TAX STRATEGIES FOR INDIVIDUALS

Tax Saving Strategies: A Helpful Checklist

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This Financial Guide provides tax saving strategies for deferring income and maximizing deductions and includes some strategies for specific categories of individuals, such as those with high income and those who are self-employed.

Before getting into the specifics, however, we would like to stress the importance of proper documentation. Many taxpayers forgo worthwhile tax deductions because they have neglected to keep receipts or records. Keeping adequate records is required by the IRS for employee business expenses, deductible travel and entertainment expenses, and charitable gifts and travel. But don't do it just because the IRS says so. Neglecting to track these deductions can lead to overlooking them. You also need to maintain records regarding your income. If you receive a large tax-free amount, such as a gift or inheritance, make certain to document the item so that the IRS does not later claim that you had unreported income.

The checklist items listed below are for general information only and should be tailored to your specific situation. If you think one of them fits your tax situation, we'd be happy to discuss it with you.

Avoid or Defer Income Recognition

Deferring taxable income makes sense for two reasons. Most individuals are in a higher tax bracket in their working years than they are during retirement. Deferring income until retirement may result in paying taxes on that income at a lower rate. Additionally, through the use of tax-deferred retirement accounts you can actually invest the money you would have otherwise paid in taxes to increase the amount of your retirement fund. Deferral can also work in the short term if you expect to be in a lower bracket in the following year or if you can take advantage of lower long-term capital gains rates by holding an asset a little longer.

> You can achieve the same effect of deferring income by accelerating deductions, for example, by paying a state estimated tax installment in December instead of at the following January due date.

Max Out Your 401(k) or Similar Employer Plan

Many employers offer plans where you can elect to defer a portion of your salary and contribute it to a tax-deferred retirement account. For most companies, these are referred to as 401(k) plans. For many other employers, such as universities, a similar plan called a

403(b) is available. Check with your employer about the availability of such a plan and contribute as much as possible to defer income and accumulate retirement assets.

> Some employers match a portion of employee contributions to such plans. If this is available, you should structure your contributions to receive the maximum employer matching contribution.

If You Have Your Own Business, Set Up and Contribute to a Retirement Plan

If you have your own business, consider setting up and contributing as much as possible to a retirement plan. These are allowed even for a sideline or moonlighting business. Several types of plans are available which minimize the paperwork involved in establishing and administering such a plan.

Contribute to an IRA

If you have income from wages or self-employment income, you can build tax-sheltered investments by contributing to a traditional or a Roth IRA. You may also be able to contribute to a spousal IRA -even where the spouse has little or no earned income. All IRAs defer the taxation of IRA investment income and in some cases can be deductible or be withdrawn tax-free.

> To get the most from IRA contributions, fund the IRA as early as possible in the year. Also, pay the IRA trustee out of separate funds, not out of the amount in the IRA. Following these two rules will ensure that you get the most tax-deferred earnings possible from your money.

Defer Bonuses or Other Earned Income

If you are due a bonus at year-end, you may be able to defer receipt of these funds until January. This can defer the payment of taxes (other than the portion withheld) for another year. If you're self-employed, defer sending invoices or bills to clients or customers until after the new year begins. Here, too, you can defer some of the tax, subject to estimated tax requirements. This may even save taxes if you are in a lower tax bracket in the following year. Be advised, however, that the amount subject to social security or self-employment tax increases each year.

Accelerate Capital Losses and Defer Capital Gains

If you have investments on which you have an accumulated loss, it may be advantageous to sell it prior to year-end. Capital losses are deductible up to the amount of your capital gains plus $3,000. If you are planning on selling an investment on which you have an accumulated gain, it may be best to wait until after the end of the year to defer payment of the taxes for another year (subject to estimated tax requirements). For most capital assets held more than 12 months (long-term capital gains) the maximum capital gains tax is 20 percent. However, make sure to consider the investment potential of the asset. It may be wise to hold or sell the asset to maximize the economic gain or minimize the economic loss.

Watch Trading Activity in Your Portfolio

When your mutual fund manager sells stock at a gain, these gains pass through to you as realized taxable gains, even though you don't withdraw them, so you may prefer a fund with low turnover, assuming satisfactory investment management. Turnover isn't a tax consideration in tax-sheltered funds such as IRAs or 401(k)s. For growth stocks you invest in directly and hold for the long term, you pay no tax on the appreciation until you sell them. No capital gains tax is imposed on appreciation at your death.

Use the Gift-Tax Exclusion to Shift Income

You can give away $16,000 ($32,000 if joined by a spouse) per donee in 2022 ($15,000 in 2021), per year without paying federal gift tax. You can give $16,000 to as many donees as you like. The income on these transfers will then be taxed at the donee's tax rate, which is in many cases lower.

> Special rules apply to children under age 18. Also, if you directly pay the medical or educational expenses of the donee, such gifts will not be subject to gift tax.

Invest in Treasury Securities

For high-income taxpayers, who live in high-income-tax states, investing in Treasury bills, bonds, and notes can pay off in tax savings. The interest on Treasuries is exempt from state and local income tax. Also, investing in Treasury bills that mature in the next tax year results in a deferral of the tax until the next year.

Consider Tax-Exempt Municipal Bonds

Interest on state or local municipal bonds is generally exempt from federal income tax and from tax by the issuing state or locality. For that reason, interest paid on such bonds is somewhat less than that paid on commercial bonds of comparable quality. However, for individuals in higher brackets, the interest from municipal bonds will often be greater than from higher-paying commercial bonds after reduction for taxes. Gain on sale of municipal bonds is taxable and loss is deductible. Tax-exempt interest is sometimes an element in the computation of other tax items. Interest on loans to buy or carry tax-exempts is non-deductible.

Give Appreciated Assets to Charity

If you're planning to make a charitable gift, it generally makes more sense to give appreciated long-term capital assets to the charity, instead of selling the assets and giving the charity the after-tax proceeds. Donating the assets instead of the cash prevents your having to pay capital gains tax on the sale, which can result in considerable savings, depending on your tax bracket and the amount of tax that would be due on the sale. Additionally, you can obtain a tax deduction for the fair market value of the property.

> Many taxpayers also give depreciated assets to charity. The deduction is for fair market value; no loss deduction is allowed for depreciation in value of a personal asset. Depending on the item donated, there may be strict valuation rules and deduction limits.

Keep Track of Mileage Driven for Business, Medical or Charitable Purposes

If you drive your car for business, medical or charitable purposes, you may be entitled to a deduction for miles driven. For 2022, it's 58.5 cents per mile for business, 18 cents for medical and moving purposes (members of the armed forces only for tax years 2018-2025), and 14 cents for service for charitable organizations. To substantiate the deduction, you need to keep detailed daily records of the mileage driven for these purposes.

