

# **California Educational Studies**

**Federal Individual Income Tax**

**20-Hour Course**

**CTEC Provider No: 2089  
IRS Approved Provider**

**2012 Edition**

**California Educational Studies**

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**PROGRAM AGENDA:** California Educational Studies is proud to serve the community of tax professionals for over 10 years. Our study course helps to navigate the tax preparer through the sometimes, complicated maze of tax rules, restrictions and requirements. This is accomplished through a home study course, which includes a self-study guide and final examination. The study course is monitored with the use of a final examination comprised of two hundred questions that test the individuals knowledge and retention of materials learned in the study guide. The study guide adheres to all tax rules and regulations. It is ultimately provided to allow the student quick and easy access to how particular tax items and situations should be treated. It also serves as a reference tool for more comprehensive tax research and tax planning. With comprehension, utilization and application of the study guide, suggested reading, and a thorough testing method, the student will be wholly prepared to provide themselves and their clients with an educated tax assessment and the highest of quality service in ensuring one adheres to CTEC and IRS standards.

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# Miscellaneous Federal Tax Updates

## [Section 1]

### *1. Filing Information -*

#### *\*Do I Have To File a Return?*

You must file a federal income tax return if you are a citizen or resident of the United States or a resident of Puerto Rico and you meet the filing requirements for any of the following categories that apply to you.

1. Individuals in general.
2. Dependents.
3. Certain children under age 19 or full-time students.
4. Self-employed persons.
5. Aliens.

#### *\*Individuals in General*

If you are a U.S. citizen or resident, whether you must file a return depends on three factors:

1. Your gross income,
2. Your filing status, and
3. Your age.

#### *\*When Do I Have To File?*

April 17, 2012, is the due date for filing your 2011 income tax return if you use the calendar year. If you use a fiscal year, your income tax return is due by the 15th day of the 4th month after the close of your fiscal year.

When the due date for doing any act for tax purposes, filing a return, and paying taxes falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

Your paper return is filed on time if it is mailed in an envelope that is properly addressed, has enough postage, and is postmarked by the due date. If you send your return by registered mail, the date of the registration is the postmark date. The registration is the evidence that the return was delivered. If you send a return by certified mail and have your receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered.

### *2. Reporting Gains and Losses -*

In previous years, many transactions would have been reported only on Schedule D. For 2011, you are also required to use the new Form 8949.

Use Form 8949 to report:

- The sale or exchange of a capital asset not reported on another form or schedule,
- Gains from involuntary conversions of capital assets not held for business or profit, and
- Non-business bad debts.

Use Schedule D (Form 1040):

- To figure the overall gain or loss from transactions reported on Form 8949, and
- To report capital gain distributions not reported directly on Form 1040, line 13.

On Form 8949, enter all sales and exchanges of capital assets, including stocks, bonds and real estate. Include these transactions even if you did not receive a Form 1099-B or 1099-S for the transaction. Report short-term gains or losses on line 1.

Report long-term gains or losses on line 3. If needed, use multiple Forms 8949.

### ***\*Capital Losses***

If your capital losses are more than your capital gains, you can claim a capital loss deduction.

**Limit on deduction.** Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- ◆ \$3,000, or
- ◆ Your total net loss as shown on line 16 of Schedule D.

### ***\*Capital Gain Tax Rates***

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. For 2011, the maximum capital gain rates are 0%, 15%, 25%, or 28%.

***Investment interest deducted.*** If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction.

***Gain on qualified small business stock.*** If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude up to 50% of your gain from income. The exclusion can be up to 75% for stock acquired after February 17, 2009. The exclusion can be up to 60% for certain empowerment zone business stock. The eligible gain minus your section 1202 exclusion is a 28% rate gain.

## ***3. Car Expenses and Other Employee Business Expenses***

### ***\*Tax Home***

To determine whether you are traveling away from home, you must first determine the location of your tax home. Your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the entire city or general area in which your business or work is located. If you do not have a regular or a main place of business, your tax home is your main place of business.

### ***\*What Travel Expenses Are Deductible?***

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible. You can deduct ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

### ***\*Meals and Incidental Expenses***

You can deduct the cost of meals in either of the following situations.

- ◆ It is necessary for you to stop for substantial sleep or rest to properly perform your duties while traveling away from home on business.
- ◆ The meal is business-related entertainment.

**50% limit on meals.** You can figure your meal expenses using either of the following methods.

- ◆ Actual cost.
- ◆ The standard meal allowance.

You generally can deduct only 50% of the un-reimbursed cost of your meals.

**Actual cost.** You can use the actual cost of your meals to figure the amount of your expense before reimbursement and application of the 50% deduction limit. If you use this method, you must keep records of your actual cost.

**Standard meal allowance** - You can use the “standard meal allowance” method as an alternative to the actual cost method. It allows you to use a set amount for your daily meals and incidental expenses instead of keeping records of your actual costs.

### ***\*Standard Mileage Rate***

You may be able to use the standard mileage rate to figure the deductible costs of operating your car for business purposes. For 2011, the standard mileage rate for each mile of business use is 51 cents per mile before July 1, 2011. After June 30, 2011, the business mileage rate increases to 55½ cents per mile.

You generally can use the standard mileage rate whether or not you are reimbursed and whether or not any reimbursement is more or less than the amount figured using the standard mileage rate.

If you want to use the standard mileage rate for a car you own, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use, either the standard mileage rate or actual expenses.

In respect to depreciation limits on cars, trucks, and vans, the first-year limit on the total section 179 deduction, special depreciation allowance, and depreciation deduction for cars increases to \$11,060. For trucks and vans the first-year limit has increased to \$11,260.

### ***\*Transportations and Standard Mileage Rate***

For medical expenses amounts paid for transportation for primarily 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.**

**You can include out-of-pocket expenses, such as the cost of gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.**

**If you do not want to use your actual expenses for 2011, you can use the standard medical mileage rate of 19 cents a mile for miles driven from January 1 to June 30, and 23.5 cents a mile for miles driven from July 1 to December 31, 2011, for use of a car for medical reasons.**

**You can also include parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate.**

**What are medical expenses? Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body.**

### ***\*Deductible Moving Expenses***

**You can deduct only those expenses that are reasonable for the circumstances of your move. The cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If during your trip to your new home, you stop over, or make side trips for sightseeing, the additional expenses for your stopover or side trips are not deductible as moving expenses.**

**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:**

- **Your actual expenses, such as the amount you pay for gas and oil for your car, if you keep an accurate record of each expense, or**
- **The standard mileage rate of 19 cents per mile for miles driven during the period from January 1 to June 30, 2011, and 23.5 cents per mile for miles driven during the period from July 1 to December 31, 2011.**

**Whether you use actual expenses or the standard mileage rate to figure your expenses, you can deduct the parking fees and tolls you pay to move. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.**

## ***4. Standard Deduction -***

### ***\*Standard Deduction Amount***

**The standard deduction amount depends on your filing status, whether you are 65 or older or blind, and whether another taxpayer can claim an exemption for you. The standard deduction amounts are adjusted each year for inflation.**

### ***\*Standard Deduction***

**Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. If you have a choice, you can use the method that gives you the lower tax.**

**The standard deduction is a dollar amount that reduces your taxable income. It is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A. The standard deduction is higher for taxpayers who:**

- Are 65 or older, or
- Are blind.

The standard deduction for some taxpayers who do not itemize their deductions on Schedule A of form 1040 is higher for 2011 than it was for 2010. The amount depends on your filing status.

### ***\*Standard deduction for dependents***

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

- ◆ \$950, or
- ◆ The Individual's earned income for the year plus \$300.

However, if the individual is 65 or older or blind, the standard deduction may be higher.

## ***5. Personal Exemptions and Dependents -***

### ***\*Personal Exemptions and Dependents***

Under personal exemptions, you generally can take one for yourself and, if you are married, one for your spouse.

- In Exemptions for dependents, you generally can take an exemption for each of your dependents. A dependent is your qualifying child or qualifying relative. If you are entitled to claim an exemption for a dependent, that dependent cannot claim a personal exemption on his or her own tax return.
- In regards to Social security number requirement for dependents, you must list the SSN of any dependent for whom you claim an exemption.

How you claim an exemption on your tax return depends on which form you file. If you file Form 1040EZ, the exemption amount is combined with the standard deduction amount and entered on line 5.

The amount you can deduct for each exemption has increased. It was \$3,650 for 2010. It is \$3,700 for 2011.

### ***\*Exemptions for Dependents***

You are allowed one exemption for each person you can claim as a dependent. You can claim an exemption for a dependent even if your dependent files a return.

The term "dependent" means:

- ◆ A qualifying child, or
- ◆ A qualifying relative.

You can claim an exemption for a qualifying child or qualifying relative only if these three tests are met.

1. Dependent taxpayer test.
  2. Joint return test.
  3. Citizen or resident test.
1. **Dependent taxpayer test** – If another person could claim you as a dependent, you cannot claim anyone else as a dependent. Even if you have a qualifying child or qualifying relative, you cannot claim that person as a dependent.

2. **Joint return test** – You generally cannot claim a married person as a dependent if he or she files a joint return. An exception to the joint return test applies if your child and his or her spouse file a joint return only as a claim for refund and no tax liability would exist for either spouse on separate returns.
3. **Citizen or resident test** – You cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico. However, there is an exception for certain adopted children.

## ***6. Medical and Dental Expenses -***

### ***\*What are Medical Expenses?***

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.

Medical 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 expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.

### ***\*How much of the Expenses Can You Deduct?***

You can deduct on Schedule A, only the amount of your medical and dental expenses that is more than 7.5% of your AGI. The term “7.5 limit” is used to refer to 7.5% of your AGI. The phrase “subject to the 7.5% limit” is also used. This phrase means that you must subtract 7.5% of your AGI from your medical expenses to figure your medical expense deduction.

### ***\*Insurance Premiums***

You can include in medical expenses, insurance premiums you pay for policies that cover medical care. Medical care policies can provide payment for treatment that includes:

- ◆ Hospitalization, surgical services, X-rays,
- ◆ Prescription drugs and insulin,
- ◆ Dental care,
- ◆ Replacement of lost or damaged contact lenses, and
- ◆ Long-term care.

### ***\*Health Insurance Costs for Self-Employed Persons***

If you were self-employed and had a net profit for the year, you may be able to deduct, as an adjustment to income, amounts paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, your dependents, and, your children who were under age 27 at the end of 2011.

You cannot deduct payments for medical insurance for any month in which you were eligible to participate in a health plan subsidized by your employer, your spouse’s employer, or, an employer of your dependent or your child under age 27 at the end of 2011. You

cannot deduct payments for a qualified long-term care insurance contract for any month in which you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer.

If you qualify to take the deduction, use the Self-Employed Health Insurance Deduction Worksheet in the Form 1040 instructions to figure the amount you can deduct. But if any of the following applies, do not use that worksheet.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

You take this deduction on Form 1040, line 29 because it is no longer allowed on Schedule SE (Form 1040). If you itemize your deductions and do not claim 100% of your self-employed health insurance on line 29, include any remaining premiums with all other medical expenses on Schedule A (Form 1040), subject to the 7.5% limit.

## ***7. How to Figure Your Tax -***

### ***\*Figuring Your Tax***

Your income tax is based on your taxable income. After you figure your income tax and any alternative minimum tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.

Most taxpayers use either the Tax Table or the Tax Computation Worksheet to figure their income tax. However, there are special methods if your income includes any of the following items.

- A net capital gain.
- Qualified dividends taxed at the same rates as a net capital gain.
- Lump-sum distributions.
- Farming or fishing income.
- Investment income over \$1,900 for certain children.
- Parents election to report child's interest and dividends.
- Foreign earned income exclusion or the housing exclusion.

### ***\*Credits***

After you figure your income tax and any alternative minimum tax, determine your tax credits.

### ***\*Alternative Minimum Tax***

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the alternative minimum tax (AMT).

You may have to pay the AMT if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than a certain amount.

***\*Adjustments and tax preference items***

The more common adjustments and tax preference items include:

- Addition of personal exemptions
- Addition of the standard deduction
- Addition of itemized deductions claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses.
- Subtraction of any refund of state and local taxes included in gross income.
- Changes to accelerated depreciation of certain property.
- Difference between gain or loss on the sale of property reported for regular tax purposes and AMT purposes.
- Addition of certain income from incentive stock options.
- Change in certain passive activity loss deductions.
- Addition of certain depletion that is more than the adjusted basis of the property.
- Addition of part of the deduction for certain intangible drilling costs.
- Addition of tax-exempt interest on certain private activity bonds.

The AMT exemption amount has increased to \$48,450 and \$74,450 if married filing jointly or a qualifying widow (er). The AMT exemption amount is \$37,225 if married filing separately.

***8. Wages, Salaries, and Other Earnings –***

***\*Employee Compensation***

If you are an employee, you should receive Form W-2 from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2. If you performed services, other than as an independent contractor, and your employer did not withhold social security and Medicare taxes from your pay, you must file Form 8919, Uncollected Social Security and Medicare Tax on wages, with your Form 1040. These wages must be included on line 7 of Form 1040.

*Childcare providers.* If you provide childcare, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you are not an employee, you are probably self-employed and must include payments for your services on Schedule C, Profit or Loss From Business, or Schedule C-EZ, Net profit From business. You generally are not an employee unless you are subject to the will and control of the person who employs you as to what you are to do and how you are to do it.

***\*Accident or Health Plan***

The values of accident or health plan coverage provided to you by your employer are not included in your income. Benefits you receive from the plan may be taxable.

***\*Health savings accounts (HSAs) and Archer MSAs***

For distributions after 2010, the additional tax on distributions from HSAs and Archer MSAs not used for qualified medical expenses has increased to 20%.

You can include only the medical and dental expenses you paid this 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 “online” 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. If you use a credit card, include medical expenses you charge to your credit card in the year the charge is made, not when you actually pay the amount charged.

If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

The amounts paid for medicine or a drug is qualified medical expense only if the medicine or drug is a prescribed drug or insulin.

***\*Community Property States***

If you and your spouse live in a community property state and file separate returns, or are registered domestic partners in Nevada, Washington, or California, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one individual, only the individual who paid the medical expenses can include them.

## **[Section 1 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Under filing information, if you use the calendar year to file your 2012 Form 1040EZ, the due date to file your return is:
  - a. April 15, 2012
  - b. April 16, 2012
  - c. April 17, 2012
  - d. April 18, 2012
  
2. In regards to dealing with Form 8949, you want to enter all sales and exchanges of capital assets, such as \_\_\_\_\_, and then complete Schedule D.
  - a. Bonds, Motor Vehicles, and Stocks.
  - b. Stocks, Bonds, and Child Tax Credits
  - c. Real Estate, Bonds, and Stocks.
  - d. Motor Vehicles, Child Tax Credits, and Stocks.
  
3. Which of the following expenses below can you include in standard mileage rates for medical expenses when using your car for medical reasons?
  - a. General Repair
  - b. Depreciation
  - c. Oil
  - d. Insurance

## **[Section 2] – Miscellaneous Federal Tax Updates Continued**

### ***9. Rollovers -***

#### ***\*Who Can Open a Traditional IRA?***

You can open and make contributions to a traditional IRA if:

- You received taxable compensation during the year, and
- You were not age 70½ by the end of the year.

You can have a traditional IRA whether or not you are covered by any other retirement plan. However, you may not be able to deduct all of your contributions if you or your spouse is covered by an employer retirement plan.

You can open different kinds of IRAs with a variety of organizations. You can open an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also open 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.

#### ***\*Simplified Employee Pension (SEP)***

A simplified employee pension (SEP) is a written arrangement that allows your employer to make deductible contributions to a traditional IRA set up for you to receive such contributions. Generally, distributions from SEP IRAs are subject to the withdrawal and tax rules that apply to traditional IRAs.

#### ***\*Individual Retirement Bonds***

The sale of individual retirement bonds issued by the federal government was suspended after April 30, 1982. The bonds have the following features:

- They stop earning interest when you reach age 70½. If you die, interest will stop 5 years after your death or on the date you would have reached age 70½, whichever is earlier.
- You cannot transfer the bonds.

If you cash the bonds before the year in which you reach age 59½, you may be subject to a 10% additional tax.

#### ***\*Roth IRAs***

If you converted or rolled over an amount to a Roth IRA in 2010 and did not elect to report the taxable amount on your 2010 return, you generally must report half of it on your 2011 return and the rest on your 2012 return.

If you rolled over an amount from a 401k or 403b plan to a designated Roth account in 2010 and did not elect to report the taxable amount on your 2010 return, you generally must report half of it on your 2011 return and the rest on your 2012 return.

## ***10. Other Credits -***

### ***\*Foreign Tax Credit***

You generally can choose to take income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction.

You cannot take a credit (or deduction) for foreign income taxes paid on income that you exclude from U.S. tax under any of the following.

1. Foreign earned income exclusion.
2. Foreign housing exclusion.
3. Income from Puerto Rico exempt from U.S. tax.
4. Possession exclusion.

### ***\*Mortgage Interest Credit***

The mortgage interest credit is intended to help lower-income individuals own a home. If you qualify, you can take the credit each year for part of the home mortgage interest you pay.

### ***\*Alternative Motor Vehicle Credit***

You may be able to take this credit if you place a qualified fuel cell vehicle in service in 2011. The credit is also allowed for the cost of converting a vehicle to a qualified plug-in electric drive vehicle. However, you cannot claim the AMV Credit for a vehicle you bought in 2011, unless it is a new fuel cell motor vehicle.

The credit has expired for advanced learn burn technology vehicles, qualified hybrid vehicles, and qualified alternative fuel vehicles purchased after 2010. You cannot claim the credit on your 2011 return for these vehicles. However, you may be able to claim the credit for one of these vehicles purchased in 2010 but not placed in service until 2011.

### ***\*Residential Energy Credits***

You may be able to take one or both of the following credits if you made energy saving improvements to your home located in the United States in 2011.

- ◆ Non-business energy property credit.
- ◆ Residential energy efficient property credit.

### ***\*First-Time Homebuyer Credit***

For most people, this credit is not available for home purchased in 2011. Members of the uniformed services or Foreign Service and employees of the intelligence community may still be able to claim the credit.

You can claim the credit only if you meet all three of the following requirements.

1. You are, or were, a member of the uniformed services or Foreign Service or an employee of the intelligence community and were on qualified official extended duty for at least 90 days during the period beginning after December 31, 2008, and ending before May 1, 2010.
2. You bought a main home in the United States;
  - a. After December 31, 2010, and before May 1, 2011, or

- b. After April 30, 2011, and before July 1, 2011, and you entered into a binding contract before May 1, 2011, to buy the home before July 1, 2011.
3. You did not own any other main home during the 3-year period ending on the date of purchase.

***\*Non-business energy property credit***

You may be able to take a credit equal to the sum of:

- a. 10% of the amount paid or incurred for qualified energy efficiency improvements installed during 2011, and
- b. Any residential energy property costs paid or incurred in 2011.

