin

Community Income

Income generated from community property is community income. Community income also includes compensation for services if the spouse earning the compensation is domiciled in a community property state.

Community income must be divided equally between you and your spouse when separate returns are filed.

Separate Property

Separate property is:

- ◆ Property owned separately by the husband or wife before marriage;
- ◆ Property received separately as gifts or inheritances;
- ◆ Property purchased with separate property funds;
- ◆ Money earned while domiciled in a separate property state; and
- ◆ All property declared separate property in a valid agreement.

Separate property must be maintained separately. If the property or the income from the property is used for community purposes, or commingled, it could lose its separate property character, overriding any agreements.

Separate Income

Generally, income from separate property is income of the spouse who owns the property. When separate returns are filed, you and your spouse must each report your separate income on your separate return.

Deductions

Expenses incurred to earn or produce community business or investment income are generally divided equally between you and your spouse. Each spouse is entitled to deduct half of the expenses of the business or investment expenses on his or her separate return.

Expenses incurred to earn or produce separate business or investment income are deductible by the spouse who owns the investment generating the income, provided that spouse pays the expenses from his or her separate funds.

Expenses that are not attributable to any specific income, such as medical expenses, are deductible by the spouse who pays them. If these expenses are paid from community funds, the deduction is divided equally between you and your spouse.

Note: If one spouse itemizes deductions, both spouses must itemize deductions, even if the itemized deductions of one spouse are less than the standard deduction.

Exemption Credits

When you file separate returns, you and your spouse must each claim your own personal exemption credit. When you have more than one dependent supported by community funds, you and your spouse may divide the number of dependents between you in any manner you choose. However, you may not split the credit for any one dependent.