Take Advantage of Your Employer's Benefit Plans to Get an Effective Deduction for Items Such as Medical Expenses

Medical and dental expenses are generally only deductible to the extent they exceed 7.5 percent of your adjusted gross income (AGI). For most individuals, particularly those with high incomes, this eliminates the possibility of a deduction. You can effectively get a deduction for these items if your employer offers a Flexible Spending Account, sometimes called a cafeteria plan. These plans permit you to redirect a portion of your salary to pay these types of expenses with pretax dollars. Another such arrangement is a Health Savings Account. Ask your employer if they provide either of these plans.

Check Out Separate Filing Status

Certain married couples may benefit from filing separately instead of jointly. Consider filing separately if you meet the following criteria:

- One spouse has large medical expenses, miscellaneous itemized deductions, or casualty losses.
- The spouses' incomes are about equal.

Separate filing may benefit such couples because the adjusted gross income "floors" for taking the listed deductions will be computed separately. On the other hand, some tax benefits are denied to couples filing separately. In some states, filing separately can also save a significant amount of state income taxes.

If Self-Employed, Take Advantage of Special Deductions

You may be able to expense up to $1,080,000 in 2022 for qualified equipment purchases for use in your business immediately instead of writing it off over many years. Additionally, self-employed individuals can deduct 100 percent of their health insurance premiums as business expenses. You may also be able to establish a Keogh, SEP or SIMPLE IRA plan, or a Health Savings Account, as mentioned above.

If Self-Employed, Hire Your Child in the Business

If your child is under age 18, he or she is not subject to employment taxes from your unincorporated business (income taxes still apply). This will reduce your income for both income and employment tax purposes and shift assets to the child at the same time; however, you cannot hire your child if he or she is under the age of 8 years old.

Take Out a Home-Equity Loan

> Due to tax reform legislation passed in 2017, the following information applies only to tax years prior to 2018. For tax years 2018-2025, interest on home equity loans is not deductible when used for the purposes listed below.

Most consumer-related interest expense, such as from car loans or credit cards, is not deductible. Interest on a home equity loan, however, can be deductible. It may be advisable to take out a home-equity loan to pay off other nondeductible obligations.

Bunch Your Itemized Deductions

Certain itemized deductions, such as medical or employment-related expenses, are only deductible if they exceed a certain amount. It may be advantageous to delay payments in one year and prepay them in the next year to bunch the expenses in one year. This way you stand a better chance of getting a deduction.

Travel and Entertainment: Maximizing the Tax Benefits

Don't overpay your income taxes by overlooking expenses that you are entitled to deduct. Use this Financial Guide to ensure you are handling your business travel and meal costs in a tax-wise manner.

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This Financial Guide shows you how to take advantage of all of the travel and entertainment expenses you're legally entitled to and offers guidance on which expenses are deductible and what percentage of them you can deduct. It also discusses the importance of following IRS rules for keeping records and substantiating your expenses in order to avoid an audit.

Travel Expenses

Tax law allows you to deduct two types of travel expenses related to your business, local and what the IRS calls "away from home."

1. First, local travel expenses. You can deduct local transportation expenses incurred for business purposes, for example, the cost of getting from one location to another via public transportation, rental car, or your own automobile. Meals and incidentals are not deductible as travel expenses, although as you will read later in this guide,

you can deduct meals as an entertainment expense as long as certain conditions are met.

2. Second, you can deduct away from home travel expenses-including meals and incidentals; however, if your employer reimburses your travel expenses, your deductions are limited.

Local Transportation Costs

The cost of local business transportation includes rail fare and bus fare, as well as the costs of using and maintaining an automobile used for business purposes. For those whose main place of business is their personal residence, business trips from the home office and back are considered deductible transportation and not non-deductible commuting.

You generally cannot deduct lodging and meals unless you stay away overnight. Meals may be partially deductible as an entertainment expense as discussed below.

Away From-Home Travel Expenses

Due to the economic devastation caused by the coronavirus pandemic, in 2021 and 2022, you are able to deduct 100 percent of the cost of business meals and beverages purchased from restaurants. Typically, you can only deduct one-half of the cost of meals (50 percent). Lodging expenses incurred while traveling away from home are fully deductible (no pandemic-related change). The IRS also allows you to deduct 100 percent of your transportation expenses as long as business is the primary reason for your trip.

> You do not need to eat the food at the restaurant; you can order take-out and still take the 100 percent deduction.

To be deductible, travel expenses must be "ordinary and necessary", although "necessary" is liberally defined as "helpful and appropriate," not "indispensable." The deduction is also denied for that part of any travel expense that is "lavish or extravagant," though this rule does not bar deducting the cost of first-class travel or deluxe accommodations or (subject to percentage limitations below) deluxe meals.

What does "away from home" mean?

To deduct the costs of lodging and meals (and incidentals-see below) you must generally stay somewhere overnight. In other words, away from your regular place of business longer than an ordinary day's work and you need to sleep or rest to meet the demands of your work while away from home. Otherwise, your costs are considered local transportation costs and the costs of lodging and meals are not deductible.

Where is your "home" for tax purposes?

The general view is that your "home" for travel expense purposes is your place of business or your post of duty. It is not where your family lives (some courts have stated that it's the general area of your residence). Here is an example:

> George's family lives in Boston and George works in Washington, DC. George spends the weekends in Boston and the weekdays in Washington, where he stays in a hotel and eats out. For tax purposes, George's "home" is in Washington, not Boston, therefore, he cannot deduct any of the following expenses: cost of traveling back and forth between Washington and Boston, cost of eating out in Washington, cost of staying in a hotel in Washington, or any costs incurred traveling between his hotel in Washington and his job in Washington (the latter are considered non-deductible commuting costs).

There are some rules in the tax law concerning where a taxpayer's "home" is for purposes of deducting travel expenses that are less clear such as when a taxpayer works at a temporary site or works in two different places.

We'll cover these rules briefly in these two examples:

> **Example #1:** Joe, who lives in Connecticut, works eight months out of the year in Connecticut (from which he usually earns about $50,000) and four months out of the year in Florida (from which he usually earns about $15,000). Joe's "tax home" for travel expense purposes is Connecticut. Therefore, the costs of traveling to and from the "lesser" place of employment (Florida), as well as meals and lodging costs incurred while working in Florida, are deductible.
>
> **Example #2:** Susan works and lives in New York. Occasionally, she must travel to Maryland on temporary assignments, where she spends up to a week at a time. Assuming Susan's employer does not reimburse her for travel expenses, she can deduct the costs of meals and lodging while she's in Maryland, as well as the costs of traveling to and from Maryland. This holds true because her work assignments in Maryland are considered temporary since they will end within a foreseeable time. If an assignment is considered indefinite, that is, expected to last for more than a year, under the tax law, travel, meal, and lodging costs are not deductible.