There is a lifetime limit of \$500 for all years after 2005, of which only \$200 can be for windows; \$50 for any advanced main air circulating fan; \$150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and \$300 for any item of energy efficient building property.

Qualified energy efficiency improvements are the following improvements that are new, can be expected to remain in use at least 5 years, and meet certain requirements for energy efficiency.

- Any insulation material or system that is specifically and primarily designed to reduce heat loss or gain of a home.
- Exterior doors.
- Any metal or asphalt roof that has appropriate pigmented coatings or cooling granules specifically and primarily designed to reduce heat gain of the home.

***\*Health Coverage Tax Credit***

If you received any advance payments in March through December 2011, you are eligible to receive an additional 7.5% retroactive credit.

You may be able to take this credit for any month in which all the following statements were true on the first day of the month.

- You were an eligible trade adjustment assistance recipient, alternative TAA recipient, reemployment TAA recipient, or Pension Benefit Guaranty Corporation pension recipient; or you were a qualified family member of one of these individuals when the individual died or you finalized a divorce with one of these individuals.
- You and/or your family members were covered by a qualified health insurance plan for which you paid the entire premiums, or your portion of the premiums, directly to your health plan or to "U.S. Treasury".
- You were not enrolled in Medicare Part A, B, or C, or you were enrolled in Medicare but your family members qualified for the HCTC.
- You were not enrolled in Medicaid or the Children's Health Insurance Program.

- You were not enrolled in the Federal Employees Health Benefits program or eligible to receive benefits under the U.S. military health system.
- You were not imprisoned under federal, state, or local authority.
- Your employer did not pay 50% or more of the cost of coverage.
- You did not receive a 65% COBRA premium reduction from your former employer or COBRA administrator.

### ***\*Foreign Financial Assets***

If you had foreign financial assets in 2011, you may have to file new Form 8938 with your return.

### ***\*Adoption Credit***

You may be able to take a tax credit of up to \$13,360 for qualified expenses paid to adopt an eligible child. The credit may be allowed for the adoption of a child with special needs even if you do not have any qualified expenses.

If your modified adjusted gross income (AGI) is more than \$185,210, your credit is reduced. If your modified AGI is \$225,210 or more, you cannot take the credit.

### ***\*Qualified Adoption Expenses***

Qualified adoption expenses are reasonable and necessary expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. These expenses include:

- Adoption fees,
- Court costs,
- Attorney fees,
- Travel expenses while away from home.
- Re-adoption expenses to adopt a foreign child.

### ***\*Employer-Provided Vehicles***

The Fair Market Value of an employer-provided vehicle is the amount the employee would have to pay a third party to lease the same or similar vehicle on the same or comparable terms in the geographic area where the employee uses the vehicle. A comparable lease term would be the amount of time the vehicle is available for the employee's use, such as a 1-year period.

Do not determine the FMV by multiplying a cents-per-mile rate times the number of miles driven unless the employee can prove the vehicle could have been leased on a cents-per-mile basis.

### ***\*Cents-Per-Mile Rule***

Under this rule, you determine the value of a vehicle you provide to an employee for personal use by multiplying the standard mileage rate by the total miles the employee drives the vehicle for personal purposes. Personal use is any use of the vehicle other than use in your trade or business. This amount must be included in the employee's wages or

reimbursed by the employee once this figure has been determined. For 2011, the standard mileage rate for business use is 51 cents per mile. For 2012, the standard mileage rate for business use is 55.5 cents per mile.

You can use the cents-per-mile rule if either of the following requirements is met.

- You reasonably expect the vehicle to be regularly used in your trade or business throughout the calendar year.
- The vehicle meets the mileage test.

***\*Foreign Earned Income Exclusion and Housing Exclusion and Deduction***

If you meet certain requirements while living abroad, you may qualify to treat up to \$92,900 of your income as not taxable by the United States. You also may be able to either deduct part of your housing expenses from your income or treat a limited amount of income used for housing expenses as not taxable by the United States. These benefits are called the foreign earned income exclusion and the foreign housing deduction and exclusion.

To qualify for either of the exclusions or the deduction, you must have a tax home in a foreign country and earn income from personal services performed in a foreign country.

## **[Section 2 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. In regards to non-business energy property credit, qualified energy efficiency improvements must remain in use for:
  - a. At least 2 years.
  - b. At least 5 years.
  - c. Maximum 2 years.
  - d. Maximum 5 years.
  
2. Under non-business energy property credit, which of the following below is not a qualified energy efficiency improvement?
  - a. Insulation Material.
  - b. Interior Doors.
  - c. System Designed to Reduce Heat Loss.
  - d. Exterior Doors.
  
3. Under the health coverage tax credit, amounts paid for qualified health insurance coverage after February 2011, has:
  - a. Increased to 80% from 72.5%.
  - b. Decreased to 72.5% from 80%.
  - c. Decreased to 7.5% from 8.0%.
  - d. Stayed the same.

## **[Section 3] – Miscellaneous Federal Tax Updates Continued**

### ***\*Self-Employment Tax Reduced***

The 2010 Tax Relief Act reduced the self-employment tax by 2% for self-employment income earned in calendar year 2011. The self-employment tax rate for self-employment income earned in calendar year 2011 is 13.3%. For self-employment income earned in 2010, the self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security and 2.9% for Medicare.

For both 2010 and 2011, the first \$106,800 of your combined wages, tips, and net earnings is subject to any combination of the Social Security part of self-employment tax, Social Security tax, or railroad retirement tax. Income you make after \$106,800 will not be subject to the Social Security tax.

All your combined wages, tips, and net earnings in the current year are subject to any combination of the 2.9% Medicare part of Self-Employment tax, Social Security tax, or railroad retirement tax.

If your wages and tips are subject to either Social Security or railroad retirement tax, or both, and total at least \$106,800, do not pay the Social Security part of the self-employment tax on any of your net earnings. You must pay the 2.9% Medicare part of the self-employment tax on all your net earnings.

If you use a tax year other than the calendar year, you must use the tax rate and maximum earnings limit in effect at the beginning of your tax year. Even if the tax rate or maximum earnings limit changes during your tax year, continue to use the same rate and limit throughout your tax year.

### ***\*Mortgage Insurance Premium Deduction***

The mortgage insurance premium deduction has changed for 2012. An itemized deduction for premium you pay or accrue for qualified mortgage insurance in connection with home acquisition debt on your qualified home is no longer available for 2011.

### ***\*Earned Income Credit***

The maximum amount of income you can earn and still get the credit has increased. You may be able to take the credit if you earn less than:

- \$13,660, do not have a qualifying child, and are at least 25 years old and under 65.
- \$36,052, and you have one qualifying child,
- \$40,964, and you have two qualifying children, or
- \$43,998, and you have three or more qualifying children.

### ***\*Retirement Savings Contributions Credit***

If you or your employers make eligible contributions to a retirement plan, you may be able to take a credit of up to \$1,000. This credit could reduce the federal income tax you pay dollar for dollar.

***\*Can you claim the credit?***

If you or your employer make eligible contributions to a retirement plan, you can claim the credit if all of the following apply.

1. You are not under age 18.
2. You are not a full-time student.
3. No one else, such as your parents, claims an exemption for you on their tax return.
4. Your adjusted gross income is not more than:
  - a. \$56,500 for 2011 (\$57,500 for 2012) If your filing status is married filing jointly,
  - b. \$42,375 for 2011 (\$43,125 for 2012) if your filing status is head of household, or
  - c. \$28,250 for 2011 (\$28,750 for 2012) if your filing status is single, married filing separately, or qualifying widow with dependent child.

***\*Full-time Student***

You are a full-time student if, during some part of each of 5 calendar months during the calendar year, you are either:

- A full-time student at a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance.
- A student taking a full-time, on-farm training course given by either a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance, or a state, county, or local government.

You are a full-time student if you are enrolled for the number of hours or courses the school considers to be full-time.

***\*Modified AGI Limit For Traditional IRA Contributions Increased.***

For 2012, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced if your modified AGI is:

- More than \$92,000 but less than \$112,000 for a married couple filing a joint return or a qualifying widow,
- More than \$58,000 but less than \$68,000 for a single individual or head of household, or
- Less than \$10,000 for a married individual filing a separate return.

If you live with your spouse or file a joint return, and your spouse is covered by a retirement plan at work, but you are not, your deduction is phased out if your modified AGI is more than \$173,000 but less than \$183,000. If your modified AGI is \$183,000 or more, you cannot take a deduction for contributions to a traditional IRA.

***\*Modified AGI Limit for Roth IRA Contributions Increased.***

- Your filing status is married filing jointly or qualifying widow and your modified AGI is at least \$173,000. You cannot make a Roth IRA contribution if your modified AGI is \$183,000 or more.
- Your filing status is single, head of household, or married filing separately and you did not live with your spouse at any time in 2012 and your modified AGI is at least \$110,000. You cannot make a Roth IRA contribution if your modified AGI is \$125,000 or more.
- Your filing status is married filing separately, you lived with your spouse at any time during the year, and your modified AGI is more than 0. You cannot make a Roth IRA contribution if your modified AGI is \$10,000 or more.

***\*Social Security and Medicare Tax for 2011***

For 2011, the employee tax rate for social security is 4.2%.

The employer tax rate for social security remains unchanged at 6.2%. The 2011 social security wage base limit is \$106,800. In 2011, the Medicare tax rate is 1.45% each for employers and employees, unchanged from 2010. There is no wage base limit for Medicare Tax.

Employers should implement the 4.2% employee social security tax rate as soon as possible, but not later than January 31, 2011. After implementing the new 4.2% rate, employers should make an offsetting adjustment in a subsequent pay period to correct any overwithholding of social security tax as soon as possible, but not later than March 31, 2011.

Social security and Medicare taxes apply to the wages of household workers you pay \$1,700 or more in cash or an equivalent form of compensation. Social security and Medicare taxes apply to election workers who are paid \$1,500 or more in cash or an equivalent form of compensation.

***\*Making Work Pay Credit***

The making work pay credit expires on December 31, 2010. As a result:

- The income tax withholding tables for 2011 are not adjusted for the Making Work Pay credit.
- There is no longer an optional additional withholding adjustment for pensions.
- The procedure for withholding on wages of nonresident aliens has been modified.

***\*Tax Rates***

For tax years beginning in 2011, the social security part of the self-employment tax decreases from 12.4% to 10.4%. The medicare part of the tax remains at 2.9%. As a result, the self-employment tax is reduced from 15.3% to 13.3%.

***\*Maximum Net Earnings***

The maximum net self-employment earnings subject to the social security part of the self-employment tax remains \$106,800 for 2011. There is no maximum limit on earnings subject to the Medicare and the tax remains at 2.9%.

***\*Start-up costs back to \$5,000 in 2011***

For tax years beginning in 2011, you can elect to deduct up to \$5,000 of your business start-up costs paid or incurred after October 22, 2004. The increased limit of \$10,000 for start-up costs was only allowed in 2010.

***\*Increased Section 179 Expense Deduction Dollar Limits***

The maximum amount you can elect to deduct for most 179 property you placed in service in 2011 is \$500,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds \$2 million.

***\*What Property Can Be Depreciated***

You can depreciate most types of tangible property, such as buildings, machinery, equipment, vehicles, certain livestock, and furniture. You can also depreciate certain intangible property, such as copyrights, patents, and computer software. To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income producing activity.
- It must have a determinable useful life.
- It must have a useful life that extends substantially beyond the year you place it in service.

***\*Property You Own***

To claim depreciation, you usually must be the owner of the property. You are considered as owning property even if it is subject to a debt.

***\*Special Depreciation Allowance for Certain Qualified Property Acquired After September 8, 2010***

You may be able to take a 100% special depreciation allowance for certain qualified property acquired after September 8, 2010, and placed in service before January 1, 2012.

## **[Section 3 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. The Tax Relief Act reduced the self-employment tax by:
  - a. 2%.
  - b. 12.4%.
  - c. 2.9%.
  - d. 15.3%.
  
2. In regards to mortgage insurance premium, if your adjusted gross income for 2011 is more than \_\_\_\_\_ or \$54,500 if married filing separately, you cannot deduct your mortgage insurance premium.
  - a. \$89,900.
  - b. \$109,000.
  - c. \$129,000.
  - d. None of the above.
  
3. Under retirement savings contributions, you can claim the credit if which of the following apply?
  - a. You are not a full time student.
  - b. You are not under age 18.
  - c. No one else can claim you on their tax return.
  - d. All of the above.

# Federal Tax Law

## [Section 4]

### Filing Information –

#### *\*Do I Have To File a Return?*

You must file a federal income tax return if you are a citizen or resident of the United States or a resident of Puerto Rico and you meet the filing requirements for any of the following categories that apply to you:

1. **Individuals in general.** (There are special rules for surviving spouses, executors, administrators, legal representatives, U.S. citizens living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
2. **Dependents.**
3. **Child under age 19.**
4. **Self-employed persons.**
5. **Aliens.**

File only one federal income tax return for the year regardless of how many jobs you had, how many Forms W-2 you received, or how many states you lived in during the year.

If you are a U.S. citizen or resident, whether you must file a return depends on three factors:

- 1) **Your gross income,**
- 2) **Your filing status, and**
- 3) **Your age.**

#### *\*Gross Income*

This includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. It also includes income from sources outside the United States or from the sale of your main home (even if you may exclude all or part of it). Include part of your social security benefits if:

1. You were married, filing a separate return, and you lived with your spouse at any time during 2009; or
2. Half of your social security benefits plus your other gross income and any tax-exempt interest is more than \$25,000.

If you are married and your permanent home is in a community property state, half of any income described by state law as community income may be considered yours. This affects your federal taxes, including whether you must file if you do not file a joint return with your spouse.

A registered domestic partner in Nevada, Washington, or California generally must report half the combined community income of the individual and his or her domestic partner.

#### *\*Self-Employed Individuals*

If you are self-employed, your gross income includes the amount on line 7 of Schedule C (Form 1040), Profit or Loss from Business, or line 1 of Schedule C-EZ (Form 1040), Net

**Profit from Business.** If you do not report all of your self-employment income, you could cause your social security benefits to be lower when you retire.

***\*U.S. Citizens and Residents living outside the United States***

If you are a U.S. citizen or resident living outside the United States, you must file a return if you meet the filing requirements. For information on special tax rules that may apply to you, see Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad. It is available at most U.S. embassies and consulates.

Generally, if you are a U.S. citizen and a resident of Puerto Rico, you must file a U.S. income tax return if you meet the filing requirements. This is in addition to any legal requirement you may have to file an income tax return for Puerto Rico.

If you are a resident of Puerto Rico for the entire year, gross income does not include income from sources within Puerto Rico, except for amounts received as an employee of the United States or a U.S. agency. If you receive income from Puerto Rican sources that is not subject to U.S. tax, you must reduce your standard deduction. As a result, the amount of income you must have before you are required to file a U.S. income tax return is lower than the applicable amount.

***\*Filing Status***

Your filing status depends on whether you are single or married and on your family situation. Your filing status is determined on the last day of your tax year, which is December 31 for most taxpayers.

***\*Age***

If you are 65 or older at the end of the year, you generally can have a higher amount of gross income than other taxpayers before you must file. You are considered 65 on the day before your 65<sup>th</sup> birthday.

***\*Surviving Spouses, Executors, and Administrators***

You must file a final return for a decedent (a person who died) if both of the following are true:

- You are the surviving spouse, executor, administrator, or legal representative.
- The decedent met the filing requirements at the date of death.

***\*Responsibility of Parent***

Generally, a child is responsible for filing his or her own tax return and for paying any tax on the return. But if a dependent child who must file an income tax return cannot file it for any reason, such as age, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the parent or guardian must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them. If the child does not pay the tax due on this income, the parent is liable for the tax.

### ***\*Individuals with Income from U.S. Possessions***

If you had income from Guam, the Commonwealth of the Northern Mariana Islands, American Samoa, or the U.S. Virgin Islands, special rules may apply when determining whether you must file a U.S. federal income tax return. In addition, you may have to file a return with the individual island government.

### ***\*Child Under Age 19***

If a child's only income is interest and dividends (including Alaska Permanent Fund dividends) and certain other conditions are met, a parent can elect to include the child's income on the parent's return if that child is under the age of 19. If this election is made, the child does not have to file a return.

### ***\*Self-Employed Persons***

You are self-employed if you:

1. Carry on a trade or business as a sole proprietor,
2. Are an independent contractor,
3. Are a member of a partnership, or
4. Are in business for yourself in any other way.

Self-employment can include work in addition to your regular full-time business activities. It also includes certain part-time work that you do at home or in addition to your regular job. You must file a return if your gross income is at least as much as the filing requirement amount for your filing status and age.

Also, you must file Form 1040 and Schedule SE (Form 1040), Self-Employment Tax, if:

1. Your net earnings from self-employment (excluding church employee income) were \$400 or more, or
2. You had church employee income of \$108.28 or more.

### ***\*Ministers***

You must include income from services you performed as a minister when figuring your net earnings from self-employment, unless you have a exemption from self-employment tax. This also applies to Christian Science practitioners and members of a religious order who have no taken a vow of poverty.

### ***\*Aliens***

Your status as an alien-resident, nonresident, or dual status determines whether you must file an income tax return.

If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens.

If you are a nonresident alien, the rules and tax forms that apply to you are different from those that apply to U.S. citizens and resident aliens. Dual-status taxpayer. If you were a resident alien for part of the tax year and a nonresident alien for the rest of the year, you are a dual-status taxpayer. Different rules apply for each part of the year.

### ***\*Where Do I File?***

After you complete your return, you must send it to the IRS. You can mail it or you may be able to file it electronically.

***\*Who Should File***

Even if you do not have to file, you should file a federal income tax return to get money back if any of the following conditions apply:

- 1) You had federal income tax withheld or made estimated tax payments.
- 2) You qualify for the earned income credit.
- 3) You qualify for the additional child tax credit.
- 4) You qualify for the health coverage tax credit.
- 5) You qualify for the refundable credit for prior year minimum tax.
- 6) You qualify for the first-time homebuyer credit.
- 7) You qualify for the American opportunity credit.
- 8) You qualify for the credit for federal tax on fuels.
- 9) You qualify for the adoption credit.

## **[Section 4 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. In addition to money, goods, and property, which of the following forms of income received would be included as gross income:
  - a. A service that is not exempt from tax.
  - b. Income from sources outside the United States.
  - c. The sale of your main home.
  - d. All of the above.
  
2. Your filing status is determined on the last day of your tax year, which is December 31<sup>st</sup> for most taxpayers. It is dependent on which of the following factors:
  - a. Your filing status depends on whether you are married or single.
  - b. Your filing status depends on your family situation.
  - c. Both A & B are correct.
  - d. Neither are correct responses.
  
3. You must file Form 1040 and Schedule SE if you had church employee income of:
  - a. \$100.28 or more.
  - b. \$90.02 or more.
  - c. \$108.28 or more.
  - d. \$108.27 or more.