Here's a list of some deductible away-from-home travel expenses:

- Meals (100 percent in 2021 and 2022; limited to 50 percent in other years) and lodging while traveling or once you get to your away-from-home business destination.
- The cost of having your clothes cleaned and pressed away from home.

- Costs for telephone, fax or modem usage.
- Costs for secretarial services away-from-home.
- The costs of transportation between job sites or to and from hotels and terminals.
- Airfare, bus fare, rail fare, and charges related to shipping baggage or taking it with you.
- The cost of bringing or sending samples or displays, and of renting sample display rooms.
- The costs of keeping and operating a car, including garaging costs.
- The cost of keeping and operating an airplane, including hangar costs.
- Transportation costs between "temporary" job sites and hotels and restaurants.
- Incidentals, including computer rentals, stenographers' fees.
- Tips related to the above.

However, many away-from-home travel expenses are not deductible or are restricted in some way. These include:

Commuting expenses. The costs of traveling between your home and your job are not deductible.

Travel as a form of education. Trips that are educational in a general way, or improve knowledge of a certain field but are not part of a taxpayer's job, are not deductible.

Job search expenses. Tax reform eliminated miscellaneous deductions for tax years 2018 through 2025.

Seeking a new location. Travel costs (and other costs) incurred while you are looking for a new place for your business (or for a new business) must be capitalized and cannot be deducted currently.

Luxury water travel: If you travel using an ocean liner, a cruise ship, or some other type of "luxury" water transportation, the amount you can deduct is subject to a per-day limit.

Seeking foreign customers: The costs of traveling abroad to find foreign markets for existing products are not deductible.

> Starting in 2008, travel (and other) costs incurred in unsuccessfully trying to acquire a specific business are currently deductible.

Meal and Entertainment Expenses

Prior to tax reform, there were limits and restrictions on deducting meal and entertainment expenses, with most deductible at 50 percent. Due to COVID-19 legislation, for tax years 2021 and 2022, the deductible amount for business-related meals is 100 percent. Meal costs must be "ordinary and necessary" and not "lavish or extravagant" and directly related to or associated with your business. They must also be substantiated.

Under tax reform, there were a number of changes, the most notable being that entertainment expenses paid or incurred after December 31, 2017, are not deductible unless they fall under specific exceptions, for example, expenses incurred for social activities primarily for the benefit of your employees. As such, reasonable costs for food and refreshments for year-end parties for employees are 100 percent deductible.

Prior to 2018, if you rented a skybox or other private luxury box for more than one event, say for the season, at the same sports arena, you generally could deduct more than the price of a non-luxury box seat ticket. Each game or other performance counted as one event, and the deduction for those seats was subject to the 50 percent entertainment expense limit. Starting January 1, 2018, however, that deduction is eliminated. Furthermore, even if the costs of food and beverages are separately stated, you cannot deduct these expenses.

Deductions are still disallowed for depreciation and upkeep of "entertainment facilities" such as yachts, hunting lodges, fishing camps, swimming pools, and tennis courts. However, the costs of entertainment provided at such facilities are no longer deductible. Prior to 2018, these expenses were deductible at 50 percent, subject to entertainment expense limitations.

Dues paid to country clubs or social or golf and athletic clubs are not deductible nor are dues that you pay to professional and civic organizations. Prior to 2018, these dues were deductible at 50 percent as long as your membership has a business purpose. Such organizations included business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

How Do You Prove Expenses Are "Directly Related?"

The following section applies only to expenses incurred before January 1, 2018.

As noted earlier, most entertainment-related expenses are no longer deductible. Expenses are directly related if you can show:

- There was more than a general expectation of gaining some business benefit other than goodwill.
- You conducted business during the entertainment.

- Active conduct of business was your main purpose.

There is a presumption (in the eyes of the IRS) that events that take place in what it considers places non-conducive to doing business are not directly related to your business. These places include nightclubs, theaters, sporting events or cocktail parties. It also includes meetings with a group of people who are not business associates, at cocktail lounges, country clubs, or athletic clubs. However, you can overcome the presumption by showing that you engaged in a business discussion or otherwise conducted business during the event.

How Do You Meet The "Associated With" Test?

The following section applies only to expenses incurred before January 1, 2018.

As noted earlier, most entertainment-related expenses are no longer deductible. Even if you can't show that the entertainment was "directly related" as discussed above, you can still deduct the expenses as long as you can prove the entertainment was "associated" with your business. To meet this test, the entertainment must directly precede or come after a substantial business discussion. Further, you must have had a clear business purpose when you took on the expense.

For Whom Can You Get The Deduction?

The following section applies only to expenses incurred before January 1, 2018.

As noted earlier, most entertainment-related expenses are no longer deductible. The person entertained must be a business associate. That is, someone who could reasonably be expected to be a customer or conduct business with you, including an employee or professional advisor.

In circumstances where it's customary to entertain a business associate with his or her spouse, and your spouse also attends, entertainment of both spouses is deductible, thanks to the "closely connected rule."

Recordkeeping and Substantiation Requirements

Tax law requires you to keep records that will prove the business purpose and amounts of your business travel, entertainment, and local transportation costs.

Which Records You Must Keep

You must substantiate the following business expenses:

- Travel expenses while away from home (including meals and lodging).
- Business meals and entertainment if allowed under a tax code exception, and
- Business gifts.

To substantiate these items, you must prove:

- The amount.
- The time and place of the travel, entertainment, or recreation, or the date and a description of the business gift.
- The business purpose, and
- The business relationship of the recipient of entertainment or gifts.

> The most frequent reason for IRS's disallowance of travel and entertainment expenses is the failure to show the place and business purpose of an item. Therefore, pay special attention to these aspects of your record-keeping.
>
> Keeping a diary or logbook and recording your business-related activities at or close to the time the expense is incurred is one of the best ways to document your business expenses.

Here's how these rules apply to your record-keeping for travel expenses, entertainment expenses, and business gifts.

Away-from-home travel expenses. You must document the following for each trip:

- The amount of each expense, e.g., the cost of each transportation, lodging and meal. You can group similar types of incidentals together, i.e., "meals, taxis."
- The dates of your departure and return and the number of days you spent on business.
- Your destination.
- The business reason for the travel or the business benefit you expect.

Entertainment expenses (exceptions allowed under the tax code) for tax years before 2018. You must prove the following for each claimed deduction for entertainment expenses:

- The amount of each separate expense, though incidentals may be totaled on a daily basis.

- The date of the entertainment.
- The name, title, and occupation (showing business relation) of the people you entertained.

Business gifts. You must keep the following documentation for a business gift to substantiate the deduction:

- The cost of the gift and the date it was made.
- The business reason for the gift.
- The name, title, and occupation of the recipient.
- A description of the gift.

Employees "Fully Reimbursed"

Employees who are "fully reimbursed" by their employer must:

- Adequately account to their employer.
- Receive full reimbursement.
- Return any excess reimbursement.

As a fully reimbursed employee, you must adequately account to your employer by means of an expense account statement. If you are covered by (and follow) an "accountable plan," and your reimbursements don't exceed your expenses, you won't have to report the reimbursements as gross income. Some per diem arrangements (by which you receive a flat amount per day) and mileage allowances can avoid detailed expense accounting to the employer, but proof of time, place, and business purpose is still required.

However, if your employer's reimbursement plan is not "accountable," you must report the reimbursements as income. Prior to 2018, you could deduct these expenses on your tax return as miscellaneous itemized deductions on Form 1040 Schedule A, subject to the two percent-of-adjusted-gross-income floor. Tax reform, however, eliminated miscellaneous deductions for tax years 2018 through 2025.

Auto Expenses

If you are self-employed and use a car for business, you have two choices as to how to claim the deduction for auto expenses. Parking fees and tolls may be deducted no matter which method you use.

1. You can deduct the actual business-related costs of gas, oil, lubrication, repairs, tires, supplies, parking, tolls, chauffeur salaries, and depreciation, or
2. You can use the standard mileage deduction, which is an inflation-adjusted amount that is multiplied by the number of business miles driven.

From 2018 through 2025, employees who use their cars for business but either don't get reimbursed or are reimbursed under an employer's "non-accountable" reimbursement plan can no longer deduct auto expenses on Form 1040 Schedule A.

The standard mileage rate produces a larger deduction for some business owners, while others fare better (tax-wise) by deducting actual expenses. Figuring your deduction using both methods tells you which method is better for you tax-wise.

Expensing and depreciating vehicle costs. Deduction options and amounts depend on the percentage used for business. Also, if the car is used more than 50 percent for business, it can be included as business property and qualify for Section 179 expensing in the year of purchase. The deduction is reduced proportionately to the extent the car is used for personal purposes. If you take this deduction, you can't use the actual mileage for that vehicle in any year.

Depreciation. Assuming the car cost more than the Section 179 limit, or Section 179 is not available or is not claimed, depreciation is also allowed. Several depreciation options are available, but there are limits to the amount of depreciation that can be claimed per year. Depreciation otherwise allowable is reduced by the proportion of personal use. For example, a car used 20 percent for personal use is depreciated at 80 percent of the amount otherwise allowed.

Accelerated depreciation is defined as depreciation that is at a rate higher than normal that results from dividing the vehicle's cost by the number of years it will be used. It is not allowed where personal use is 50 percent or more. If you claimed accelerated depreciation in a prior year and your business use then falls to 50 percent or less, you become subject to "recapture" of the excess depreciation (i.e., it's included in income). Of course, using the standard mileage deduction described below allows you to avoid these limits.

Determining whether to use the standard mileage deduction. If you opt for the standard mileage rate, you simply multiply the current cents-per-mile rate by the number of business miles you drive for the year. Be aware, however, that the standard mileage deduction may understate your costs. This is especially true for taxpayers who use the car 100 percent for business, or close to that percentage.

> Once you choose the standard mileage rate, you cannot use accelerated depreciation even if you opt for the actual cost method in a later year. You may use only straight line.
>
> The standard mileage method usually benefits taxpayers who have less expensive cars or who travel a large number of business miles. To determine which method is better for you, make the calculations each way during the first year you use the car for business.

You may use the standard mileage for leased cars if you use it for the entire lease period. Or, you can deduct actual expenses instead, including leasing costs.

Recordkeeping. Tax law requires that you keep travel expense records and that you give information on your return showing business versus personal use. Not only is keeping good records essential in case of an audit, but it also allows you to make the most of your auto deductions. For example, you won't be able to determine which of the two options is better if you don't know the number of miles driven and the total amount you spent on the car. If you use the actual cost method, you'll have to keep receipts as well. For many business owners, using a separate credit card for business simplifies your record-keeping.

> Don't forget to deduct the interest you pay to finance a business-use car if you're self-employed.

The "Nanny Tax" Rules: What To Do If You Have Household Employees

If you have a household employee, you may need to pay state and federal employment taxes. Which forms do you need to file for your household employees? Is your maid, housekeeper, or babysitter covered by the rules? This Financial Guide provides the answers to these and other questions.

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This Financial Guide will help you decide whether you have a "household employee," as defined by the IRS and if you do, whether you need to pay federal employment taxes. It explains the rules for determining, paying, and reporting Social Security tax, Medicare tax, federal unemployment tax, federal income tax withholding, and state unemployment tax for your household employee. It also explains what records you need to keep. In addition, it provides you with the information you need to find out whether you need to pay state unemployment tax for your household employee.

While many people disregard the need to pay taxes on household employees, they do so at the risk of stiff tax penalties. As you will see below, these rules are quite complex and professional tax guidance is highly recommended.

A basic familiarity with these rules will make it easier to work with your tax advisor, saving you time, reducing tax costs, and avoiding tax penalties and interest charges.

Who is a Household Employee?

The "nanny tax" rules apply to you only if (1) you pay someone for **household work** and (2) that worker is your **employee**.

1. A household employee is someone who does work in or around your home. Examples of household employees include babysitters, nannies, health aides, private nurses, maids, caretakers, yard workers, and similar domestic workers.

2.

A household worker is your **employee** if you can control not only what work is done, but how it is done. If the worker is your employee, it does not matter whether the work is full-time or part-time, or if you hired the worker through an agency or from a list provided by an agency or association. It also does not matter whether you pay the worker on an hourly, daily, or weekly basis, or by the job.

On the other hand, if only the worker can control how the work is done, the worker is not your employee but is self-employed. A self-employed worker usually provides his or her own tools and offers services to the general public in an independent business. If an agency provides the worker and controls what work is done and how it is done, the worker is not your employee.

You pay Emily to babysit your child and do light housework four days a week in your home. Emily follows your specific instructions about household and childcare duties. You provide the household equipment and supplies that Emily needs to do her work. Emily is your household employee.

You pay Nathan to care for your lawn. Nathan also offers lawn care services to other homeowners in your neighborhood. He provides his own tools and supplies, and he hires and pays any helpers he needs. Neither Nathan nor his helpers are your household employees.

How Do You Verify That an Employee Can Legally Work in the United States?

It is unlawful for you to knowingly hire or continue to employ a person who cannot legally work in the United States.

When you hire a household employee to work for you on a regular basis, he or she must complete USCIS Form I-9, *Employment Eligibility Verification*. It is your responsibility to verify that the employee is either a U.S. citizen or an alien who can **legally** work and then complete the employer part of the form. Keep the completed form for your records. Do not return the form to the U.S. Citizenship and Immigration Services (USCIS).