## **[Section 5] – Federal Tax Law Continued**

### **Which Form Should I Use? -**

#### ***\*Form 1040EZ***

Form 1040EZ is the simplest form to use. You can use Form 1040EZ if all of the following apply:

1. Your filing status is single or married filing jointly. If you were a nonresident alien at any time during the tax year, your filing status must be married filing jointly.
2. You (and your spouse if married filing a joint return) were under age 65, and not blind at the end of the tax year.
3. You do not claim any dependents.
4. Your taxable income is less than \$100,000.
5. Your income is only from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, , and taxable interest of \$1500 or less.
6. You did not receive any advance earned income credit (EIC) payments.
7. You do not claim any adjustments to income, such as a deduction for IRA contributions or student loan interest.
8. You do not claim any credits other than the earned income credit.
9. You do not owe any household employment taxes on wages you paid to a household employee.
10. You are not a debtor in a chapter 11 bankruptcy case filed after October 16, 2005.

You must meet all of these requirements to use Form 1040EZ. If you do not, you must use Form 1040A or Form 1040.

On Form 1040EZ, you can only use the tax table to figure your tax. You cannot use Form 1040EZ to report any other tax.

#### ***\*Form 1040A***

You can use Form 1040A if all of the following apply:

- 1) Your income is only from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, ordinary dividends (including Alaska Permanent Fund dividends), capital gain distributions, qualified state tuition program earnings, and unemployment compensation.
- 2) Your taxable income is less than \$100,000.
- 3) Your adjustments to income are for only the following items.
  - a) Educator expenses.
  - b) The student loan interest deduction.
  - c) IRA deduction
  - d) Tuition & fees deduction.
- 4) You do not itemize your deductions.

- 5) **Your taxes are from only the following items.**
  - a) **Tax Table.**
  - b) **Alternative minimum tax.**
  - c) **Advance earned income credit (EIC) payments, if you received any.**
  - d) **Recapture of an education credit.**
  - e) **Form 8615, Tax for Children Who Have Investment Income of More Than \$1800.**
  - f) **Qualified Dividends and Capital Gain Tax Worksheet.**
- 6) **You claim only the following credits.**
  - a) **The credit for child and dependent care expenses.**
  - b) **The credit for the elderly or the disabled.**
  - c) **The child tax credit.**
  - d) **The additional child tax credit.**
  - e) **The education credits.**
  - f) **The retirement savings contributions credit.**
  - g) **The earned income credit.**
- 7) **You did not have an alternative minimum tax adjustment on stock you acquired from the exercise of an incentive stock option.**

If you receive a capital gain distribution that includes un-recaptured section 1250 gain, section 1202 gain, or collectibles (28%) gain, you cannot use Form 1040A. You must use Form 1040.

***\*Form 1040***

If you cannot use Form 1040EZ or Form 1040A, you must use Form 1040. You can use Form 1040 to report all types of income, deductions, and credits.

You may have received Form 1040A or Form 1040EZ in the mail because of the return you filed last year. If your situation has changed this year, it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions, some adjustments to income, and credits you cannot take on Form 1040A or Form 1040EZ.

You must use Form 1040 if any of the following apply:

1. **Your taxable income is \$100,000 or more.**
2. **You itemize your deductions.**
3. **You had income that cannot be reported on Form 1040EZ or Form 1040A, including tax-exempt interest from private activity bonds issued after August 7, 1986.**
4. **You claim any adjustments to gross income other than the adjustments listed earlier under Form 1040A.**

5. Your Form W-2, box 12, shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance.
6. You received \$20 or more in tips in any one month and did not report all of them to your employer.
7. You were a bona fide resident of Puerto Rico and exclude income from sources in Puerto Rico.
8. You Claim any credits other than the credit listed earlier under Form 1040A.
9. You owe the excise tax on insider stock compensation from an expatriated corporation.
10. Your Form W-2 shows an amount in box 12 with a code Z.
11. You had a qualified health savings account funding distribution from our IRA.
12. You are an employee and your employer did not withhold social security and Medicare tax.
13. You have to file other forms with your return to report certain exclusions, taxes, or transactions.
14. You are a debtor in a bankruptcy case filed after October 16, 2005.
15. You must recapture the first-time homebuyer credit.
16. You received a refund or credit of certain taxes or net disaster loss you claimed as part of your standard deduction.

***\*Electronically filed returns***

If you use IRS e-file, your return is considered filed on time if the authorized electronic return transmitter postmarks the transmission by the due date. An authorized electronic return transmitter received the transmission of your electronically filed return on its host system. The date and time in your time zone controls whether your electronically filed return is timely.

The processing of e-file returns is faster and more accurate than the processing of paper returns. However, errors on the return or problems with its transmission can delay processing. As with a paper return, you are responsible for making sure your return contains accurate information and is filed on time. Using e-file does not affect your chances of an IRS examination of your return. Benefits of IRS e-file include:

- ◆ Free File allows qualified taxpayers to prepare and e-file their own tax returns for free.
- ◆ Free File is available in English and Spanish.
- ◆ Free File is available online 24 hours a day, 7 days a week.
- ◆ Get your refund faster by e-filing using Direct Deposit.
- ◆ Sign electronically with a secure self-selected PIN number and file a completely paperless return.
- ◆ Receive an acknowledgement that your return was accepted.
- ◆ If you owe, you can e-file and authorize an electronic funds withdrawal or pay by credit card. You can also file a return early and pay the amount you owe by the due date of your return.
- ◆ Save time by preparing and e-filing federal and state returns together.
- ◆ IRS computers quickly and automatically check for errors or other missing information.
- ◆ Help the environment, use less paper, and save taxpayer money. It costs less to process an e-filed return than a paper return.

### ***\*Refunds***

You can have a refund check mailed to you, or you can have your refund deposited directly to your checking or savings account.

### ***\*Free Help with Your Return***

Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low to moderate income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 or older with their tax returns. Many VITA sites offer free electronic filing and all volunteers will let you know about the credits and deductions you may be entitled to claim. To find a site near you, call 1-800-829-1040. Or to find the nearest AARP Tax Aide site, visit AARP's website at [www.aarp.org/taxaide](http://www.aarp.org/taxaide) or call 1-888-227-7669.

### ***\*Power of attorney***

If an agent is signing your return for you, a power of attorney (POA) must be filed. Attach the POA to Form 8453 or 8453-OL and file it using that form's instructions.

### ***\*State Returns***

In most states, you can file an electronic state return simultaneously with your federal return. For more information, check with your local IRS office, state tax agency, tax professional, or the IRS website.

### ***\*Refund inquiries***

You can go online to check the status of your refund 72 hours after the IRS acknowledges receipt of your e-filed return.

### ***\*Amount you owe***

To avoid late-payment penalties and interest, pay your taxes in full by April 17, 2012.

### ***\*Using a tax professional***

Many tax professionals electronically file tax returns for their clients. You may personally enter your PIN or complete Form 8879, IRS e-file Signature Authorization, to authorize the tax professional to enter your PIN on your return.

## ***Extensions of Time To File -***

You may be able to get an extension of time to file your return. Special rules apply if you were:

- Outside the United States, or
- Serving in a combat zone.

### ***\*Automatic Extension***

If you cannot file your tax return by the due date, you may be able to get an automatic 6-month extension of time to file. You can get the automatic extension by: 1. Using IRS e-file (electronic filing), or 2. Filing a paper form.

### ***\*Individuals outside the United States***

You are allowed an automatic 2-month extension to file your 2009 return and pay any federal income tax due if:

1. You are a U.S. citizen or resident, and

2. **On the due date of your return:**
  - a. **You are living outside the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, or**
  - b. **You are in military or naval service on duty outside the United States and Puerto Rico.**

However, if you pay the tax due after the regular due date, interest will be charged from that date until the date the tax is paid.

If you served in a combat zone or qualified hazardous duty area, you may be eligible for a longer extension of time to file.

### ***\*Married Taxpayers***

If you file a joint return, only one spouse has to qualify for this automatic extension. If you and your spouse file separate returns, this automatic extension applies only to the spouse who qualifies.

### ***\*How to get the extension***

To use this automatic extension, you must attach a statement to your return explaining what situation qualified you for the extension.

### ***\*Extensions beyond 2 months***

If you cannot file your return within the automatic 2-month extension period, you may be able to get an additional 4-month extension, for a total of 6 months.

An extension of more than 6 months will generally not be granted. However, if you are outside the United States and meet certain tests, you may be granted a longer extension.

### ***\*Filing a Paper Form 4868***

You can get an extension of time to file by filing a paper Form 4868. Mail it to the address shown in the form instructions.

You must request the automatic extension by the due date for your return. You can file your return any time before the 6-month extension period ends.

### ***\*When Do I Report My Income and Expenses?***

You must figure your taxable income on the basis of a tax year. A "tax year" is an annual accounting period used for keeping records and reporting income and expenses. You must account for your income and expenses in a way that clearly shows your taxable income. The way you do this is called an accounting method. This section explains which accounting periods and methods you can use.

### ***\*Individual Serving in Combat Zone***

The deadline for filing your tax return, paying any tax you may owe, and filing a claim for refund is automatically extended if you serve in a combat zone. This applies to members of the Armed Forces, as well as merchant marines serving aboard vessels under the operational control of the Department of Defense, Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces. The deadline is automatically extended for at least 180 days.

For purposes of the automatic extension, the term “combat zone” includes the following areas.

1. The Persian Gulf area, effective January 17, 1991.
2. The qualified hazardous duty area of the Federal Republic of Yugoslavia, Albania, the Adriatic Sea, and the Ionian Sea north of the 39<sup>th</sup> parallel, effective March 24, 1999.
3. Afghanistan, effective September 19, 2001.

## ***How Do I Prepare My Return? -***

### ***\*Accounting Periods***

Most individual tax returns cover a calendar year - the 12 months from January 1 through December 31. If you do not use a calendar year, your accounting period is a fiscal year. A regular fiscal year is a 12-month period that ends on the last day of any month except December. A 52-53 week fiscal year varies from 52 to 53 weeks and always ends on the same day of the week.

You must choose your accounting period when you file your first income tax return. It cannot be longer than 12 months.

### ***\*Accounting Methods***

Your accounting method is the way you account for your income and expenses. Most taxpayers use either the cash method or an accrual method. You choose a method when you file your first income tax return. If you want to change your accounting method after that, you generally must get IRS approval.

### ***\*Cash Method***

If you use this method, report all items of income in the year in which you actually or constructively receive them. Deduct all expenses in the year you actually pay them. This is the method most individual taxpayer’s use.

### ***\*Constructive Receipt***

You constructively receive income when it is credited to your account or set apart in any way that makes it available to you. You do not need to have physical possession of it.

### ***\*Accrual Method***

If you use an accrual method, you generally report income when you earn it, rather than when you receive it. You generally deduct your expenses when you incur them, rather than when you pay them.

### ***\*Garnisheed Wages***

If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, then the full amount has been received by you. You must include these wages in income for the year you would have received them.

### ***\*Debts paid for you***

If another person cancels or pays your debts, you have constructively received the amount and generally must include it in your gross income for the year.

***\*Payment to third party***

If a third party is paid income from property you own, you have constructively received the income. It is the same as if you had actually received the income and paid it to the third party.

***\*Payment to an agent***

Income an agent receives for you is income you constructively received in the year the agent receives it. If you indicate in a contract that your income is to be paid to another person, you must include the amount in your gross income when the other person receives it.

***\*No constructive receipt***

There may be facts to show that you did not constructively receive income.

***\*Income Paid in Advance***

Prepaid income is generally included in gross income in the year you receive it. Your method of accounting does not matter as long as the income is available to you. Prepaid income includes rents or interest you receive in advance and pay for services you will perform later.

***\*Social Security Number***

You must provide the SSN of each dependent you claim, regardless of the dependent's age. This requirement applies to all dependents (not just your children) claimed on your tax return. If your child was born and died in the tax year and you do not have an SSN for the child. You may attach a copy of the child's birth certificate instead.

***\*Name Change***

If you changed your name because of marriage, divorce, etc., be sure to report the change to your local social Security Administration (SSA) office before filing your return. This prevents delays in processing your return and issuing refunds. It also safeguards your future social security benefits.

***\*Dependent's social security number***

You must provide the SSN of each dependent you claim, regardless of the dependent's age. This requirement applies to all dependents claimed on your tax return.

***\*Adoption taxpayer identification number***

If you are in the process of adopting a child who is a U.S. citizen or resident and cannot get an SSN for the child until the adoption is final, you can apply for an ATIN to use instead of an SSN.

File form W-74, Application for Taxpayer identification Number for Pending U.S. Adoptions, with the IRS to get an ATIN if all of the following are true.

- You have a child living with you who was placed in your home for legal adoption.
- You cannot get the child's existing SSN even though you have made a reasonable attempt to get it from the birth parents, the placement agency, and other persons.
- You cannot get an SSN for the child from the SSA because, for example, the adoption is not final.
- You are eligible to claim the child as a dependent on your tax return.

After the adoption is final, you must apply for an SSN for the child. You cannot continue using the ATIN.

### ***\*Presidential Election Campaign Fund***

This fund was set up to help pay for presidential election campaigns. You may have \$3 of your tax liability go to this fund by checking the Yes box on Form 1040, Form 1040A, or Form 1040EZ. If you are filing a joint return, your spouse may also have \$3 go to the fund. If you check yes, it will not change the tax you pay or the refund you will receive.

### ***\*Computations***

The following information on entering numbers on your tax return may be useful in making the return easier to complete.

**Rounding off dollars.** You may round off cents to whole dollars on your return and schedules. If you do round to whole dollars, you must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar.

### ***\*Attachments***

Attach any forms and schedules behind Form 1040 in order of the "Attachment Sequence Number" shown in the upper right corner of the form or schedule. Put forms without an attachment sequence number next. Then arrange all other statements or attachments in the same order as the forms and schedules they relate to and attach them last. Do not attach items unless required to do so.

### ***\*Third Party Designee***

You can authorize the IRS to discuss your return with a friend, family member, or any other person you choose. If you check the "Yes" box in the third party designee area of your tax return and provide the information required, you are authorizing:

- 1) The IRS to call the designee to answer any questions that arise during the processing of your return, and
- 2) The designee to:
  - a) Give information that is missing from your return to the IRS,
  - b) Call the IRS for information about the processing of your return or the status of your refund or payments, and
  - c) Respond to certain IRS notices that you have shown the designee. These notices about math errors, offsets, and return preparation will be sent to you, not the designee.

The authorization cannot be revoked. However, it will automatically end no later than the due date (without any extensions) for filing your next year's tax return.

### ***\*Signatures***

You must sign and date your return. If you file a joint return, both you and your spouse must sign the return, even if only one of you had income.

If you file a joint return, both spouses are generally liable for the tax, and the entire tax liability may be assessed against either spouse. If you are due a refund, it cannot be issued unless you have signed your return.

### ***\*Paid Preparer***

Generally, anyone you pay to prepare, assist in preparing, or review your tax return must sign it and fill in the other blanks in the paid preparer's area of your return. Signature stamps and labels are not acceptable.

If the preparer is self-employed (that is, not employed by any person or business to prepare the return), he or she should check the self-employed box in the Paid Preparer's Use Only space on the return.

The preparer must give you a copy of your return in addition to the copy filed with the IRS. If you prepare your own return, leave this area blank. If another person prepares your return and does not charge you, that person should not sign your return.

The Preparer Tax Identification Number, or PTIN application, lets a paid preparer apply for and receive a PTIN immediately over the Internet. There is no longer the need to complete and mail a paper Form W-7P. It reduces processing time and input errors associated with a paper application. Anyone paid to prepare a tax return must sign the return and provide either a PTIN or a Social Security Number. The ability to substitute a PTIN for a Social Security Number began in 1999 to address concerns that clients and others outside the IRS could use a preparer's Social Security Number inappropriately.

### ***\*Refunds***

If your overpayment is less than one dollar, you will not get a refund unless you ask for it in writing. Cash your tax refund check soon after you receive it. Checks not cashed within 12 months of the date they are issued will be canceled and the proceeds returned to the IRS. If your check has been canceled, you can apply to the IRS to have it reissued.

### ***\*Joint Return and Injured Spouse***

When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an injured spouse. An injured spouse should file Form 8379, Injured Spouse Allocation, if both of the following apply and the spouse wants a refund of his or her share of the over-payment shown on the joint return.

1. You would not be legally obligated to pay the past-due amount.
2. You made and reported tax payments (such as federal income tax withheld from your wages or estimated tax payments), or claimed a refundable tax credit (such as the earned income credit or additional child tax credit).

### ***\*How To Pay***

If you have an amount due on your tax return, you can pay by check, money order, or credit card. If you filed electronically, you may also be able to make your payment by electronic funds withdrawal. You do not have to pay if the amount you owe is less than \$1.

If you pay by check or money order, make it out to the "United States Treasury." Please show your correct name, address, social security number, daytime telephone number, and the tax year and form number on the front of your check or money order.

If your bank does not honor your check, money order, or any other commercial instrument for payment and the IRS does not receive the funds, you still owe the tax.

***\*Interest***

Interest is charged on tax you do not pay by the due date of your return. Interest is charged even if you get an extension of time for filing.

***\*Interest on penalties***

Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 21 calendar days from the date of the notice.

***\*Interest on erroneous refund***

All or part of any interest you were charged on an erroneous refund generally will be forgiven. Any interest charged for the period before demand for repayment was made will be forgiven unless:

You, or a person related to you, caused the erroneous refund in any way, or  
The refund is more than \$50,000.

***\*Interest due to IRS error or delay***

An officer or employee of the IRS in performing a ministerial or managerial act can forgive all or part of any interest you were charged if the interest is due to an unreasonable error or delay. A ministerial act is a procedural or mechanical act that occurs during the processing of your case. A managerial act includes personnel transfers and extended personnel training. A decision concerning the proper application of federal tax law is not a ministerial or managerial act. The interest can be forgiven only if you are not responsible in any important way for the error or delay and the IRS has notified you in writing of the deficiency or payment.

Interest and certain penalties may also be suspended for a limited period if you filed your return by the due date and the IRS does not provide you with a notice specifically stating your liability and the basis for it before the close of the 36-month period beginning on the later of:

- The date the return is file, or
- The due date of the return without regard to extensions.

***\*Electronic funds withdrawal***

You can e-file and pay in a single step by authorizing an electronic funds withdrawal from your checking or savings account. If you select this payment option, you will need to have your account number, your financial institution's routing transit number, and account type. You can schedule the payment for any future date up to and including the return due date.

## **[Section 5 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Which method can be used to request an automatic 6-month extension of time to file, if you cannot file on time:
  - a. Request through use of IRS e-file.
  - b. Request by filing a paper form.
  - c. Both A & B are correct.
  - d. None of the above are true.
  
2. A regular fiscal year is a \_\_\_\_\_ period that ends on the last day of any month except December.
  - a. 51 weeks.
  - b. 3 month.
  - c. 12 month.
  - d. 50 weeks.
  
3. Under garnished wages, if your employer uses your wages to pay your debts, or if your wages are attached or garnished, then:
  - a. Only partial amount has been received by you.
  - b. You do not include these wages as income for the year.
  - c. The wages garnished are tax exempt.
  - d. The full amount has been received by you.

## **[Section 6] – Federal Tax Law Continued**

### ***What If I Made a Mistake? -***

Errors may delay your refund or result in notices being sent to you. If you discover an error, you can file an amended return or claim for refund.

#### ***\*Amended Returns and Claims for Refund***

You should correct your return if, after you have filed it, you find that:

1. You did not report some income,
2. You claimed deductions or credits you should not have claimed,
3. You did not claim deductions or credits you could have claimed, or
4. You should have claimed a different filing status.

#### ***\*Form 1040X***

Use Form 1040X, Amended U.S. Individual Income Tax Return, to correct a return you have already filed. An amended tax return cannot be filed electronically under the e-file system.

On Form 1040X, enter your income, deductions, and credits as you originally reported them on your return, the changes you are making, and the corrected amounts. Then figure the tax on the corrected amount of taxable income and the amount you owe for your refund. If you owe tax, pay the full amount with Form 1040X. The tax owed will not be subtracted from any amount you had credited to your estimated tax.

#### ***\*Filing Form 1040X***

After you finish your Form 1040X, check it to be sure that it is complete. Do not forget to show the year of your original return and explain all changes you made. Be sure to attach any forms or schedules needed to explain your changes. Mail your Form 1040X to the Internal Revenue Service Center serving the area where you now live. However, if you are filing Form 1040X in response to a notice you received from the IRS, mail it to the address shown on the notice. File a separate form for each tax year involved.

#### ***\*Limit on amount of refund***

If you file your claim within 3 years after the date you filed your return, the credit or refund cannot be more than the part of the tax paid within the 3-year period immediately before you filed the claim. This time period suspended while you are financially disabled.

#### ***\*Protective claim for refund***

A protective claim is a formal claim or amended return for credit or refund normally based on current litigation or expected changes in tax law or other legislation. You file a protective claim when your right to a refund is contingent on future events and may not be determinable until after the statute of limitations expires. A valid protective claim does not have to list a particular dollar amount or demand an immediate refund. A valid protective claim must:

- ◆ Be in writing and signed,
- ◆ Include your name, address, SSN or ITIN, and other contact information,
- ◆ Identify and describe the contingencies affecting the claim,
- ◆ Clearly alert the IRS to the essential nature of the claim, and

- ◆ Identify the specific years for which a refund is sought.

### ***\*Time for filing a claim for refund***

You must file your claim for a credit or refund within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. Returns filed before the due date are considered filed on the due date. These time periods are suspended while you are financially disabled.

### ***\*Reduced refund***

Your refund may be reduced by an additional tax liability that has been assessed against you.

### ***\*Effect on state tax liability***

If your return is changed for any reason, it may affect your state income tax liability. This includes changes made as a result of an examination of your return by the IRS. Contact your state tax agency for more information.

### ***\*Interest on refund***

If you receive a refund because of your amended return, interest will be paid on it from the due date of your original return or the date you filed your original return, whichever is later, to the date you filed the amended return. If the refund is not made within 45 days after you file the amended return, interest will be paid up to the date the refund is paid.

### ***\*Civil Penalties***

If you do not file your return and pay your tax by the due date, you may have to pay a penalty. You may also have to pay a penalty if you substantially understate your tax, file a frivolous return, or fail to supply your social security number. If you provide fraudulent information on your return, you may have to pay a civil fraud penalty.

If you do not file your return by the due date (including extensions), you may have to pay a failure-to-file penalty. The penalty is based on the tax not paid by the due date (without regard to extensions). The penalty is usually 5% for each month or part of a month that a return is late, but not more than 25%.

If your failure to file is due to fraud, the penalty is 15% for each month or part of a month that your return is late, up to a maximum of 75%. If you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$135 or 100% of the unpaid tax.

You will have to pay a failure-to-pay penalty of 1/2 of 1% (.50%) of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the automatic 6-month extension of time to file period, if you paid at least 90% of your actual tax liability on or before the due date of your return and pay the balance when you file the return.

### ***\*Combined Penalties***

If both the failure-to-file penalty and the failure-to-pay penalty apply in any month, the 5% failure-to-file penalty is reduced by the failure-to-pay penalty. If you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of \$135 or 100% of the unpaid tax.

### ***\*Accuracy-related penalty***

You may have to pay an accuracy-related penalty if you underpay your tax because:

1. You show negligence or disregard of the rules or regulations,
2. You substantially understate your income tax,
3. You claim tax benefits for a transaction that lacks economic substance, or
4. You fail to disclose a foreign financial asset

The penalty is equal to 20% of the underpayment. The penalty is 40% of any portion of the underpayment that is attributable to an undisclosed non-economic substance transaction or an undisclosed foreign financial asset transaction. The penalty will not be figured on any part of an underpayment on which the fraud penalty is charged.

### **\*Criminal Penalties**

You may be subject to criminal prosecution (brought to trial) for actions such as:

- 1) Tax evasion,
- 2) Willful failure to file a return, supply information, or pay any tax due,
- 3) Fraud and false statements, or
- 4) Preparing and filing a fraudulent return.

## ***Personal Exemptions & Dependents -***

There are two types of exemptions: personal exemptions and exemptions for dependents. While these are both worth the same amount, different rules apply to each type.

You are generally allowed one exemption for yourself and, if you are married, one exemption for your spouse. These are called personal exemptions. You can take one exemption for yourself unless you can be claimed as a dependent by another taxpayer.

If another taxpayer is entitled to claim you as a dependent, you cannot take an exemption for yourself. This is true even if the other taxpayer does not actually claim your exemption. If you file a joint return, you can take your own exemption. If you file a separate return, you can take your own exemption only if another taxpayer is not entitled to claim you as a dependent.

### ***\*Your Spouse's Exemption***

Your spouse is never considered your dependent. You may be able to take one exemption for your spouse only because you are married. On a joint return you can claim one exemption for yourself and one for your spouse.

If you file a separate return, you can claim the exemption for your spouse only if your spouse had no gross income and was not the dependent of another taxpayer. This is true even if the other taxpayer does not actually claim your spouse's exemption. This is also true if your spouse is a nonresident alien.

### ***\*Death of spouse***

If your spouse died during the year and you file a joint return for yourself and your deceased spouse, you generally can claim your spouse's exemption under the rules explained under, "Joint Return". If you file a separate return for the year, you may be able to claim your spouse's exemption under the rules described in , "Separate Return".

### ***\*Exemptions for Dependents***

You are allowed one exemption for each person you can claim as a dependent. You can claim an exemption for a dependent even if your dependent files a return.

The term “dependent” means:

- A qualifying child, or
- A qualifying relative.

You can claim an exemption for a qualifying child or qualifying relative only if these three tests are met.

- Dependent taxpayer test.
- Joint return test.
- Citizen or resident test.

***\*Tests to be a Qualifying Child***

There are five tests that must be met for a child to be your qualifying child. The five tests are, the relationship, age, residency, support, and special test for qualifying child.

The child must be your son, daughter, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.

The child must be (a) under age 19 at the end of the year, (b) under age 24 at the end of the year and a full-time student, or (c) any age if permanently and totally disabled.

The child must have lived with you for more than half of the year. The child must not have provided more than half of his or her own support for the year.

If the child meets the rules to be a qualifying child of more than one person, you must be the person entitled to claim the child as a qualifying child.

***\*Dependent not allowed a personal exemption***

If you can claim an exemption for your dependent, the dependent cannot claim his or her own exemption on his or her own tax return. This is true even if you do not claim the dependent’s exemption on your return or if the exemption will be reduced or eliminated under the phase out rule described under Phase out of Exemptions.

***\*Housekeepers, maids, or servants***

If these people work for you, you cannot claim exemptions for them.

***\*Child tax credit***

You may be entitled to a child tax credit for each qualifying child who was under age 17 at the end of the year.

***\*Dependent Taxpayer Test***

If another person could claim you as a dependent, you cannot claim anyone else as a dependent. Even if you have a qualifying child or qualifying relative, you cannot claim that person as a dependent.

If you are filing a joint return and someone else could claim your spouse as a dependent, you and your spouse cannot claim any dependents on your joint return.

***\*Child’s Place of Residence***

Children usually are citizens or residents of the country of their parents.

If you were a U.S. citizen when your child was born, the child may be a U.S. citizen even if the other parent was a nonresident alien and the child was born in a foreign country. If so, this test is met.

### ***\*Foreign Students' Place of Residence***

Foreign students brought to this country under a qualified international education exchange pro-gram and placed in American homes for a temporary period generally are not U.S. residents and do not meet this test. You cannot claim an exemption for them. However, if you provided a home for a foreign student, you may be able to take a charitable contribution deduction.

### ***\*U.S. national***

A U.S. national is an individual who, although not a U.S. citizen, owes his or her allegiance to the United States. U.S. nationals include American Samoans and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens.

### ***\*Qualifying Child***

There are five tests that must be met for a child to be your qualifying child. The five tests are:

1. Relationship,
2. Age,
3. Residency,
4. Support, and
5. Special test for qualifying child of more than one person.

### ***\*Relationship Test***

To meet this test, a child must be:

- Your son, daughter, stepchild, eligible foster child, or a descendant (for example, your grandchild) of any of them, or
- Your brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant (for example, your niece or nephew) of any of them.

### ***\*Adopted Child***

An adopted child is always treated as your own child. The term “adopted child” includes a child who was lawfully placed with you for legal adoption.

### ***\*Eligible Foster Child***

An eligible foster child is an individual who is placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

### ***\*Age Test***

To meet this test, a child must be:

- Under age 19 at the end of the year,
- A full-time student under age 24 at the end of the year, or
- Permanently and totally disabled at any time during the year, regardless of age.

### ***\*Residency Test***

To meet this test, your child must have lived with you for more than half of the year. There are exceptions for temporary absences, children who were born or died during the year, kid-napped children, and children of divorced or separated parents.

### ***\*Temporary Absences***

Your child is considered to have lived with you during periods of time when one of you, or both, are temporarily absent due to special circumstances such as:

- Illness,
- Education,
- Business,
- Vacation or Military service.

### ***\*Support Test (To Be a Qualifying Child)***

To meet this test, the child cannot have provided more than half of his or her own support for the year.

### ***\*Scholarships***

A scholarship received by a child who is a full-time student is not taken into account in determining whether the child provided more than half of his or her own support.

### ***\*Qualifying Relative***

There are four tests that must be met for a person to be your qualifying relative. The four tests are:

1. Not a qualifying child test,
2. Member of household or relationship test,
3. Gross income test, and
4. Support test.

### ***\*Age***

Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative.

### ***\*Not a Qualifying Child Test***

A child is not your qualifying relative if the child is your qualifying child or the qualifying child of anyone else.

### ***\*Member of Household or Relationship Test***

To meet this test, a person must either:

- 1) Live with you for the entire year as a member of your household, or
- 2) Be related to you.

A person related to you in any of the following ways does not have to live with you for the entire year as a member of your household to meet the test:

- Your child, grandchild, great grandchild, etc. (a legally adopted child is considered your child).
- Your stepchild.
- Your brother, sister, half brother, half sister, stepbrother, or stepsister.
- Your parent, grandparent, or other direct ancestor, but not foster parent.
- Your stepfather or stepmother.
- A brother or sister of your father or mother.
- A son or daughter of your brother or sister.
- Your father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

You can claim an exemption for your cousin only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother.

***\*Cousin***

Your cousin meets only if he or she lives with you all year as a member of your household. A cousin is a descendant of a brother or sister of your father or mother.

***\*Citizen or Resident Test***

To meet the citizen or resident test, a person must be 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 begins.

***\*Joint Return Test***

Even if the other dependency tests are met, you are generally not allowed an exemption for your dependent if he or she files a joint return.

***\*Gross Income Test***

To meet this test, a person's gross income for the year must be less than \$3,700.

***\*Support Test***

Generally, you must provide more than half of a person's total support during the calendar year to meet the support test. You figure whether you have provided more than half of a person's total support by comparing the amount you contributed to that person's support with the entire amount of support that person received from all sources.

***\*Do Not Include in Total Support***

The following items are not included in total support:

- 1) Federal, state, and local income taxes paid by persons from their own income.
- 2) Social security and Medicare taxes paid by persons from their own income.
- 3) Life insurance premiums.
- 4) Funeral expenses.
- 5) Scholarships received by your child if your child is a full-time student.
- 6) Survivors' and Dependents' Educational Assistance payments used for support of the child who receives them.

***\*Multiple Support Agreement***

Sometimes no one provides more than half of the support of a person. Instead, two or more persons, each of who would be able to take the exemption but for the support test, together provide more than half of the person's support.

When this happens, you can agree that any one of you who individually provides more than 10% of the person's support, but only one, can claim an exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption. Form 2120, Multiple Support Declaration, can be used for this purpose.

***\*Custodial Parent and Noncustodial parent***

The custodial parent is the parent with whom the child lived for the greater part of the year. The other parent is the noncustodial parent.

A child is treated as living with a parent for a night if the child sleeps:

- At that parent’s home, whether or not the parent is present, or
- In the company of the parent, when the child does not sleep at a parent’s home.

If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater part of the rest of the year.

In most cases, in a support test, a child of divorced or separated parents will be a qualifying child of one of the parents. However, if the child does not meet the requirements to be a qualifying child of either parent, the child may be a qualifying relative of one of the parents, if other requirements are met.

The amount you can claim as a deduction for exemptions is reduced once your adjusted gross income (AGI) goes above a certain level for your filing status.

If your dependent does not have and cannot get an SSN, you must list the individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN) instead of an SSN.

***\*Child in Canada or Mexico***

A child who lives in Canada or Mexico may be your qualifying relative, and you may be able to claim the child as a dependent. If the child does not live with you, the child does not meet the residency test to be your qualifying child. If the persons the child does live with are not U.S. citizens and have no U.S. gross income, those persons are not “taxpayers,” so the child is not the qualifying child of any other taxpayer. If the child is not your qualifying child or the qualifying child of any other taxpayer, the child is your qualifying relative if the gross income test and the support test are met.

You cannot claim as a dependent a child who lives in a foreign country other than Canada or Mexico, unless the child is a U.S. citizen, U.S. resident alien, or U.S. national. There is an exception for certain adopted children who lived with you all year.

***\*Emancipated child***

If a child is emancipated under state law, the child is treated as not living with either parent.

***\*Equal number of nights***

If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income.

***\*Parent works at night***

If, due to a parent’s nighttime work schedule, a child lives for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as living at the primary residence registered with the school.

***\*Absences***

If a child was not with either parent on a particular night, the child is treated as living with the parent with whom the child normally would have lived for that night, except for the absence. But if it cannot be determined with which parent the child normally would have lived or if the child would not have lived with that night, the child is treated as not living with either parent that night.

## ***Special Rule for Qualifying Child of More Than One Person –***

### ***\*Tiebreaker Rules***

To determine which person can treat the child as a qualifying child to claim these six tax benefits, the following tiebreaker rules apply.

- If only one of the persons is the child's parent, the child is treated as the qualifying child of the parent.
- If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year.
- If a parent can claim the child as a qualifying child but no parent does so claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year.

### ***\*Social Security Numbers for Dependents***

You must show the social security number of any dependent for whom you claim an exemption on Form 1040 or Form 1040A.

If a person for whom you expect to claim an exemption on your return does not have an SSN, either you or that person should apply for an SSN as soon as possible by filling Form SS-5, Application for a Social Security Card, with the Social Security Administration (SSA). It usually takes about 2 weeks to get an SSN once the SSA has all the information it needs. If you do not have a required SSN by the filing due date, you can file Form 4868 for an extension of time to file.

If your child was born and died in 2011, and you do not have an SSN for the child, you may attach a copy of the child's birth certificate, death certificate, or hospital records instead. The document must show the child was born alive. If you do this, enter "DIED" on Form 1040 or Form 1040A.

If your dependent does not have and cannot get an SSN, you must list the individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN) instead of an SSN.

## **[Section 6 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. For purposes of the gross income test, a persons gross income for the year must be less than:
  - a. \$2,700.
  - b. \$3,500.
  - c. \$3,700.
  - d. \$4,700.
  
2. When dealing with an emancipated child, the child is treated as:
  - a. Living with either parent.
  - b. Not living with either parent.
  - c. Living with only one of the parents.
  - d. None of the above.
  
3. In regards to the tie-breaker rules, if no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest:
  - a. Net income for the year.
  - b. Earned income credit for the year.
  - c. Amount of exemptions for the year.
  - d. AGI for the year.

## **[Section 7] – Federal Tax Law Continued**

### ***Withholding & Estimated Tax -***

#### ***\*Salaries and Wages***

Income tax is withheld from the pay of most employees. Your pay includes your regular pay, bonuses, commissions, and vacation allowances. It also includes reimbursements and other expense allowances paid under a non-accountable plan.

Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments.

#### ***\*Determining Amount of Tax Withheld***

The amount of income tax your employer withholds from your regular pay depends on two things:

- 1) The amount you earn.
- 2) The information you give your employer on Form W-4.

Form W-4 includes three types of information that your employer will use to figure your withholding:

- 1) Whether to withhold at the single rate or at the lower married rate.
- 2) How many withholding allowances you claim.
- 3) Whether you want an additional amount withheld.

Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

You must give your employer a new Form W-4 within 10 days after either of the following:

- 1) Your divorce, if you have been claiming married status.
- 2) Any event that decreases the number of withholding allowances you can claim.

#### ***\*New Job***

When you start a new job, you must fill out Form W-4 and give it to your employer. Your employer should have copies of the form. If you need to change the information later, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid over withholding if your employer agrees to use the part-year method.

### ***\*Employee also receiving pension income***

If you receive pension or annuity income and begin a new job, you will need to file Form W-4 with your new employer. However, you can choose to split your withholding allowances between your pension and job in any manner.

### ***\*Changing your withholding***

During the year changes may occur to your marital status, exemptions, adjustments, deductions, or credits you expect to claim on your tax return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

If the changes reduce the number of allowances you are claiming or changes your marital status from married to single, you must give your employer a new Form W-4 within 10 days. You can submit a new Form W-4 whenever you wish to change the number of your withholding allowances for any other reason.

### ***\*Completing Form W-4***

If you have income from two jobs at the same time, complete only one set of Form W-4 worksheets. Then split your allowances between the Forms W-4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them any other way.

If both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances any way, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

If you do not give your employer a completed Form W-4, your employer must withhold at the highest rate as if you were single and claimed no allowances.

If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W-4. Your employer cannot repay any of the tax previously withheld.

### ***\*Exemption From Withholding***

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 2012 only if both of the following situations apply:

- ◆ For 2011 you had a right to a refund of all federal income tax withheld because you had no tax liability.
- ◆ For 2012 you expect a refund of all federal income tax withheld because you expect to have no tax liability.

If you are a student, you are not automatically exempt. If you work only part time or only during the summer, you may qualify for exemption from withholding.