Two copies of Form I-9 are contained in the UCIS Employer Handbook. Visit the USCIS website or call 800-767-1833 to order the handbook, additional copies of the form, or to get more information.

Do You Need to Pay Employment Taxes?

If you have a household employee, you may need to withhold and pay Social Security and Medicare taxes, or you may need to pay federal unemployment tax, or you may need to do both. To find out, read the table below.

If you:	Then you need to:
Pay cash wages of $2,400 or more in 2022 to any one household employee. Do not count wages you pay to: • Your spouse, • Your child under age 21, • Your parent, or • Any employee under age 18 during 6	Withhold and pay Social Security and Medicare taxes. • The combined taxes are generally 15.3% of cash wages. • Your employee's share is 7.65%. (You can choose to pay the employee's share yourself and not withhold it.) • Your share is 7.65%.

Pay total cash wages of $1,000 or more in any calendar quarter of 2021 or 2022 to household employees. Do not count wages you pay to: • Your spouse, • Your child under age 21, or • Your parent.	Pay federal unemployment tax. • The tax is 6.0% of cash wages. • Wages over $7,000 a year per employee are not taxed. • You also may owe state unemployment tax.

If neither of these two columns applies, then you do not need to pay any federal unemployment taxes. However, you may still need to pay state unemployment taxes.

You do not need to withhold federal income tax from your household employee's wages. But if your employee asks you to withhold it, you can choose to do so.

If your household employee cares for your dependent under the age of 13 or your spouse or dependent who is not capable of self-care so that you can work, you may be able to take an income tax credit of up to 35% (or $1,100) of your expenses for each qualifying dependent. For two or more qualifying dependents, you can claim up to 35% (or $2,200). For higher-income earners, the credit percentage is reduced, but not below 20%, regardless of the amount of AGI. If you can take the credit, then you can include your share of the federal and state employment taxes you pay, as well as the employee's wages, in your qualifying expenses.

State Unemployment Taxes

To find out whether you need to pay state unemployment tax for your household employee contact your state unemployment tax agency. You'll also need to determine whether you need to pay or collect other state employment taxes or carry workers' compensation insurance.

> If you do not need to pay Social Security, Medicare, or federal unemployment tax and do not choose to withhold federal income tax, the rest of this publication does not apply to you.

Social Security and Medicare Taxes

> **Additional Medicare Tax.** As of January 1, 2013, employers are responsible for withholding the 0.9% Additional Medicare Tax on an individual's wages paid in excess of $200,000 in a calendar year. An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee. There is no employer match for Additional Medicare Tax.

Both you and your household employee may owe social security and Medicare taxes. Your share is 7.65% (6.2% for social security tax and 1.45% for Medicare tax) of the employee's social security and Medicare wages. Your employee's share is 6.2% for social security tax and 1.45% for Medicare tax for wages below the Additional Medicare Tax threshold (see above).

You are responsible for payment of your employee's share of the taxes as well as your own. You can either withhold your employee's share from the employee's wages or pay it from your own funds.

Social Security and Medicare Wages

You figure Social Security and Medicare taxes on the Social Security and Medicare wages you pay your employee. If you pay your household employee cash wages of $2,400 or more in 2022, all cash wages you pay to that employee in 2022 (regardless of when the wages were earned) up to $147,000 are social security wages and all cash wages are Medicare wages. However, any non-cash wages (food, lodging, clothing, and other non-cash items) you pay do not count as social security and Medicare wages. If you pay the employee less than $2,400 in cash wages in 2022, none of the wages you pay the employee are Social Security and Medicare wages, and neither you nor your employee will owe Social Security or Medicare tax.

Wages Not Counted

Do not count wages you pay to any of the following individuals as Social Security and Medicare wages:

1. Your spouse.
2. Your child who is under age 21.
3. Your parent.
4. However, you should count wages to your parent if both of the following apply: (a) your child lives with you and is either under age 18 or has a physical or mental condition that requires the personal care of an adult for at least four continuous weeks in a calendar quarter, and (b) you are divorced and have not remarried, or you are a widow or widower, or you are married to and living with a person whose physical or mental condition prevents him or her from caring for your child for at least four (4) continuous weeks in a calendar quarter.An employee who is under age 18 at any time during the year.

However, you should count these wages to an employee under 18 if providing household services is the employee's principal occupation. If the employee is a student, providing household services is not considered to be his or her principal occupation.
Also, if your employee's Social Security and Medicare wages reach $147,000 in 2022, do not count any wages you pay that employee during the rest of the year as Social Security wages to figure Social Security tax (but continue to count the employee's cash wages as Medicare wages to figure Medicare tax).

You figure federal income tax withholding on both cash and non-cash wages (based on their value). However, do not count as wages any of the following items:

- Meals provided at your home for your convenience.
- Lodging provided at your home for your convenience and as a condition of employment.
- $280 a month in 2022 for transit passes that you give your employee or, in some cases, for cash reimbursement you make for the amount your employee pays to commute to your home by public transit. A transit pass includes any pass, token, fare card, voucher, or similar item entitling a person to ride on mass transit, such as a bus or train.
- Up to $280 a month in 2022 to reimburse your employee for the cost of parking at or near your home or at or near a location from which your employee commutes to your home.

Withholding the Employee's Share

You should withhold the employee's share of Social Security and Medicare taxes if you expect to pay your household employee Social Security and Medicare wages of $2,400 or more in 2022. However, if you prefer to pay the employee's share yourself; see "Not Withholding the Employee's Share" in the next section.

You may withhold the employee's share of the taxes even if you are not sure your employee's Social Security and Medicare wages will be $2,400 or more in 2022. If you withhold the taxes but then actually pay the employee less than $2,400 in Social Security and Medicare wages for the year, you should repay the employee.

You pay withheld taxes as part of your regular income tax obligation. You don't deposit them periodically subject to an exception for business owners. See "Payment Options for Business Employers" below.

Withhold 7.65% (6.2% for Social Security tax and 1.45% for Medicare tax) from each payment of Social Security and Medicare wages. Wages exceeding the $200,000 (single filer) threshold amount are subject to the additional Medicare tax or 0.9%. Instead of paying this amount to your employee, you will pay the IRS 7.65% for your share of the taxes. Do not withhold any social security tax after your employee's social security wages for the year reach $147,000 in 2022.

If you make an error by withholding too little, you should withhold additional taxes from a later payment. If you withhold too much, you should repay the employee.

> You hire a household employee (who is an unrelated individual over age 18) to care for your child and agree to pay cash wages of $100 every Friday. You expect to pay your employee $2,200 or more for the year. You should withhold $7.65 from each $100 wage payment and pay your employee the remaining $92.35. The $7.65 is the sum of $6.20 ($100 x 6.2%) for your employee's share of Social Security tax and $1.45 ($100 x 1.45%) for your employee's share of Medicare tax (for wages under $200,000 for single filers). You will pay $7.65 from your own funds when you pay the taxes.