To claim exemption, you must give your employer a Form W-4. Print "EXEMPT" on line 7.

Your employer must send the IRS a copy of your Form W-4 if you claim exemption from withholding and your pay is expected to usually be more than \$200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

### ***\*Unemployment Compensation***

You can choose to have income tax withheld from unemployment compensation. To make this choice, you will have to fill out Form W-4V, Voluntary Withholding Request (or a similar form provided by the payer) and give it to the payer. The amount withheld will be 10% of each payment.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments.

### ***\*Tips***

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. Tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways.

- ◆ By withholding at the regular rate on the sum of your pay plus your reported tips.
- ◆ By withholding at the regular rate on your pay plus a percentage of your reported tips.

If your regular pay is not enough for your employer to withhold all the tax due on your pay plus your tips, you can give your employer money to cover the shortage.

Your employer should not withhold income tax, Medicare tax, social security tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your reported tips. Your employer should refund to you any incorrectly withheld tax.

### ***\*Sick Pay***

Sick pay is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as sick pay, it must be paid under a plan to which your employer is a party. If you receive sick pay from your employer or an agent of your employer, income tax must be withheld. An agent who does not pay regular wages to you may choose to withhold income tax at a flat rate.

However, if you receive sick pay from a third party that is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. If you receive payments under a plan in which your employer does not participate, the payments are not sick pay and usually are not taxable.

### ***\*Union Agreements***

If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding.

### ***\*Backup Withholding***

Banks and other businesses that pay you certain kinds of income must file an information return (Form 1099) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN).

These payments generally are not subject to withholding. However, "backup" withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on Form 1099.

The payer must withhold at a flat 28% rate in the following situations.

- ◆ You do not give the payer your TIN in the required manner.
- ◆ The IRS notifies the payer that the TIN you gave is incorrect
- ◆ You are required, but fail, to certify that you are not subject to backup withholding.
- ◆ The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 210-day period.

There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000 or imprisonment of up to 1 year, or both.

### ***\*Estimated Tax***

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Estimated tax is used to pay income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough tax, either through withholding or estimated tax, or a combination of both, you may have to pay a penalty. If you do not pay enough by the due date of each payment period, you may be charged a penalty even if you are due a refund when you file your tax return.

## **[Section 7 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Under salaries and wages, income tax is withheld from the pay of most employees. Your pay includes your:
  - a. Bonuses
  - b. Commissions
  - c. Regular Pay
  - d. All of the above.
  
2. In regards to salaries and wages, military retirement pay is treated \_\_\_\_\_, even though it is treated as a pension or annuity for other tax purposes.
  - a. As special pay for income tax exemption purposes.
  - b. In the same manner as regular pay for income tax withholding purposes.
  - c. As a special military tax.
  - d. None of the above.
  
3. When determining amount of tax withheld, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances if changes are needed.
  - a. True
  - b. False
  
4. In regards to completing Form W-4, if both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your:
  - a. Adjustments, Exemptions, Combined Income, and Credits.
  - b. Adjustments, Dividend Income, and Exemptions
  - c. Adjustments, Combined Income, Dividend Income, and Credits.
  - d. None of the above.

## **[Section 8] – Federal Tax Law Continued**

### ***\*Who Must Make Estimated Tax Payments?***

If you had a tax liability for this tax year, you may have to pay estimated tax for the following year, if both of the following apply:

- 1) You expect to owe at least \$1,000 in tax for next year after subtracting your withholding and credits.
- 2) You expect your withholding and credits to be less than the smaller of:
  - 90% of the tax to be shown on your next year's tax return, or
  - 100% of the tax shown on your current tax return. Your current tax return must cover all 12 months.

You do not have to pay estimated tax for next year if you meet all three of the following conditions:

- 1) You had no tax liability for current tax year.
- 2) You were a U.S. citizen or resident for the whole year.
- 3) Your current tax year covered a 12-month period.

You and your spouse cannot make joint estimated tax payments if:

1. You are legally separated under a decree of divorce or separate maintenance,
2. Either spouse is a nonresident alien, or
3. You and your spouse have different tax years.

### ***\*When To Pay Estimated Tax***

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

<u>For the period</u>	<u>Due Date</u>
January 1 through March 31	April 15
April 1 through May 31	June 15
June 1 through August 31	September 15
September 1 through December	January 17 next year

### ***\*When To Start***

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in installments.

If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installment payments by the due dates for the later periods.

### ***\*The 1099 Series***

Most forms in the 1099 series are not filed with your return. You should receive these forms by February 1 of the following year. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099-B, Proceeds From Broker and Barter Exchange Transactions,
- Form 1099-DIV, Dividends and Distributions,
- Form 1099-G, Certain Government and Qualified State Tuition Program Payments,
- Form 1099-INT, Interest Income,
- Form 1099-MISC, Miscellaneous Income,
- Form 1099-OID, Original Issue Discount,
- Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,
- Form SSA-1099, Social Security Benefit Statement, and
- Form RRB-1099, Payments by the Railroad Retirement Board.
- Which IRS address you sent the payments to,
- Your name when you made the payments, and
- Your social security number.

### ***\*Gambling Winnings***

Income tax is withheld at a flat 25% rate from certain kinds of gambling winnings. Gambling winnings of more than \$5,000 from the following sources are subject to income tax withholding.

- ◆ Any sweepstakes, wagering pool, including payments made to winners of poker tournaments on or lottery.
- ◆ Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not paid in cash are taken into account at their fair market value. Gambling winnings from bingo, keno, and slot machines generally are not subject to income tax withholding. However, you may need to provide the payer with a social security number to avoid withholding.

If you receive gambling winnings not subject to withholding, you may need to pay estimated tax. If you do not pay enough tax through withholding or estimated tax payments, you may have to pay a penalty.

### ***\*Underpayment Penalty***

If you did not pay enough tax, either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. Generally, you will not have to pay a penalty if any of the following situations applies.

- ◆ The total of your withholding and estimated tax payments was at least as much as your prior tax (or 110% of your prior tax if your AGI was more than \$150,000, \$75,000 if your current filing status is married filing separately) and you paid all required estimated tax payments on time.
- ◆ The tax balance due on your return is no more than 10% of your total current tax, and you paid all required estimated tax payments on time.
- ◆ Your total current tax minus your withholding is less than \$1,000.
- ◆ You did not have a tax liability for prior year.
- ◆ You did not have any withholding taxes and your current year tax less any

household employment taxes is less than \$1,000.

## **Rental Income & Expenses -**

**You generally must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. Report rental income on your return for the year you actually or constructively receive it, if you are a cash basis taxpayer. You are a cash basis taxpayer if you report income in the year you receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account.**

**Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.**

**Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.**

**If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.**

**If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses.**

**If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.**

**If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses.**

### ***\*Rental Expenses***

**If you are a cash basis taxpayer, you generally deduct your rental expenses in the year you pay them. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.**

**You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.**

**You can begin to depreciate rental property when it is ready and available for rent. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.**

**If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited.**

### ***\*Repairs and Improvements***

You can deduct the cost of repairs to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation.

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement. An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Improvements include the following items:

- Putting a recreation room in an unfinished basement.
- Paneling a den.
- Adding a bathroom or bedroom.
- Putting decorative grillwork on a balcony.
- Putting up a fence.
- Putting in new plumbing or wiring.
- Putting in new cabinets.
- Putting on a new roof.
- Paving a driveway.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

### ***\*Other Expenses***

If you pay an insurance premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are non-depreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and non-rental activities.

You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property. Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate.

### ***\*Not Rented for Profit***

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. Any rental expenses in excess of rental income cannot be carried forward to the next year.

### ***\*Property Changed to Rental Use***

If you change your home or other property, (or a part of it), to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use. You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

### ***\*Renting Part of Property***

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes, as though you actually had two separate pieces of property.

You can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest, qualified mortgage insurance premiums, and real estate taxes, as rental expenses on Schedule E. You can also deduct as rental expenses a portion of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house.

There is no change in the types of expenses deductible for the personal-use part of your property. Generally, these expenses may be deducted only if you itemize your deductions on Schedule A. You cannot deduct any part of the cost of the first phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. For example, if you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenants use, all of the cost of the second line is deductible as a rental expense.

### ***\*Dwelling Unit Used as Home***

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

- 1) 14 days, or
- 2) 10% of the total days it is rented to others at a fair rental price.

A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

### ***\*Depreciation***

You recover your cost in income producing property through yearly tax deductions. You do this by depreciating the property; that is, by deducting some of your cost on your tax return each year.

Three basic factors determine how much depreciation you can deduct. They are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense. You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange. You may have to use Form 4562 to figure and report your depreciation.

You can never depreciate land. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

### ***\*Use As Main Home Before or After Renting***

For purposes of determining whether a dwelling unit was used as a home, you may not have to count days you used the property as your main home before or after renting it or offering it for rent as days of personal use. Do not count them as days of personal use if:

- You rented or tried to rent the property for 12 or more consecutive months.
- You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

### ***\*Figuring Days of Personal Use***

A day of personal use of a dwelling unit is any day that the unit is used by any of the following persons.

1. You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement.
2. A member of your family or a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
3. Anyone under an arrangement that lets you use some other dwelling unit.
4. Anyone at less than a fair rental price.

## **[Section 8 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. After subtracting your withholding and credits, you must make estimated tax payments for the tax year if you expect to owe at least \$1,000 in tax for the next year and your withholding and credits are less than the smaller of \_\_\_\_\_ shown on next years return or \_\_\_\_\_ of the tax shown on your current return.
  - a. 90%, 100%.
  - b. 90%, 80%.
  - c. 100%, 90%.
  - d. 80%, 90%.
  
2. In regards to who must make estimated tax payments, which of the following conditions must be met to be excused from paying estimated tax for 2012?
  - a. You had no tax liability for current tax year.
  - b. You were a U.S. citizen or resident for the whole year.
  - c. Your current tax year covered a 12-month period.
  - d. All of the above conditions must be met.
  
3. If you are considered \_\_\_\_\_, you and your spouse cannot make joint estimated tax payments.
  - a. Legally separated under a decree of separate maintenance.
  - b. A nonresident alien.
  - c. You and your spouse have different tax years.
  - d. All of the above.
  
4. Under rental income and expenses, generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are:
  - a. Non-depreciable capital expenditures.
  - b. Depreciable capital expenditures.
  - c. Green Energy Tax Credits.
  - d. None of the above.

## **[Section 9] – Federal Tax Law Continued**

### ***\*Main home***

If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one he or she lived in most of the time.

### ***\*Alternative Minimum Tax***

If you use accelerated depreciation, you may have to file Form 6251. Accelerated depreciation can be determined under MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

### ***\*Donation of use of property***

You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The “purchaser” uses the unit.

### ***\*Shared equity financing agreement***

This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home.

### ***\*Days Used for Repairs and Maintenance***

Any day that you spend working substantially full time repairing and maintaining (not improving) your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

### ***\*How to Divide Expenses***

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. You can deduct expenses for the rental use of the unit.

When dividing your expenses follow these rules.

- Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
- Any day that the unit is available for rent but not actually rented is not a day of rental use.

### ***\*How to Figure Rental Income and Deductions***

How you figure your rental income and deductions depends on whether you used the dwelling unit as a home and, if you used it as a home, how many days the property was rented at a fair rental price. If you use a dwelling unit as a home and rent it 15 days or more during the year, include all your rental income in your income. If you had a net profit from the rental property for the year, deduct all of your rental expenses. However, if you had a net loss, your deduction for certain rental expenses is limited.

### ***\*Property Not Used as a Home***

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. Your deductible rental expenses can be more than your gross rental income.

### ***\*Property Used as a Home***

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home*, earlier), how you figure your rental income and deductions depends on how many days the unit was rented at a fair rental price.

### ***\*Limits on Rental Losses***

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. However, you may be able to deduct rental losses without regard to whether you have income from other passive activities if you "materially" or "actively" participated in your rental activity.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986. If your rental losses are less than \$25,000 and you actively participated in the rental activity, the passive activity limits probably do not apply to you.

### ***\*At-Risk Rules***

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity.

### ***\*Passive Activity Limits***

In general, rental activities (except those meeting the exception for real estate professionals) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

You may have to complete Form 8582 to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

Rental activities in which you materially participated during the year are not passive activities if, during that year, you were a real estate professional because you met the requirements.

***\*Losses From Rental Real Estate Activities***

**If you or your spouse actively participated in a passive rental real estate activity, you can deduct up to \$25,000 of loss from the activity from your non-passive income. If you are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than \$12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot use the special allowance to reduce your non-passive income or tax on non-passive income.**

**The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than \$100,000 (\$50,000 if married filing separately).**

**You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.**

## **[Section 9 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. A day of personal use of a dwelling unit is considered:
  - a. Generally, any day that the unit is not in use.
  - b. Generally, any day that the unit is available for rent.
  - c. Generally, any day that the unit is available to buy.
  - d. Generally, any day that the unit is used by your or any other person who has an interest in it.
  
2. You can \_\_\_\_\_ expenses for the rental use of the unit.
  - a. Deduct
  - b. Never deduct
  - c. Depreciate
  - d. Capitalize
  
3. In regards to rental activity, losses from holding real property, other than property, placed in service before 1987 are not subject to the at-risk rules.
  - a. Cash Property
  - b. Divided Property
  - c. Rental Property
  - d. Mineral Property

## **[Section 10] – Federal Tax Law Continued**

### ***\*Maximum special allowance***

The maximum special allowance is:

- ◆ \$25,000 for single individuals and married individuals filing a joint return for the tax year,
- ◆ \$12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- ◆ \$25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

If your modified adjusted gross income is \$100,000 or less, you can deduct your loss up to the amount specified above. If your MAGI are more than \$100,000, your special allowance is limited to 50% of the difference between \$150,000 and your MAGI.

### ***\*How To Report Rental Income and Expenses***

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040). However, do not use that schedule to report a not-for-profit activity.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), Profit or Loss From Business or Schedule C-EZ, Net Profit From Business (Sole Proprietorship). Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. You also may have to pay self-employment tax on your rental income.

If you paid \$600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, Mortgage Interest Statement, or similar statement showing the interest you paid for the year.

## **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.

### ***\*Simplified Method***

Under the Simplified Method, you figure the tax-free part of each annuity payment by dividing your cost by the total number of anticipated monthly payments.

Who must use the Simplified Method?

You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you both:

1. Receive pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity.
2. On your annuity starting date, you were either under age 75, or entitled to less than 5 years of guaranteed payments.

### ***\*Tax on Early Distributions***

Most distributions (both periodic and non-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.

### ***\*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.**

## **[Section 10 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Which of the following are not considered significant services provided for your convenience?
  - a. Regular Cleaning
  - b. Trash Collection
  - c. Maid Service
  - d. Changing Linen
  
2. If you paid \_\_\_\_\_ or more mortgage interest on your rental to any one person, you should receive a Form 1098, mortgage interest statement, or similar statement showing the interest you paid for the year.
  - a. \$200
  - b. \$400
  - c. \$600
  - d. \$500
  
3. If you paid part of the cost of your annuity, you \_\_\_\_\_ on the part of the annuity you receive that represents a return of your cost.
  - a. Are not taxed.
  - b. Are taxed.
  - c. Are not exempt.
  - d. Are able to deduct the cost.

## [Section 11] – Federal Tax Law Continued

### **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***

You may qualify to exclude from your income all or part of any gain from the sale of your main home. 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. Increase 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.

Decrease 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.

## **Married Persons -**

### ***\*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.

- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- 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.

If your spouse died and you did not remarry before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

If you meet all of the following requirements, you may qualify to exclude up to \$500,000 of any gain from the sale or exchange of your main home.

- ◆ The sale or exchange took place after 2008.
- ◆ The sale or exchange took place no more than 2 years after the date of death of your spouse.
- ◆ You have not remarried.
- ◆ You and your spouse met the use test at the time of your spouse's death.
- ◆ You or your spouse met the ownership test at the time of your spouse's death.
- ◆ Neither you nor your spouse excluded gain from the sale of another home during the last 2 years.

### ***\*Home transferred from spouse***

If your home was transferred to you by your spouse, you are considered to have owned it during any period of time when your spouse owned it.

### ***\*Use of home after divorce***

You are considered to have used property as your main home during any period when:

- ◆ You owned it, and
- ◆ Your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

### ***\*Reporting the sale***

Do not report the 2011 sale of your main home on your tax return unless:

- You have a gain and do not qualify to exclude all of it,
- You have a gain and choose not to exclude it, or
- You received Form 1099-S

If you used the home for business or to produce rental income, you may have to use Form 4797 to report the sale of the business or rental part.

Some sales are made under arrangements that provide for part of all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive in most cases consist of both interest and principal. You must separately report as interest income, the interest you receive as part of each payment. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on Form 1040A or 1040. The buyer must give you his or her SSN, and you must give the buyer your SSN. Failure to meet these requirements may result in a \$50 penalty for each failure.

### ***\*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.

## **[Section 11 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. If you abandon your home, you may have:
  - a. An exchange.
  - b. A non-taxable trade.
  - c. A sale.
  - d. A lease.
  
2. In regards to your home, if you \_\_\_\_\_ your home and it secures a debt for which you are personally liable and the debt is cancelled, you have ordinary income equal to the amount of the cancelled debt.
  - a. Abandon
  - b. Foreclose
  - c. Sell
  - d. Are subject to a repossession
  
3. There are special rules for married persons that file joint returns. You can exclude up to \$500,000 of the gain of the sale of your main home if, either you or your spouse meets the ownership test, you both meet the use test, and during the 2-year period ending on the date of sale, neither of you:
  - a. Included the gain from the sale of another home.
  - b. Included the deductible allowance from the sale of another home.
  - c. Excluded the loss from the sale of another home.
  - d. Excluded the gain from the sale of another home.

## [Section 12] – Federal Tax Law Continued

### Reporting Gains & Losses -

Many transactions that occurred in 2011 must be reported on new Form 8949.

In previous years, gain & loss transactions would have been reported on Schedule D (Form 1040). For capital gains and losses that occurred in 2011, you must now complete Form 8949 before you complete Schedule D (Form 1040) lines 1,2,3,8,9 or 10. Enter your sales and trades of stocks, bonds, etc, and real estate. Include all these transactions even if you did receive a Form 1099-B, proceeds from broker and barter exchange transactions, or Form 1099-S, proceeds from real estate transactions (or substitute statement). Short-term gains should be reported on line 1 and long-term gains should be reported on line 3. You can use as many Forms 8949 as needed.

#### *\*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.

#### *\*Investment interest deducted*

If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet.

When dealing with a collectibles gain or loss, this is a gain or loss from the sale or trade of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held more than 1

year. Collectibles gain includes gain from sale of an interest in a partnership, S corporation, or trust due to unrealized appreciation of collectibles.

## **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.

## **[Section 12 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. If your capital losses are more than your capital gains, you can claim a capital loss deduction. You would report the deduction on \_\_\_\_\_.
  - a. Line 13 of Form 1040.
  - b. Line 10 of Form 1099, Schedule E.
  - c. Line 13 of Form 996.
  - d. Line 10 of Form 1099, Schedule B.
  
2. What are some advantages of a traditional IRA?
  - a. You may be able to deduct some or all of your contributions to the IRA.
  - b. Depending on your circumstances amounts in your IRA are not taxed until they are distributed.
  - c. Both A & B are correct.
  - d. Only A is correct.
  
3. Where would an individual be allowed to set up a traditional IRA?
  - a. A financial institution.
  - b. A life insurance company.
  - c. Both A & B are correct.
  - d. Neither of the above are correct.

## **[Section 13] – Federal Tax Law Continued**

### ***\*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 parts of the contributions are 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.

For most people, the due date for filing your return for that year is by April 15 of the following 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.

This limit is reduced by any contributions made to a 501 plan on your behalf.

In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of the following amounts.

1. \$5,000.
2. The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.
  - a. The IRA deduction for the year of the spouse with the greater compensation.
  - b. Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
  - c. Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

If you or your spouse was covered by an employer retirement plan at any time during the year for which contributions were made, your deduction may be further limited. Your deduction may be further limited. Limits on the amount you can deduct do not affect the amount that can be contributed. For purposes of the IRA deduction, federal judges are covered by an employer retirement plan.

***\*Situations in Which You Are Not Covered by an Employer Plan***

Unless you are covered under another employer plan, you are not covered by an employer plan if you are in one of the situations described below.

***Social security or railroad retirement*** – Coverage under social security or railroad retirement is not coverage under an employer retirement plan.

***Benefits from a previous employer's plan*** – If you receive retirements benefits from a previous employer's plan, you are not covered by that plan.

***Reservists*** – If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be covered by the plan. You are not covered by the plan if both of the following conditions are met.

1. The plan you participate in is established for its employees by:
  - a. The United States,
  - b. A state or political subdivision of a state, or
  - c. An instrumentality of either A or B above.
2. You did not serve more than 90 days on active duty during the year.

***Volunteer firefighters*** – If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be covered by the plan. You are not covered by the plan if both of the following conditions are met.

1. The plan you participate in is established for its employees by:
  - a. The United States,
  - b. A state or political subdivision of a state, or
  - c. An instrumentality of either A or B above.

- d. Your accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

***\*Limit if Covered by Employer Plan***

If either you or your spouse was covered by an employer retirement plan, you may be entitled to only a partial deduction or no deduction at all, depending on your income and your filing status.

Your deduction begins to decrease when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on your filing status. To determine if your deduction is subject to phaseout, you must determine your modified adjusted gross income (AGI) and your filing status.

***\*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, you are called a beneficiary. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

If you inherit a traditional IRA from your spouse, you generally have the following three choices. You can:

1. Treat it as your own IRA by designating yourself as the account owner.
2. Treat it as your own by rolling it over into your IRA, or to the extent it is taxable, into a:
  - a. Qualified employer plan,
  - b. Qualified employee annuity plan,
  - c. Tax-sheltered annuity plan, or
  - d. Deferred compensation plan of a state or local government.
3. Treat yourself as the beneficiary rather than treating the IRA as your own.

You will be considered to have chosen to treat the IRA as your own if:

- Contributions are made to the inherited IRA, or
- You do not take the required minimum distribution for a year as a beneficiary of the IRA.

You will only be considered to have chosen to treat the IRA as your own if:

- You are the sole beneficiary of the IRA, and
- You have an unlimited right to withdraw amounts from it.

If you receive a distribution from your deceased spouse's IRA, you can roll that distribution over into your own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if you are not the sole beneficiary of your deceased spouse's IRA.

### ***\*Inherited from someone other than spouse***

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 you cannot make any contributions to the IRA. It also means you cannot roll over any amounts into or out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.

### ***\*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. You can also move assets from a qualified retirement plan 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.

You may be able to roll over, tax free, a distribution from your traditional IRA into a qualified plan. These plans include the federal Thrift Savings Fund, deferred compensation plans of state or local governments, and tax-sheltered annuity plans. The part of the distribution that you can roll over is the part that would otherwise be taxable. Qualified plans may, but are not required to, accept such rollovers.

### ***\*Time limit for making a rollover contribution***

You generally must make the rollover contribution by the 60<sup>th</sup> day after the day you receive the distribution from your traditional IRA or your employer's plan. The IRS may waive the

**60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.**

**If an amount distributed to you from a traditional IRA or a qualified employer retirement plan, is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period.**

## **[Section 13 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. If both you and your spouse are 50 or older, the total combined contribution that can be made for the year to you and your spouses IRA is:
  - a. \$12,000
  - b. \$25,000
  - c. \$32,000
  - d. \$46,000
  
2. Trustee administrative fees that are billed separately and paid in connection with your traditional IRA are:
  - a. Deductible as IRA contributions.
  - b. Sometimes deductible as IRA contributions.
  - c. May be deductible as IRA contributions.
  - d. Not deductible as IRA contributions.
  
3. When do you have to designate a contribution as nondeductible?
  - a. When you earn the income.
  - b. When you receive income.
  - c. When you file your taxes.
  - d. After you file your taxes.

# Ethics Section

## [Section 14]

### *\*Conflicting interests*

(a) A practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —

- (1) The representation of one client will be directly adverse to another client; or
- (2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if:

- (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
- (2) The representation is not prohibited by law; and
- (3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

### *\*Return of client's records*

In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that pre-existed the retention of the practitioner by the client.

The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

***\*Assistance from or to disbarred or suspended persons and former IRS employees***

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

(b) Accept assistance from any former government employee any Federal law would be violated.

***\*Practice of law***

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

***\*Notaries***

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

***\*Conditions of confidentiality***

Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner's tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

***\*Contractual protection***

Written advice is subject to *contractual protection* if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not Sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the matters

addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation.

***\*Prominently disclosed***

An item is prominently disclosed if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

***\*Negotiation of taxpayer checks***

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability.

***\*State or local bond opinion***

A State or local bond opinion is written advice with respect to a *Federal tax issue* included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax-exempt obligation of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond, or any combination of the above.

***\*Contents of complaint***

(a) *Charges.* A complaint must name the respondent; provide a clear and concise description of the facts and law that constitute the basis for the proceeding, and be signed by the Director of Office of Professional Responsibility or a person representing the Director of the Office of Professional Responsibility. A complaint is sufficient if it fairly informs the respondent of the charges brought so that the respondent is able to prepare a defense.

(b) *Specification of sanction.* The complaint must specify the sanction sought by the Director of the Office of Professional Responsibility against the practitioner or appraiser. If the sanction sought is a suspension, the duration of the suspension sought must be specified.

(c) *Demand for answer.* The Director of the Office of Professional Responsibility must, in the complaint or in a separate paper attached to the complaint, notify the respondent of the time for answering the complaint, which may not be less than 30 days from the date of service of the complaint, the name and address of the Administrative Law Judge with whom the answer must be filed, the name and address of the person representing the Director of the Office of Professional Responsibility to whom a copy of the answer must be served, and that a decision by default may be rendered against the respondent in the event an answer is not filed as required.

***\*Best practices for tax advisors***

**(a) *Best practices.*** Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

- (1) Communicating clearly with the client regarding the terms of the engagement.** For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
- (2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.**
- (3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.**
- (4) Acting fairly and with integrity in practice before the Internal Revenue Service.**

**(b) *Procedures to ensure best practices for tax advisors.*** Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.

***\*Reply to answer***

The Director of the Office of Professional Responsibility may file a reply to the respondent's answer, but unless otherwise ordered by the Administrative Law Judge, no reply to the respondent's answer is required. If a reply is not filed, new matter in the answer is deemed denied.

***\*Standards with respect to tax returns and documents, affidavits and other papers***

**(a) Documents, affidavits and other papers**

- (1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.**
- (2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service**
  - (i) The purpose of which is to delay or impede the administration of the Federal tax laws;**
  - (ii) That is frivolous; or**
  - (iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also**

advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

**(b) Advising clients on potential penalties**

**(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to**

**(i) A position taken on a tax return if:**

**(A) The practitioner advised the client with respect to the position;  
or**

**(B) The practitioner prepared or signed the tax return; and**

**(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.**

**(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.**

**(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.**

**(c) Relying on information furnished by clients.**

A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

***\*Records***

**(a) Roster.** The Director of the Office of Professional Responsibility will maintain, and may make available for public inspection in the time and manner prescribed by the Secretary of the Treasury, or delegate, rosters of:

**(1) Enrolled agents, including individuals**

**(i) Granted active enrollment to practice;**

**(ii) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;**

**(iii) Whose enrollment has been placed in inactive retirement status; and**

**(iv) Whose offer of consent to resign from enrollment has been accepted by the Director of the Office of Professional Responsibility;**

**(2) Individuals (and employers, firms or other entities, if applicable) censured, suspended or disbarred from practice before the Internal Revenue Service or upon whom a monetary penalty was imposed;**

**(3) Disqualified appraisers; and**

**(4) Enrolled retirement plan agents, including individuals —**

- (i) Granted active enrollment to practice;
- (ii) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;
- (iii) Whose enrollment has been placed in inactive retirement status; and
- (iv) Whose offer of consent to resign from enrollment has been accepted by the Director of the Office of Professional Responsibility;

(b) Other records. Other records of the Director of the Office of Professional Responsibility may be disclosed upon specific request, in accordance with the applicable law.

***\*Official responsibility***

Official responsibility means the direct administrative or operating authority, whether intermediate or final, and either exercisable alone or with others, and either personally or through subordinates, to approve, disapprove, or otherwise direct Government action, with or without knowledge of the action.

***\*Conflicting interests***

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client in his or her practice before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

- (1) The representation of one client will be directly adverse to another client; or
- (2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if:

- (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
- (2) The representation is not prohibited by law;
- (3) Each affected client gives informed consent, confirmed in writing.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(Approved by the Office of Management and Budget under Control No. 1545-1726)

***\*Representing oneself and return preparation***

(a) Representing one-self. Individuals may appear on their own behalf before the Internal Revenue Service provided they present satisfactory identification.

(b) Preparing tax returns and furnishing information. Any individual may prepare a tax return; appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.

**(c) Fiduciaries.** For purposes of this part, a fiduciary (i.e., a trustee, receiver, guardian, personal representative, administrator, or executor) is considered to be the taxpayer and not a representative of the taxpayer.

**(d) Special appearances.** The Director of the Office of Professional Responsibility may, subject to such conditions as he or she deems appropriate, authorize an individual who is not otherwise eligible to practice before the Internal Revenue Service to represent another person in a particular matter.

***\*Diligence as to accuracy***

**(a) In general.** A practitioner must exercise due diligence:

- (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;**
- (2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and**
- (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.**

**(b) Reliance on others,** a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

***\*Customhouse brokers***

Nothing contained in the regulations in this part will affect or limit the right of a customhouse broker, licensed as such by the Commissioner of Customs in accordance with the regulations prescribed therefore, in any customs district in which he or she is so licensed, at a relevant local office of the Internal Revenue Service or before the National Office of the Internal Revenue Service, to act as a representative in respect to any matters relating specifically to the importation or exportation of merchandise under the customs or internal revenue laws, for any person for whom he or she has acted as a customhouse broker.

## **[Section 14 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. An example of a document, written or electronic record that a client would request be returned to them so that they may comply with Federal tax obligations, would include:
  - a. Lease agreements for a business establishment.
  - b. Email communications for contract pertaining to business.
  - c. Receipt records from an office supply store in which the client claimed as an expense.
  - d. All of the above are examples of original records that a client may ask for from their practitioner in order to comply with Federal tax obligations.
  
2. An example of a frivolous claim that a practitioner should not advise their client to use, would include:
  - a. Submitting a valid lease agreement where the client conducts business, which would be used to establish deductions.
  - b. Submitting a receipt for office supplies necessary to conduct business, which would be used to establish deductions.
  - c. Submitting a receipt for business deduction purposes on an item that was solely used for personal purposes.
  - d. Submitting a valid contract agreement for a website design relating to your business.
  
3. The IRS maintains and makes available for public inspection, records of:
  - a. All children born in the United States.
  - b. All persons that pass the bar exam.
  - c. Individuals censured, suspended or disbarred from practice before the IRS.
  - d. All notary publics.

## **[Section 15] – Ethics Continued**

### ***\*Knowledge of client's omission***

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

### ***\*Incompetence and disreputable conduct***

(a) Incompetence and disreputable conduct. Incompetence and disreputable conduct for which a practitioner may be sanctioned includes, but is not limited to:

- (1) Conviction of any criminal offense under the Federal tax laws.
- (2) Conviction of any criminal offense involving dishonesty or breach of trust.
- (3) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.
- (4) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."
- (5) Solicitation of employment as prohibited, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.
- (6) Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.
- (7) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.
- (8) Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.
- (9) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special

inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.

**(10) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.**

**(11) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.**

**(12) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.**

**(13) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion, which is intentionally, or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (a)(13) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading. For purposes of this paragraph (a)(13), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation that is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.**

**(14) Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.**

**(15) Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding.**

### ***\*Evidence***

**(a) *The rules of evidence prevailing in courts of law and equity are not controlling in hearings or proceedings conducted under this part.*** The Administrative Law Judge may, however, exclude evidence that is irrelevant, immaterial, or unduly repetitious.

**(b) *Depositions.*** The deposition of any witness may be admitted into evidence in any proceeding instituted under "Institution of proceeding".

**(c) *Requests for admission.*** Any matter admitted in response to a request for admission is conclusively established unless the Administrative Law Judge on motion permits withdrawal or modification of the admission. Any admission made by a party is for the

purposes of the pending action only and is not an admission by a party for any other purpose, nor may it be used against a party in any other proceeding.

(d) *Proof of documents.* Official documents, records, and papers of the Internal Revenue Service and the Office of Professional Responsibility are admissible in evidence without the production of an officer or employee to authenticate them. A copy attested may evidence any documents, records, and papers to or identified by an officer or employee of the Internal Revenue Service or the Treasury Department, as the case may be.

(e) *Withdrawal of exhibits.* If any document, record, or other paper is introduced in evidence as an exhibit, the Administrative Law Judge may authorize the withdrawal of the exhibit subject to any conditions that he or she deems proper.

(f) *Objections.* Objections to evidence are to be made in short form, stating the grounds for the objection. Except as ordered by the Administrative Law Judge, argument on objections will not be recorded or transcribed. Rulings on objections are to be a part of the record, but no exception to a ruling is necessary to preserve the rights of the parties.

***\*Standards for advising with respect to tax return positions and for preparing or signing returns***

(a) *Realistic possibility standard.* A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless:

- (1) The practitioner determines that the position satisfies the realistic possibility standard; or
- (2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

***\*Supplemental charges***

(a) *In general.* The Director of the Office of Professional Responsibility may file supplemental charges, by amending the complaint with the permission of the Administrative Law Judge, against the respondent, if, for example:

- (1) It appears that the respondent, in the answer, falsely and in bad faith, denies a material allegation of fact in the complaint or states that the respondent has insufficient knowledge to form a belief, when the respondent possesses such information; or
- (2) It appears that the respondent has knowingly introduced false testimony during proceedings against the respondent.

(b) *Hearing.* The supplemental charges may be heard with other charges in the case, provided the respondent is given due notice of the charges and is afforded a reasonable opportunity to prepare a defense to the supplemental charges.

### ***\*Sanctions***

**(a) Authority to censure, suspend, or disbar.** The Secretary of the Treasury, or his or her delegate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

**(b) Authority to disqualify.** The Secretary of the Treasury, or his or her delegate, after due notice and opportunity for hearing, may disqualify any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code.

**(1)** If any appraiser is disqualified pursuant to this subpart C, such appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Director of Practice, regardless of whether such evidence or testimony would pertain to an appraisal made prior to or after such date.

**(2)** Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. An appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

### ***\*Requirements for other written advice***

A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining whether a practitioner has failed to comply with this section. In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

***\*Practice by former government employees, their partners and their associates***

(1) *Assist* means to act in such a way as to advise, furnish information to, or otherwise aid another person, directly, or indirectly.

(2) *Government employee* is an officer or employee of the United States or any agency of the United States, including a special Government employee, or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) *Member of a firm* is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

***\*Violation of regulations***

A practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service for any of the following:

(a) Willfully violating any of the regulations contained in this part.

(b) Recklessly or through gross incompetence (within the meaning “Incompetence and disreputable conduct” violating “Best practices for tax advisors” or Standards with respect to tax returns and documents, affidavits and other papers.

***\*Fees***

A practitioner may not charge an unconscionable fee for representing a client in a matter before the Internal Revenue Service.

(1) A contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client’s fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) A practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return.

(3) A contingent fee may be charged for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.

***\*Communication of fee information***

Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner

may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The practitioner must retain the copy for a period of at least 36 months from the date of the last transmission or use.

***\*Establishment of advisory committees***

***Advisory committees:*** To promote and maintain the public's confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized Authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. The Director should ensure that membership of an advisory committee is balanced among those who practice as attorneys, accountants, and enrolled agents. Under procedures prescribed by the Director, an advisory committee may review and make general recommendations regarding professional standards or best practices for tax advisors

## **[Section 15 - Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Which governing body has the authority to censure, suspend, or disbar any practitioner from practice before the IRS, if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.
  - a. The Internal Revenue Service.
  - b. The General Services Authority.
  - c. The Security of the Treasury.
  - d. The office of the comptroller of the currency.
  
2. A member of a firm is a sole practitioner or an employee or associate thereof, or:
  - a. A client.
  - b. An affiliate or employee of a partnership.
  - c. A family member is a stockholder.
  - d. An attorney of counsels that is no longer a member or affiliated with a law corporation.
  
3. What is the minimum number of authorized individuals, that the Director of the Office of Professional Responsibility would enlist for the establishment of one or more advisory committees in order to promote and maintain the public's confidence in tax advisors?
  - a. Two individuals for any one advisory committee.
  - b. Three individuals for any one advisory committee.
  - c. Five individuals for any one advisory committee.
  - d. Four individuals for any one advisory committee.

# State Section - California

## [Section 16 – State Section]

If you were a full-year resident of California for the whole year and you meet the basic filing requirements outlined in Section B, file either Form 540, Form 540A, or Form 540 2EZ, California Resident Income Tax Return. If you file a joint return and either spouse/RDP was a nonresident or a part-year resident in the year, file a Long or Short Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

Use the same filing status for California that you used for your federal income tax return, unless you are in a same-sex marriage or an RDP. If you are a same-sex married individual or an RDP and file single for federal, you must file married/RDP filing jointly or married/RDP filing separately for California. If you are a same-sex married individual or an RDP and file head of household for federal purposes, you may file head of household for California purposes only if you meet the requirements to be considered unmarried or considered not in a domestic partnership. If you did not file a federal return because you did not have a federal filing requirement, you may use any filing status on your California return that you were entitled to use on your federal return had you been required to file a federal return.