Not Withholding the Employee's Share

If you prefer to pay your employee's Social Security and Medicare taxes from your own funds, you do not have to withhold them from your employee's wages. The Social Security and Medicare taxes you pay to cover your employee's share must be included in the employee's wages for income tax purposes. However, they are not counted as Social Security and Medicare wages or as federal unemployment (FUTA) wages.

> You hire a household employee (who is an unrelated individual over age 18) to care for your child and agree to pay cash wages of $100 every Friday. You expect to pay your employee $2,200 or more for the year. You decide to pay your employee's share of Social Security and Medicare taxes from your own funds. You pay your employee $100 every Friday without withholding any Social Security or Medicare taxes. For each wage payment, you will pay $15.30 when you pay the taxes. This is $7.65 ($6.20 for Social Security tax plus $1.45 for Medicare tax) to cover your employee's share plus the $7.65 for your share. For income tax purposes, your employee's wages each payday are $107.65 ($100 plus the $7.65 that you will pay to cover your employee's share of Social Security and Medicare taxes).

Federal Unemployment (FUTA) Tax

The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. Like most employers, you may owe both the federal unemployment tax (the FUTA tax) and a state unemployment tax. Or, you may owe only the FUTA tax or only the state unemployment tax. To find out whether you will owe state unemployment tax, contact your state's unemployment tax agency. See the list of state unemployment agencies at the end of this Guide for the address.

The FUTA tax is 6.0% of your employee's FUTA wages. However, you may be able to take a credit of up to 5.4% against the FUTA tax, resulting in a net tax rate of 0.6%. Your credit for 2022 is limited unless you pay all the required contributions for 2022 to your state unemployment fund by April 18, 2022. The credit you can take for any contributions for 2022 that you pay after April 15, 2023, is limited to 90% of the credit that would have been allowable if the contributions were paid by April 15, 2023.

> **WARNING:** Do not withhold the FUTA tax from your employee's wages. You must pay it from your own funds.

You figure the FUTA tax on the FUTA wages you pay. If you pay cash wages to all of your household employees totaling $1,000 or more in any calendar quarter of 2021 or 2022, the first $7,000 of cash wages you pay to each household employee in 2022 is FUTA wages. (A calendar quarter is January through March, April through June, July through September, or October through December.) If your employee's cash wages reach $7,000 during the year, do not figure the FUTA tax on any wages you pay that employee during the rest of the year. For a discussion of "cash wages," see the section on Social Security Wages, above.

If you pay less than $1,000 cash wages in each calendar quarter of 2022, but you had a household employee in 2021, the cash wages you pay in 2022 may still be FUTA wages. They are FUTA wages if the cash wages you paid to household employees in any calendar quarter of 2021 totaled $1,000 or more.

Do not count wages you pay to any of the following individuals as FUTA wages:

1. Your spouse.
2. Your child who is under age 21.
3. Your parent.

> You hire a household employee (not related to you) on January 1, 2022, and agree to pay cash wages of $200 every Friday. During January, February, and March, you pay the employee cash wages of $2,600. Because you pay cash wages of $1,000 or more in a calendar quarter of 2022, the first $7,000 of cash wages you pay the employee (or any other employee) in 2022 or 2021 is FUTA wages. The FUTA wages you pay may also be subject to your state's unemployment tax.
>
> During 2022, you pay your household employee cash wages of $10,400. You pay all the required contributions for 2022 to your state unemployment fund by April 15, 2023. Your FUTA tax for 2022 is $42 ($7,000 x 0.6%).

Do You Need to Withhold Federal Income Tax?

You are not required to withhold federal income tax from wages you pay a household employee. You should withhold federal income tax only if your household employee asks you to withhold it and you agree. The employee must give you a completed Form W-4, *Employee's Withholding Allowance Certificate*.

> Form W-4, Employee's Withholding Certificate, was redesigned in 2020.

If you agree to withhold federal income tax, you are responsible for paying it to the IRS.

Wages

You figure federal income tax withholding on both cash and non-cash wages you pay. Measure wages you pay in any form other than cash by the value of the non-cash item.

Do not count as wages any of the following items:

- Meals provided at your home for your convenience.

- Lodging provided at your home for your convenience and as a condition of employment.
- Up to $280 a month in 2022 for bus or train tokens (passes) you give your employee, or for any cash reimbursement you make for the amount your employee pays to commute to your home by public transit.
- Up to $280 a month in 2022 for the value of parking you provide your employee at or near your home or at or near a location from which your employee commutes to your home.

Paying Tax without Withholding

Any income tax you pay for your employee without withholding it from the employee's wages must be included in the employee's wages for federal income tax purposes. It is also counted as Social Security and Medicare wages and as federal unemployment (FUTA) wages.

How Do You Handle the Earned Income Tax Credit (EITC)?

Certain workers can take the earned income tax credit (EITC) on their federal income tax return. This credit reduces their tax or allows them to receive a payment from the IRS if they do not owe tax. You may have to make advance payments of part of your household employee's EITC along with the employee's wages. You also may have to give your employee a notice about the EITC.

Notice about the EITC

The employee's copy (Copy B) of IRS 2022 Form W-2, *Wage and Tax Statement* has a statement about the EITC on the back.

> If you give your employee that copy by January 31, 2022 (as discussed under Form W-2), you do not have to give the employee any other notice about the EITC.

Otherwise, you must give your household employee a notice about the EITC only if you agree to withhold federal income tax from the employee's wages but the income tax withholding tables show that no tax should be withheld. Even if not required, you are encouraged to give the employee a notice about the EITC if his or her 2022 wages are less than $59,187.

If you do not give your employee Copy B of the IRS Form W-2, your notice about the EITC can be any of the following:

- A substitute Form W-2 with the same EITC information on the back of the employee's copy that is on Copy C of the IRS Form W-2,
- Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit (EITC), or
- Your own written statement with the same wording as Notice 797.

If you give your employee a substitute Form W-2 on time which lacks the required EITC information, you must give notice about the 6IC to the employee within one week of the date you gave him or her the substitute Form W-2. If Form W-2 is required, but not given on time, you must give the employee notice about 2022 EITC by January 31, 2022. If Form W-2 is not required, you must give your notice to the employee by February 10, 2022.

How do You Make Tax Payments?

When you file your 2022 federal income tax return in 2023, attach Schedule H, *Household Employment Taxes*. Use this Schedule, discussed further below, to figure your household employment taxes. You will add the federal employment taxes on the wages you pay to your household employee in 2022, less any advance earned income credit payments you make to the employee, to your income tax. The amount you owe with your return is due to the IRS by April 15, 2023.

> You can avoid owing tax with your return if you pay enough federal income tax before you file to cover the employment taxes for your household employee, as well as your income tax. If you are employed, you can ask your employer to withhold more federal income tax from your wages in 2022. If you get a pension or annuity, you can ask for more federal income tax withholding from your benefits. Or you can make estimated tax payments for 2022 to the IRS, or increase your payments if you already make them.

Asking for More Federal Income Tax Withholding

If you are employed and want more federal income tax withheld from your wages to cover the employment taxes for your household employee, give your employer a new Form W-4, *Employee's Withholding Allowance Certificate*.

If you get a pension or annuity and want more federal income tax withheld to cover the employment taxes for your household employee, give the payer a new Form W-4P, *Withholding Certificate for Pension or Annuity Payments* (or a similar form provided by the payer).

Paying Estimated Tax

If you want to make estimated tax payments to cover the employment taxes for your household employee, get Form 1040-ES, *Estimated Tax for Individuals*. Use its payment vouchers to make your payments. You can pay all of the employment taxes at once or in installments. If you have already made estimated tax payments for 2022, you can increase your remaining payments to cover the employment taxes. Estimated tax payments for 2022 are due April 18, June 15, September 15, 2022, and January 16, 2023.

Payment Option for Business Employers

If you own a business as a sole proprietor or your home is on a farm operated for profit, you can choose either of two ways to pay the 2022 federal employment taxes for your household employee. You can pay them with your federal income tax as described above, or you can include them with your federal employment tax deposits or other payments for your business or farm employees.

If you pay the employment taxes for your household employee with business or farm employment taxes, you must report them with those taxes on Form 941 or Form 943 and on Form 940 (or 940-EZ).

What Forms Must You File?

You must file certain forms to report your household employee's wages and the federal employment taxes for the employee if you pay the employee:

1. Social Security and Medicare wages,
2. FUTA wages, or
3. Wages from which you withhold federal income tax.

The employment tax forms and instructions you need for 2022 will be sent to you automatically in January 2023 if you reported employment taxes for 2022 on Schedule H (Form 1040), *Household Employment Taxes*.

Employer Identification Number (EIN)

You must include your employer identification number (EIN) on the forms you file for your household employee. An EIN is a 9-digit number issued by the IRS and is not the same as a Social Security number.

You ordinarily will have an EIN if you previously paid taxes for employees, either as a household employer or in a business you own as a sole proprietor, or if you have a Keogh Plan. If you already have an EIN, use that number. If you do not have an EIN, get Form SS-4, *Application for Employer Identification Number*. The instructions for Form SS-4 explain how you can get an EIN immediately by telephone or in about four weeks if you apply by mail.

Form W-2

A separate 2022 Form W-2, *Wage and Tax Statement*, must be filed for each household employee to whom you pay:

- Social Security and Medicare wages of $2,400 or more, or
- Wages from which you withhold federal income tax.

You must complete Form W-2 and give Copies B, C, and 2 to your employee by January 31, 2022, You must send Copy A of Form W-2 with Form W-3, *Transmittal of Wage and Tax Statements*, to the Social Security Administration by January 31, 2022.

Schedule H

Use Schedule H (Form 1040), *Household Employment Taxes*, to report the federal employment taxes for your household employee if you pay the employee:

1. Social Security and Medicare wages of $2,400 or more in 2022,
2. FUTA wages, or
3. Wages from which you withhold federal income tax.

File Schedule H with your 2022 federal income tax return by April 15, 2023. If you get an extension to file your return, the extension will also apply to your Schedule H.

If you are not required to file a 2022 tax return, you must file Schedule H by itself. See the Schedule H instructions for details.

Business Employment Tax Returns

Do not use Schedule H (Form 1040) if you choose to pay the employment taxes for your household employee with business or farm employment taxes. Instead, include the Social Security, Medicare, and withheld federal income taxes for the employee on the Forms 941, *Employer's Quarterly Federal Tax Return*, that you file for your business or on Form 943, *Employer's Annual Tax Return for Agricultural Employees*, that you file for your farm. Include the FUTA tax for the employee on your Form 940 (or 940-EZ), *Employer's Annual Federal Unemployment (FUTA) Tax Return*.

If you report the employment taxes for your household employee on Form 941 or Form 943, file Form W-2 for the employee with the Forms W-2 and Form W-3 for your business or farm employees.

What Records Must You Keep?

Keep your copies of Schedule H or other employment tax forms you file and related Forms W-2, W-3, W-4, and W-5. You must also keep records to support the information you enter on the forms you file. If you are required to file Form W-2, you will need to keep a record of your employee's name, address, and Social Security number.

Wage and Tax Records

On each payday you should record the date and amounts of:

- Your employee's cash and non-cash wages,
- Any employee Social Security tax you withhold or agree to pay for your employee,
- Any employee Medicare tax you withhold or agree to pay for your employee,
- Any federal income tax you withhold,
- Any advance EITC payments you make, and
- Any state employment taxes you withhold.

Employee's Social Security Number

You must keep a record of your employee's name and Social Security number exactly as they appear on his or her Social Security card if you pay the employee:

- Social Security and Medicare wages, or
- Wages from which you withhold federal income tax.

You must ask for your employee's Social Security number no later than the first day on which you pay the wages. You may wish to ask for it when you hire your employee.

An employee who does not have a Social Security number must apply for one on Form SS-5, *Application for a Social Security Card*. An employee who has lost his or her Social Security card or whose name is not correctly shown on the card should apply for a new card. Employees may get Form SS-5 from any Social Security Administration office or by calling I-800-772-1213.

How Long To Keep Records

Keep your employment tax records for at least four years after the due date of the return on which you report the taxes or the date the taxes were paid, whichever is later.

State Unemployment Tax Agencies

Alabama

Unemployment Office

649 Monroe St.

Montgomery, AL 36131

(866) 234-5382

Alaska

Employment Security Tax

Department of Labor and Workforce Development

PO Box 115509

Juneau, AK 99811-5509

(888) 448-3527

Arizona

Department of Economic Security

Unemployment Insurance Tax

PO Box 6028

Phoenix, AZ 85005-6028

(602) 542-5954

Arkansas

Department of Workforce Services

PO Box 2981

Little Rock, AR 72203-2981

(501) 682-2121

(855) 225-4440

California

Employment Development Department

P.O. Box 826880 - UIPCD, MIC 40

Sacramento, CA 94280-0001

(888) 745-3886

Colorado

Unemployment Insurance Operations

Department of Labor and Employment

PO Box 8789

Denver, CO 80201-8789

(800) 480-8299

Connecticut

Connecticut Department of Labor

200 Folly Brook Blvd.

Wethersfield, CT 06109-1114

(860) 263-6550

Delaware

Division of Unemployment Insurance

Department of Labor

4425 North Market Street

Wilmington, DE 19802

(302) 761-8446

District of Columbia

Department of Employment Services

Office of Unemployment Compensation Tax Division

4058 Minnesota Ave NE Floor 4

Washington, DC 20019

(202) 698-4817

Florida

Unemployment Compensation Services

Agency for Workforce Innovation

107 E. Madison Street

Caldwell Building

Tallahassee, FL 32399-4120

(850) 245-7105

Georgia

Department of Labor

148 Andrew Young International Blvd.

Atlanta, GA 30303

(404) 232-3301 (direct line for employer tax liability)