### *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.

Nonresidents and Part-Year Residents – If you were a full year nonresident of California in 2011, and you meet the basic filing requirements outlined in Section B, or if you were a California resident for part of the year, file Long or Short Form 540 NR.

#### *\*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 to 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.

## **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.

## **[Section 16 – Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. You are considered a \_\_\_\_\_ of California if you live and work and are permanently domiciled in Colorado, but are in California to visit family for a week while vacationing.
  - a. A Resident.
  - b. A Part-Year Resident.
  - c. A Non-Resident.
  - d. None of the above.
  
2. In determining your residency for the State of California, you should compare your place where you have the \_\_\_\_\_ with your \_\_\_\_\_ to California.
  - a. Furthest connections, ties.
  - b. Closest connections, business.
  - c. Furthest connections, business.
  - d. Closest connections, ties.
  
3. Students who are non-residents of California coming to this state to attend a California school, do not \_\_\_\_\_ become \_\_\_\_\_.
  - a. Automatically, foreigners.
  - b. Apply to, exempt.
  - c. Apply to, foreigners.
  - d. Automatically, residents.

## **[Section 17 – California Section Continued]**

### **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. The location of the employer, where the payment is issued, and 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. Withholding may be required on a nonresident's business income if an exemption, waiver, or reduction is not certified or approved.

### ***\*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, is not taxable by California. However, lump-sum distributions received from most nonqualified plans after December 31, 1995, continue to be taxable by California.**

## **[Section 17 – Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Non-residents of California are taxed on income:
  - a. All income from California and other sources in determining state tax.
  - b. All income from other than California sources in determining state tax.
  - c. Only on income from California sources in determining state tax.
  - d. None of the above.
  
2. In regards to residents, distributions from employer-sponsored and self employment pension, \_\_\_\_\_, \_\_\_\_\_, or other deferred compensation arrangements are taxable by California.
  - a. Cash deposits, IPO's.
  - b. IPO's, stocks.
  - c. Profit sharing, stock bonus plans.
  - d. None of the above.
  
3. Lump-sum distributions received for most non-qualified plans after December 31, 1995, \_\_\_\_\_ by California.
  - a. Continue to be taxable.
  - b. Are not taxable.
  - c. Both A & B are correct.
  - d. None of the above.

## **[Section 18 – State Section Continued]**

### ***\*Individual Retirement Account (IRA), Roth IRA, SIMPLE IRA, Simplified Employee Pension (SEP), and Keogh Distributions***

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.

## **Withholding Services and Compliance Section -**

Withholding may be required on income with a California source. This includes, sales of California real estate, income allocations or distributions from S corporations and partnerships, and other payments of California source income paid to nonresidents.

### ***\*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.

## ***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.

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 E through I.

### ***\*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.

## **[Section 18 – Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. What is sourced and taxed based upon where the property is located?
  - a. Real Property.
  - b. Property, which is not tangible.
  - c. “Ghost” property.
  - d. None of the above.
  
2. Flight personnel who are California residents are \_\_\_\_\_ on all wages received regardless of where the flight time is spent.
  - a. Not Taxed.
  - b. Taxed.
  - c. Both A & B are correct.
  - d. None of the above.
  
3. Railroad employees or truck drivers who are California residents \_\_\_\_\_ on all wages received regardless of where the duties are performed.
  - a. Are taxed.
  - b. May be taxed.
  - c. Are not taxed.
  - d. None of the above are correct.

## **[Section 19 – State Section Continued]**

### **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 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.

## **[Section 19 – Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. If you claimed the foreign earned income exclusion on your federal return, you must include the amount of your foreign earned income exclusion on:
  - a. Form 1040EZ.
  - b. Schedule CA (540NR), Line 21f, Column C.
  - c. Schedule 5769, Line 2, Column B.
  - d. Schedule C, Line 20, Column A.
  
2. \_\_\_\_\_ consider domicile and residence to be the same. However, \_\_\_\_\_ makes a distinction and views them as two separate concepts, even though they may overlap.
  - a. Very few states, Virginia.
  - b. Many States, California.
  - c. Both A & B are correct.
  - d. None of the above.
  
3. Domicile is defined as the place where you \_\_\_\_\_, with the intent to make it your permanent home and primary establishment.
  - a. Involuntarily establish only yourself.
  - b. Involuntarily establish you and your family.
  - c. Voluntarily establish yourself and family.
  - d. None of the above.

## **[Section 20 – State Section Continued]**

### ***\*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.

## **Filing Status -**

Your filing status for California must be the same as the filing status you used on your federal income tax return. If you did not file a federal return because you did not have a federal filing requirement, use the filing status you would have used had you been required to file.

Exception for married taxpayers who file a joint federal income tax return – You may file either a joint return or separate returns if either spouse was:

- ◆ An active member of the United States Armed Forces (or an auxiliary military branch) during the tax year; or
- ◆ A nonresident for the entire year and had no income from California sources during the tax year.

Regardless of your residency status, if you file separate California returns, enter the amount you would have reported if you had filed a married filing separate return when the instructions for the California return say to enter an amount from your federal return. Attach an explanation to your California return showing how you split the income from your joint federal return between you and your spouse. If you are required to attach a copy of your federal return to your California return, attach a copy of your joint federal return.

### **\*Avoid Common Mistakes on Long Form 540NR**

Avoid making time-consuming and costly mistakes by reporting your AGI from all sources as if you were a resident of California for the entire year.

California tax returns start with federal AGI. However, there are differences between California and federal tax law. Use Schedule CA (540NR) to convert your federal AGI (column A) to your total AGI from all sources under California law (column D). This means:

- ◆ Copy your federal income, adjustments, and deductions to the applicable lines on Schedule CA (540NR), column A;
- ◆ Add income excluded on the federal return (such as foreign income or income from non-California municipal bonds), unless the income is specifically excludable under California law, by entering it on Schedule CA (540NR), column C; and
- ◆ Subtract income that is taxable under federal law but not under California law (such as California Lottery winnings and social security benefits) by entering it on Schedule CA (540NR), column B.

**Note:** Do not subtract non-California source income to determine your total AGI from all sources under California law.

When you figure your California AGI on Schedule CA (540NR), column E be sure to include:

- ◆ All income from every source while you were a resident of California; and
- ◆ Income from California sources while you was a nonresident.

***\*Double-Taxed Income***

If you paid taxes to California and to another state on the same income, you may qualify for a tax credit for taxes paid to another state.

***\*Filing Requirements***

**Residents** – You must file a California return if either your California gross income or your California adjusted gross income is more than certain amounts.

**Nonresidents and Part-Year Residents** – You must file a Long or Short Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, if you have any income from California sources and your gross income from all sources or adjusted gross income is more than certain amounts.

***\*Exclusion of Gain on Sale of a Principal Residence***

A taxpayer on qualified official extended duty in the U.S. Armed, Uniformed, or Foreign Services may suspend, for up to 10 years of such duty time, the running of the 5-year ownership-and-use period before the sale of a residence.

***\*Exclusion from Gross Income of Certain Federal Death Gratuity Payments***

A federal death gratuity payment to a survivor of a member of the Armed Forces is excludable from gross income.

***\*Combat Zone Extensions Expanded to Contingency Operations***

The various extensions granted to combat zone participants to file tax returns or pay taxes apply to those serving in Contingency Operations, as designated by the Secretary of Defense.

***\*Joint or Separate Returns***

Active duty military members and their spouses who file joint federal returns may file separate returns for California. When filing separate returns, a full-year resident spouse must file Form 540 or Form 540A. A nonresident or part-year resident spouse must file a Long Form 540NR. When filing a joint return and one spouse is a nonresident or part-year resident, you must file a Long or Short Form 540NR. You should figure your tax both jointly and separately to determine which filing status will result in the lower amount of tax.

For tax years beginning on or after January 1, 2000, a husband and wife who file a joint return may amend that return, within the general statute of limitations, after the original due date to change their filing status from married filing jointly to married filing separately if either spouse was:

- An active member of the armed forces or any auxiliary branch.
- Non-resident for the entire taxable year who had no income from a California source.

**Division of Income** – The domicile of the spouse earning the income determines the division of income between the spouses when separate returns are filed. Each spouse must follow the laws of his or her state of domicile to determine if the income is separate or community property.

## **[Section 20 – Review Questions]**

To follow, please find review questions for the section that you have just finished reading. The purpose of these review questions is to provide you with information that will reinforce what you have learned from reading this section, may answer questions in regards to subject matter either specifically or in general, and/or to support information already learned.

1. Which of the following are community property states?
  - a. California.
  - b. Mexico.
  - c. Washington.
  - d. All of the above.
  
2. Each spouse is entitled to deduct \_\_\_\_\_ of the expenses of the business or investment expenses on his or her separate return.
  - a. One-fifth.
  - b. One-third.
  - c. One-half.
  - d. One-eighth
  
3. In regards to filling separate returns, what can you and your spouse not do for any one dependent?
  - a. Divide the time spent with the dependent.
  - b. Split the credit for any one dependent.
  - c. Both A & B are correct.
  - d. None of the above are correct.

## [Review Questions & Answers]

### 1. Section 1 Review:

1. If you use the calendar year to file your 2012 Form 1040EZ, the due date to file your return is:

Feedback: April 17, 2012, is the due date for filing your 2011 income tax return if you use the calendar year. If you use a fiscal year, your income tax return is due by the 15<sup>th</sup> day of the 4<sup>th</sup> month after the close of your fiscal year. When the due date for doing any act for tax purposes, filing a return, and paying taxes falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day. Since April 15<sup>th</sup> is a Sunday and April 16<sup>th</sup> is a holiday, the correct answer is “c”.

2. When dealing with Form 8949, you want to enter all sales and exchanges of capital assets, such as \_\_\_\_\_, and then complete Schedule D.

Feedback: When reporting capital gains and losses, in previous years many transactions would have been reported only on Schedule D (Form 1040). For 2011, you will use new Form 8949 to report, the sale or exchange of capital asset not reported on another form or schedule, gains from involuntary conversions of capital assets not held for business or profit, and non-business bad debts. On Form 8949, enter all sales and exchanges of capital assets, including stocks, bonds, and real estate. Then complete line 1,2,3,8,9, or 10 of Schedule D (Form 1040). As such, the correct answer is “C”.

3. Which of the following expenses below can you include in standard mileage rates for medical expenses when using your car for medical reasons?
  - a. General Repair.
  - b. Depreciation.
  - c. Oil.
  - d. Insurance.

Feedback: Standard mileage rates for medical expenses paid for transportation expenses amounts paid for transportation for primary medical care has changed. You can include, bus, taxi, train, or plane fares, or ambulance services, 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 part of treatment. You can include out of pocket expenses, such as the cost of gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses. You can also include parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate. If you do not want to use your actual expenses for 2011, you can use 23.5 cents a mile for miles driven from July 1<sup>st</sup> to December 31<sup>st</sup>, 2011, for use of a car for medical reasons. Since you can include the cost of oil when you use your car for medical reasons, the correct answer is “c”.

### 2. Section 2 Reviews:

1. In regards to non-business energy property credit, qualified energy efficiency improvements must remain in use for:

Feedback: Qualified energy efficiency improvements are the following improvements that are new, can be expected to remain in use at least 5 years, and meet certain requirements for energy efficiency. They include any insulation material or system that is specifically and primarily designed to reduce heat loss or gain of a home, exterior doors, any metal or asphalt roof that has appropriate pigmented coatings or cooling granules specifically and that which is primarily designed to reduce heat gain of the home. Since one of the criteria states that qualified energy efficiency improvements must remain in use for at least 5 years in order to qualify to possibly take the non-business energy property credit, the correct answer is “b”.

2. Under non-business energy property credit, which of the following below is not a qualified energy efficiency improvement?

Feedback: Qualified energy efficiency improvements are the following improvements that are new, can be expected to remain in use at least 5 years, and meet certain requirements for energy efficiency. They include any insulation material or system that is specifically and primarily designed to reduce heat loss or gain of a home, exterior doors, any metal or asphalt roof that has appropriate pigmented coatings or cooling granules specifically and that which is primarily designed to reduce heat gain of the home. Since, interior doors do not qualify as an energy efficiency improvement under non-business energy property credit, the correct answer is “b”.

3. Under the health coverage tax credit, amounts paid for qualified health insurance coverage after February 2011, has:

Feedback: In regards to the Health Coverage Tax credit, amounts paid for qualified health insurance coverage after February 2011, has decreased to 72.5%, from 80% for payments made in January to February. However, if certain conditions are met and if you received any advanced monthly payments in March through December 2011, you are eligible to receive an additional 7.5% retroactive credit as detailed in Form 8885. The conditions include persons and family members being

covered by a qualified health insurance plans for which you paid the entire premium, or your portion of the premiums, directly to your health plan or to the U.S. treasury, you were not enrolled in Medicare Part A, B, or C, persons who were enrolled in Medicare but your family members qualified for HCTC, persons who were not enrolled in Medicaid or the Children's Health Insurance Program, persons that were not imprisoned under federal, state, or local authority, persons who employer did not pay 50% or more of the cost of coverage, those that didn't receive a 65% COBRA premium reduction from a former employer or administrator of COBRA, and persons who were not in the Federal Employees Health Benefit Program or eligible to receive benefits from the U.S. Military health system, or you were an eligible trade adjustment assistance recipient, alternate, reemployment TAA recipient or Pension Benefit Guaranty Corporation pension recipient or a qualified family member of one of these individuals. Since, the amounts paid for qualified health insurance coverage after February 2011 under the health coverage tax credit has decreased to 72.5% from 80%, the correct answer is "b".

### **3. Section 3 Reviews:**

1. The Tax Relief Act reduced the self-employment tax by:

Feedback: The 2010 Tax Relief Act reduced the self-employment tax by 2% for self-employment income earned in calendar year 2011. The self-employment tax rate for self-employment income earned in calendar year 2011 is now 13.3%. For self-employment income earned in 2010, the self-employment tax rate was 15.3%. The rate consists of 12.4% for social security and 2.9% for Medicare. This rate deduction of the self-employment tax asserts that the correct answer is "a" since it is reduced from 15.3% to 13.3%.

2. In regards to mortgage insurance premium, if your adjusted gross income for 2011 is more than \_\_\_\_\_ or \$54,500 if married filing separately, you cannot deduct your mortgage insurance premium.

Feedback: Amounts paid during 2011 for qualified mortgage insurance can be treated as home mortgage interest. To that extent, the insurance must be in connection with home acquisition debt and the contract issued after 2006. You must use Schedule A, Form 1040 to determine whether and figure the amount you can deduct. If your adjusted gross income for 2011 is more than \$109,000 or \$54,500 if married filing separately, you cannot deduct your mortgage insurance premium. The mortgage insurance premium deduction has changed for 2012. An itemized deduction for premium you pay or accrue for qualified mortgage insurance in connection with home acquisition debt on your qualified home is no longer available for 2011. Since, you cannot deduct your mortgage insurance premium for 2011, if your adjusted gross income is more than \$109,000 or \$54,000 if married filing separately, the correct answer is "b".

3. Under retirement savings contributions, you can claim the credit if which of the following apply?

Feedback: If you or your employer make eligible contributions to a retirement plan, you can claim the credit if all of the following apply. You are not under age 18, you are not a full-time student, no one else, such as your parents, claims an exemption for you on their tax return or your adjusted gross income is not more than, \$56,500 for 2011 (\$57,500 for 2012) if your filing status is married filing jointly. Since, all of the above must apply in order for you to be able to claim the credit under retirement savings contributions, the correct answer is "d".

### **4. Section 4 Reviews:**

1. In addition to money, goods, and property, which of the following forms of income received would be included as gross income:

Feedback: Gross income includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. It also includes income from sources outside the United States or from the sale of your main home even if you may exclude all or part of it. Since, a service that is not exempt from tax, income from sources outside the U.S and the sale of your main home all qualify as forms of income received that would be included as gross income, the correct answer is "d".

2. Your filing status is determined on the last day of your tax year, which is December 31<sup>st</sup> for most taxpayers. It is dependent on which of the following factors:

Feedback: Your filing status depends on whether you are single or married and on your family situation. It is determined on the last day of your tax year, which is December 31<sup>st</sup> for most taxpayers. Since, your filing status is dependent on whether you are married or single and your family situation, the correct answer is "c".

3. You must file Form 1040 and Schedule SE if you had church employee income of:

Feedback: You must file Form 1040 and Schedule SE (Form 1040), Self-Employment Tax if you had church employee income of \$108.28 or more. You must also file Form 1040 Schedule SE if your net earnings from self-employment (church employees income being excluded) were \$400.00 or more. Since, you must file Form 1040 and Schedule SE if you had church employee income of \$108.28 or more, the correct answer is "c".

### **5. Section 5 Reviews:**

1. Which method can be used to request an automatic 6-month extension of time to file, if you cannot file on time?

**Feedback:** If you cannot file your tax return by the due date, you may be able to get an automatic 6-month extension of time to file. An extension is not just assumed and given if you do not file your tax return by the due date. You can get the automatic extension by using IRS e-file or filing paper form. Once you file the correct paperwork, you may be able to get the extension for six months. Since, you can request an automatic 6-month extension of time to file through use of IRS e-file and by filing a paper form, the correct answer is “c”.

2. A regular fiscal year is a \_\_\_\_\_ period that ends on the last day of any month except December.

**Feedback:** Most individual tax returns cover a calendar year, which is defined as the 12-month from January 1<sup>st</sup> through December 31<sup>st</sup>. A regular fiscal year is a 12-month period that ends on the last day of any month except December. A 52-53 week fiscal year varies from 52 to 53 weeks and always ends on the same day of the week. If you do not use a calendar year, your accounting period is a fiscal year, which is a 12-month period that ends on the last day of any month, except December. Therefore, the correct answer is “c”.

3. Under garnished wages, if your employer uses your wages to pay your debts, or if your wages are attached or garnished, then:

**Feedback:** If your employer uses your wages to pay your debts, or if your wages are attached or garnished, then you have received the full amount. Since the full amount is considered received by you, the correct answer is “d”.

## 6. Section 6 Reviews:

1. For purposes of the gross income test, a persons gross income for the year must be less than:

**Feedback:** There are four tests that must be met for a person to be considered your qualifying relative. The four tests are not a qualifying child test, member of household or relationship test, the gross income test and support test. For purposes of the gross income test, a person’s gross income for the year must be less than \$3,700. Therefore, the correct answer is “c”.

2. When dealing with an emancipated child, the child is treated as:

**Feedback:** The custodial parent is the parent with whom the child lived with for the greater number of nights. The other parent is considered the non-custodial parent. If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income. In the case of an emancipated child there is an exception. If a child is emancipated under state law, the child is treated as not living with either parent. Therefore, the correct answer is “b”.

3. In regards to the tie-breaker rules, if no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest:

**Feedback:** To determine which person can treat the child as a qualifying child to claim these six tax benefits,, tiebreaker rules apply. If only one of the persons is the child’s parent, the child is treated as the qualifying child of the parent. If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year. If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year, and if a parent can claim the child as a qualifying child but no parent does so claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year. Therefore, the correct answer is “d”.

## 7. Section 7 Reviews:

1. Under salaries and wages, income tax is withheld from the pay of most employees. Your pay includes your:

**Feedback:** Income tax is withheld from the pay of most employees. Your pay includes your regular pay, bonuses, commissions, and vacation allowances. It also includes reimbursements and other expense allowances paid under a non-accountable plan. Since your pay includes bonuses, commissions, and regular pay, the correct answer is “d”.

2. Under salaries and wages, military retirement pay is treated \_\_\_\_\_, even though it is treated as a pension or annuity for other tax purposes.

**Feedback:** Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes. Since military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, the correct answer is “b”.

3. Under determining amount of tax withheld, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances if changes are needed.

**Feedback:** Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new form W-4 to change your withholding status or number of allowances. The new form must be given to your employer within 10 days after either your

divorce, if you have been claiming married status or any event that decreases the number of withholding allowances you can claim. A new Form W-4 should be given to your employer, which makes “b” the best choice answer.

4. In regards to completing Form W-4, if both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your:

**Feedback:** If both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. You can divide your total allowances anyway, but you cannot claim an allowance that your spouse also claims. You would use only one set of Form W-4 Worksheets. Since adjustments, exemptions, combined income and credits need to be used to figure your withholding allowances if both you and your spouse are employed and expect to file a joint return using form w-4, the correct answer is “a”.

## 8. Section 8 Reviews:

1. After subtracting your withholding and credits, you must make estimated tax payments for the tax year if you expect to owe at least \$1,000 in tax for the next year and your withholding and credits are less than the smaller of \_\_\_\_\_ shown on next years return or \_\_\_\_\_ of the tax shown on your current return.

**Feedback:** If you had a tax liability for this tax year, you may have to pay estimated tax for the following year, if you expect to owe at least \$1,000 in tax for the next year after subtracting your withholding and credits and you expect your withholding and credits to be less than the smaller of 90% of the tax to be shown on your next year’s tax return or 100% of the tax shown on your current tax return. Your current tax return must cover all 12 months. Since, it is determined that, after subtracting your withholding and credits, you must make estimated tax payments for the tax year if your withholding and credits are less than the smaller of 90% shown on next years return or 100% of the tax shown on your current return, the correct answer is “a”.

2. In regards to who must make estimated tax payments, which of the following conditions must be met to be excused from paying estimated tax for 2012?

**Feedback:** You do not have to pay estimated tax for next year if you had no tax liability for current tax year, you were a U.S. citizen or resident for the whole year and your current tax year covered a 12-month period. Since all of the above are correct in regards to the conditions that must be met to be excused from paying estimated tax for 2012, the correct answer is “d”.

3. If you are considered \_\_\_\_\_, you and your spouse cannot make joint estimated tax payments.

**Feedback:** You and your spouse cannot make joint estimated tax payments if you are legally separated under a decree of divorce or separate maintenance, either spouse is a nonresident alien, or you and your spouse have different tax years. Since all of the above fall under the conditions of not being able to make joint estimated tax payments, the correct answer is “d”.

4. Under rental income and expenses, generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are:

**Feedback:** Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are non-depreciable capital expenditures. You must add them to the basis of your property. You cannot deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits. Since these benefits that increase the value of your property cannot be deducted or ignored and are considered non-depreciable capital expenditures, the correct answer is “a”.

## 9. Section 9 Reviews:

1. A day of personal use of a dwelling unit is considered:

**Feedback:** A day of personal use of a dwelling unit is any day that the unit is used by, you or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement, a member of your family or a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price, anyone under an arrangement that lets you use some other dwelling unit, or anyone at less than a fair rental price. If the other person or member of the family in the statement described above has more than one home, his or her main home is ordinarily the one he or she lived in most of the time. Since, generally a day of personal use of a dwelling unit is considered any day that the unit is used by you or any other person who has interest in it, the correct answer is “d”.

2. Which of the following rules apply in determining the division of your expenses between rental use and personal use?

**Feedback:** If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. You can deduct expenses for the rental use of the unit. When dividing your expenses certain rules must be followed. One rule states that any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home. Another rule states that the day that the unit is available for rent but not actually rented

is not a day or rental use. Once you have determined what portion of the time the dwelling unit was used for rental purposes, you can deduct expenses for that rental use of the unit. Since one of the rules state that any day that the unit is rented at a fair rental price is a day of rental use, the correct answer is “a”.

3. In regards to rental activity, losses from holding real property, other than \_\_\_\_\_ property, placed in service before 1987 are not subject to the at-risk rules.

**Feedback:** The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property, other than mineral property, placed in service before 1987 are not subject to the at-risk rules. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at-risk in the activity at the end of the tax year. You are considered at-risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. Since mineral property is not considered in losses from holding real property in regards to rental activity, the correct answer is “d”.

## 10. Section 10 Reviews:

1. Which of the following are not considered significant services provided for your tenants convenience?

**Feedback:** If you provide significant services that are primarily for your tenant’s convenience such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), Profit or Loss from business or Schedule C-EZ, net profit from business (sole proprietorship). Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. Since trash collection is not considered significant services provided for your tenants convenience, the correct answer is “b”.

2. If you paid \_\_\_\_\_ or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, Mortgage Interest Statement, or similar statement showing the interest you paid for the year.

**Feedback:** If you paid \$600 or more of mortgage interest on your rental property to any of person, you should receive a Form 1098, Mortgage Interest Statement, or similar statement showing the interest you paid for the year. Since you should receive a Form 1098, Mortgage Interest Statement, or similar statement showing the interest you paid for the year, if you paid \$600 or more of mortgage interest on your rental property to anyone person, the correct answer is “c”.

3. If you paid part of the cost of your annuity, you \_\_\_\_\_ on the part of the annuity you receive that represents a return of your cost.

**Feedback:** 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. Since you are not taxed on the part of the annuity you receive that represents a return of your cost, the correct answer is “a”.

## 11. Section 11 Reviews:

1. If you abandon your home, you may have:

**Feedback:** If your home was foreclosed on or repossessed, you have a sale. If you abandon your home, you may have ordinary income. Since you may have ordinary income if you abandon your home, the correct answer is “c”.

2. In regards to your home, if you \_\_\_\_\_ your home and it secures a debt for which you are personally liable and the debt is cancelled, you have ordinary income equal to the amount of the canceled debt.

**Feedback:** If your home was foreclosed on or repossessed, you have a sale. If you abandoned 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. Therefore, the correct answer is “a”.

3. There are special rules for married persons that file joint returns. You can up to \$500,000 of the gain of the sale of your main home if, either you or your spouse meets the ownership test, you both meet the use test, and during the 2-year period ending on the date of sale, neither of you:

**Feedback:** You can exclude up to \$500,000 of the gain on the sale of your main home if, you are married and file a joint return for the year, either you or your spouse meets the ownership test, both you and your spouse meet the use test, and 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. Since neither of you can exclude the gain from the sale of another home in order to exclude up to \$500,000 of the gain on the sale of your main home, the correct answer is “d”.

## 12. Section 12 Reviews:

1. If your capital losses are more than your capital gains, you can claim a capital loss deduction. You would report the deduction on:

**Feedback:** 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. Your allowable capital loss deduction, figured on Schedule D, is the lesser of \$3,000 (\$1,500 if you are married and file a separate return), or your total net loss as shown on line 16 of Schedule D. Since you would report a capital loss deduction on Line 13 of Form 1040 your capital losses are more than your capital gains, the correct answer is “a”.

2. What are some advantages of a traditional IRA?

**Feedback:** The original IRA sometimes called an ordinary or regular IRA is referred to as a “traditional IRA.” Two advantages of a traditional IRA you may be able to deduct some or all of your contributions to it, depending on your circumstances, and generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed. Therefore the correct answer is “c”.

3. Where would an individual be allowed to set up a traditional IRA?

**Feedback:** 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. Since you can set up an IRA at anytime at a financial institution or a life insurance company for example, the correct answer is “c”.

### 13. Section 13 Reviews:

1. If both you and your spouse are 50 or older, the total combined contribution that can be made for the year to you and your spouses IRA is:

**Feedback:** The total combined contributions that can be made for the year to your IRA and your spouses 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. Since the amounts of \$25,000, \$32,000 and, \$46,000 are not the true maximum amount allowable to contribute, but \$12,000 is if both you and your spouse are 50 or older, the correct answer is “a”.

2. Trustee administrative fees that are billed separately and paid in connection with your traditional IRA are;

**Feedback:** Trustee 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 contributions 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 \$5,000 or \$6,000 if you are 50 or older, or 100% of your compensation. If you meet the criteria to take the deduction you may it on Schedule A (Form 1040) as a miscellaneous itemized deduction. Since trustee administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions, the correct answer is “d”.

3. When do you have to designate a contribution as nondeductible?

**Feedback:** 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. Since you would designate a contribution as non-deductible when you file your taxes, the correct answer is “c”.

### 14. Section 14 Reviews:

1. An example of a document, written or electronic record that a client would request be returned to them so that they may comply with Federal tax obligations, would include:

**Feedback:** Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner’s representation of the client, that pre-existed the retention of the practitioner by the client. For example, if a client asks their practitioner for their records of mileage and receipts as proof for an auditor, the practitioner would make a copy and provide the client with the original. Since all of the above would be included in types of records, the correct answer is “d”.

2. An example of a frivolous claim that a practitioner should not advise their client to use, would include:

**Feedback:** A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service for the purpose of which is to deal or impede the administration of the Federal tax laws, that is frivolous, or that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation. For example, an agent cannot knowingly advise a client to submit fraudulent receipts related to business expenses, for the purpose of claiming those receipts as deductions and defrauding the IRS. Since a practitioner may not advise a client to submit information deemed to contain or omit information in a manner that demonstrates an intentional disregard, such as submitting a receipt for business deduction purposes of an item that was solely used for personal purposes, the correct answer is “c”.

3. The IRS maintains and makes available for public inspection, records of:

**Feedback:** The Director of the Office of Professional Responsibility will maintain, and may make available for public inspection in the time and manner prescribed by the Secretary of the Treasury, or delegate, rosters of Enrolled agents, Individuals (and employers, firms, or other entities, if applicable) censured, suspended or disbarred from practice before the Internal Revenue Service or upon whom a monetary penalty was imposed, disqualified appraisers, and enrolled retirement plan agents. For example, records are maintained and may be made publicly available, of a previous enrolled retirement plan agent that is not longer licensed to practice due to fraudulently claiming information that did not exist for numerous clients. Since, the IRS maintains and makes available for public inspection, records of individuals censured, suspended, or disbarred from practice before the IRS, the correct answer is “c”.

### **15. Section 15 Reviews:**

1. Which governing body has the authority to censure, suspend, or disbar any practitioner from practice before the IRS, if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

**Feedback:** The Secretary of the Treasury, or his or her delegate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand that would for example, prevent a practitioner that has failed to comply with the rules of maintaining a license, to practice. Since the secretary of the Treasury has the authority to censure, suspend, or disbar, the correct answer is “c”.

2. A member of a firm is a sole practitioner or an employee or associate thereof, or:

**Feedback:** A member of a firm is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties. For example, an attorney of counsel for a law corporation would be considered an affiliate or employee of a partnership. Therefore the correct answer is “b”.

3. What is the minimum number of authorized individuals, that the Director of the office of Professional Responsibility would enlist for the establishment of one or more advisory committees in order to promote and maintain the public’s confidence in tax advisors?

**Feedback:** To promote and maintain the public’s confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. The Director should ensure that membership of an advisory committee is balanced among those who practice as attorneys, accountants, and enrolled agents. Since at least five individuals are needed for anyone advisory committee, the correct answer is “c”.

### **16. Section 16 – Reviews:**

1. You are considered a \_\_\_\_\_ if you live and work and are permanently domiciled in Colorado, but are in California to visit family for a week while vacationing.

**Feedback:** A non-resident is any individual who is not a resident. You are considered a resident if you are domiciled in California for permanent purposes and a part-year resident if you are a non-resident of the state for part of the year but a resident for the other part of the year. Since vacationing to visit family in California, while having a permanent residence and working in Colorado would qualify one as being a non-resident, the correct answer is “c”.

2. In determining your residency for the State of California, you should compare your place where you have the \_\_\_\_\_ with your \_\_\_\_\_ to California.

**Feedback:** The underlying theory of residency is that you are a resident of the place where you have the closest connections. Since your residence is usually the place where you have the closest ties, you should compare your connections to California with your ties elsewhere. Then you must determine the strength of your ties, not just the number of ties to determine your residency. Since you should compare your place where you have the closest connections with your ties to California in determining whether or not you are a resident of California, the correct answer is “d”.

3. Students who are non-residents of California coming to this state to attend a California school, do not \_\_\_\_\_ become \_\_\_\_\_.

**Feedback:** Students who are residents of California leaving this state to attend an out-of-state school do not automatically become non-residents, nor do students who are non-residents of California coming to this state to attend a California school to automatically become residents. Individuals must determine their residency status based on their facts and circumstances such as where their drivers license was received and the origin of their primary accounts. Since students who are non-residents of California coming to this state to attend a California school, do not automatically become residents, the correct answer is “d”.

### **17. Section 17 – Reviews:**

1. Non-residents of California are taxed on income \_\_\_\_\_.

**Feedback:** Residents of California are taxed on all income, including income from sources outside California. Non-residents of California are taxed only on income from California sources. Non-residents of California are taxed only on income from California sources. Non-residents 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 non-resident. Since non-residents are taxed only on income from California sources in determining state tax, the correct answer is “c”.

2. In regards to residents, distributions from employer-sponsored and self-employment pension, \_\_\_\_\_, \_\_\_\_\_, or other deferred compensation arrangements are taxable by California.

**Feedback:** In regards to nonresidents, distributions are not taxable by California if received after December 31, 1995. In regards to 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. Since profit sharing and stock bonus plans are taxable by California, the correct answer is “c”.

3. Lump-sum distributions received for most non-qualified plans after December 31, 1995, \_\_\_\_\_ by California.

**Feedback:** In regards to non-residents, lump sum distributions from a qualified plan or annuity after December 31, 1995, is not taxable by California. However, lump-sum distributions received from most non-qualified plans after December 31, 1995, continue to be taxable by California. Since lump-sum distributions received from non-qualified plans after December 31, 1995, continue to be taxable by California, the correct answer is “a”.

### **18. Section 18 – Review:**

1. What is sourced and taxed based upon where the property is located?

**Feedback:** For taxable years beginning 2002, California taxes installment gains received by a non-resident from the sale of tangible property on a source basis. California taxes residents on all income regardless of source. Real property is sourced and taxed based upon where the property is located. Since it is determined that real property is sourced and taxed based upon where it is located, the correct answer is “a”.

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

**Feedback:** The ages of non-resident flight personnel such as the pilot, copilot and flight attendant, are not taxable by California unless more than 50% of the individual’s scheduled flight time is in California. However, flight personnel who are California residents are taxed on all wages received regardless of where the flight time is spent. Since it is determined that all wages are subject to taxation by flight personnel who are California residents, the correct answer is “b”.

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

**Feedback:** The wages of non-resident railroad employees or truck drivers whose regularly assigned duties are performed in two or more states may only be taxed by the individuals 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. Since it is determined that truck drivers and railroad employees who are California residents, are taxed on all wages received, the correct answer is “a”.

### **19. Section 19 – Review:**

1. If you claimed the foreign earned income exclusion on your federal return, you must include the amount of your foreign earned income exclusion on \_\_\_\_\_.

**Feedback:** California does not allow a foreign tax credit or foreign earned income exclusion. If you claimed the foreign earned income exclusion on your federal return, include the amount of your foreign income exclusion on Schedule CA (540NR), Line 21F, column C. Therefore, the correct answer is “b”.

2. \_\_\_\_\_ consider domicile and residence to be the same. However, \_\_\_\_\_ makes a distinction and views them as two separate concepts, even though they may overlap.

**Feedback:** 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. Since California makes a distinction between the legal definition of the term domicile and residence and many other states consider domicile and residence to be the same, the correct answer is “b”.

3. Domicile is defined as the place where you \_\_\_\_\_, with the intent to make it your permanent home and primary establishment.

**Feedback:** You have only one domicile at a time. Once you acquire a domicile, you retain that domicile until you acquire another. Domicile is defined as the place where you voluntarily establish yourself and family, not just for a limited purpose (such as vacation), but with the intent to make it your permanent home and primary establishment. It is the place that you always return to, when you are absent from it. Since domiciled is defined as the place where you voluntarily establish yourself and family, the correct answer is “c”.

## **20. Section 20 – Review:**

1. Which of the following are community property states?

**Feedback:** Community property is considered 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 half of all community property. The following are community property states: Arizona, New Mexico, California, Puerto Rico, Idaho, Texas, Louisiana, Washington, Nevada, and Wisconsin. Since all of the above are considered community property states, the correct answer is “d”.

2. Each spouse is entitled to deduct \_\_\_\_\_ of the expenses of the business or investment expenses on his or her separate return.

**Feedback:** 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. Since each spouse is entitled to deduct half of the expenses of the business or investment expenses on their separate returns, the correct answer is “c”.

3. In regards to filing separate returns, what can you and your spouse not do for anyone dependent?

**Feedback:** 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 anyone dependent. Since you may not split the credit for anyone dependent, the correct answer is “b”.

## **Reference Materials & Prerequisites**

#1 - #10 you can download at [www.irs.gov](http://www.irs.gov). If you cannot download the publications you may also call to order the publications for free of charge. A hard copy of the publications will be sent to the address you specified.

1. Publication 17, Your Federal Income Tax Guide for Individuals.
2. Publication 575, Pension and Annuity Income.
3. Publication 15B, Employer's Tax Guide to Fringe Benefits.
4. Publication 54, Tax Guide for U.S Citizens and Resident Aliens Abroad.
5. Publication 530, Tax Information for Homeowners.
6. Publication 554, Tax guide for Seniors.
7. Publication 571, Tax-Sheltered Annuity Plans.
8. Publication 590, Individual Retirement Arrangements.
9. Publication 15, Employer's Tax guide.
10. Publication 225, Farmer's Tax Guide.

#11 - #17 you can download at [www.ftb.ca.gov](http://www.ftb.ca.gov). If you cannot download the publications you may also call to order the publications for free of charge. A hard copy of the publications will be sent to the address you specified.

11. 540/540A, Personal Income Tax Booklet.
12. 540NR, Nonresident or Part-Year Resident Booklet.
13. 540 2EZ, Personal Income Tax Booklet.
14. 1001 Publication, Supplemental Guidelines to California Adjustments.
15. 1005 Publication, Pension and Annuity Guidelines.
16. 1031 Publication, Guidelines for Determining Resident Status.
17. 1032 Publication, Tax Information for Military personnel.

#18 you can download at [www.irs.gov](http://www.irs.gov). If you cannot download the publications you may also call to order the publications for free of charge. A hard copy of the publications will be sent to the address you specified.

18. Circular 230, Regulations Governing Practice before the Internal Revenue Service.