Hawaii

Department of Labor and Industrial Relations

830 Punchbowl Street, Rm. 437

Honolulu, HI 96813

(808) 586-8915

Idaho

Department of Employment

317 Main Street

Boise, ID 83735

(800) 448-2977

Illinois

Department of Employment Security

33 South State Street

Chicago, IL 60603

(800) 247-4984

Indiana

Department of Workforce Development

10 North Senate Avenue

Indiana Government Center South

Indianapolis, IN 46204

(800) 437-9136

Iowa

Workforce Development

1000 East Grand Avenue

Des Moines, IA 50319-0209

(515) 281-5387 (Des Moines)

(888) 848-7442

Kansas

Department of Labor

401 SW Topeka Blvd.

Topeka, KS 66603-3182

(785) 296-5027

Kentucky

Division for Employment Services

275 East Main Street

Frankfort, KY 40602

(502) 564-2272

Louisiana

Louisiana Workforce Commission

1001 North 23rd Street

PO Box 94094

Baton Rouge, LA 70804-9094

(225) 342-3111

Maine

Department of Labor

54 State House Station

Augusta, ME 04333

(207) 621-5120

Maryland

Department of Labor, Licensing & Regulation

Division of Labor and Industry

1100 North Eutaw Street, Room 600

Baltimore, MD 21201

(410) 767-2241

Massachusetts

Division of Employment and Training

Charles F. Hurley Building

19 Staniford Street

Boston, MA 02114

(617) 626-6560

Michigan

Unemployment Insurance Agency

3024 W. Grand Boulevard

Detroit, MI 48202-6024

(855) 484-2636

Minnesota

Department of Employment & Economic Development

332 Minnesota Street

Suite E200

St. Paul, MN 55101-1351

(651) 296-6141

Mississippi

Department of Employment Security

1235 Echelon Pkwy

Jackson, MS 39213

(601) 321-6000

Missouri

Division of Employment Security

421 E Dunklin Street

Jefferson City, MO 65101

(573) 751-3215

Montana

Unemployment Insurance Bureau

1327 Lockey Avenue

Helena, MT 59601

(406) 444-3834

Nebraska

Department of Labor

550 South 16th

PO Box 94600

Lincoln, NE 68509-4600

(402) 471-9940

Nevada

Department of Employment Training and Rehabilitation

Employment Security Division

500 East Third Street

Carson City, NV 89713-0030

(775) 486-6310

New Hampshire

Department of Employment Security

45 South Fruit Street

Concord, NH 03301

(603) 228-4100

New Jersey

Department of Labor & Workforce Development

P.O. Box 110

Trenton, NJ 08625-0110

(609) 292-2810

New Mexico

Department of Workforce Solutions

401 Broadway NE

Albuquerque, NM 87102

(877) 664-6984

New York

Department of Labor

WA Harriman State Office Campus

Building 12, Room 356

Liability and Determination Section

Albany, NY 12240

(888) 899-881

North Carolina

Department of Commerce

Employment Security Commission

301 North Wilmington Street

Raleigh, North Carolina 27601-1058

(919) 814-4600

North Dakota

Job Service North Dakota

PO Box 5507

Bismarck, ND 58506-5507

(701) 328-2814

Ohio

Department of Job & Family Services

PO Box 182404

Columbus, OH 43218-2404

(877) 644-6562

Oklahoma

Employment Security Commission

2401 N Lincoln Blvd

Oklahoma City, OK 73105

(405) 557-7100

Oregon

Employment Department

875 Union Street, NE

Salem, OR 97311

(503) 947-1394

Pennsylvania

Department of Labor and Industry

7th and Forster Street

Harrisburg, PA 17120

(866) 403-6163

Puerto Rico

Department of Labor and Human Resources

PO Box 1020

San Juan, PR 00919-1020

(787) 754-5353

Rhode Island

Division of Taxation

One Capitol Hill

Providence, RI 02908

(401) 574-8700

South Carolina

Employment Security Commission

PO Box 995

Columbia, SC 29202-0995

(803) 737-2400

South Dakota

Department of Labor & Regulation

123 W. Missouri Avenue

Pierre, SD 57501-0405

(605) 626-2312

Tennessee

Department of Labor and Workforce Development

220 French Landing Drive

Nashville, TN 37243

(844) 224-5818

Texas

Texas Workforce Commission

101 E 15th St, Rm 122

Austin, TX 78778-0001

(512) 463-2699

Utah

Department of Workforce Services

PO Box 45249

140 East 300 South

Salt Lake City, UT 84145-0249

(801) 526-9235

Vermont

Department of Labor

PO Box 488

5 Green Mountain Drive

Montpelier, VT 05601-0488

(802) 828-4000

Virgin Islands

Department of Labor

2353 Kronprindsens Gade

Charlotte Amalie, St. Thomas, VI 00802

(340) 776-3700

Virginia

Employment Commission

PO Box 1358

703 E. Main Street

Richmond, VA 23219

(866) 832-2363

Washington

Employment Security Department

PO Box 9046

212 Maple Park Ave SE

Olympia, WA 98507

(360) 902-9500

West Virginia

Workforce West Virginia

PO Box 2753

1321 Plaza East Shopping Center

Charleston, WV 25330

(304) 558-0291

Wisconsin

Department of Workforce Development

PO Box 7946

Madison, WI 53707-7946

(608) 266-3131

Wyoming

Unemployment Tax Division

PO Box 2760

100 West Midwest

Casper, WY 82602-2760

(307) 235-3264

Household Employers Checklist

You may need to do the following things when you have a household employee: When you hire a household employee:

- Find out if the person can legally work in the United States.
- Find out if you need to pay state taxes.

When you pay your household employee:

- Withhold Social Security and Medicare taxes.
- Withhold federal income tax.
- Make advance payments of the earned income credit.
- Decide how you will make tax payments.
- Keep records.

By January 31, 2022:

- Get an employer identification number, if needed.
- Give your employee Copies B, C, and 2 of Form W-2, *Wage and Tax Statement*.

By January 31, 2022:

- Send Copy A of Form W-2 to the Social Security Administration.

By April 18, 2022:

- File Schedule H (Form 1040), *Household Employment Taxes*, with your tax return.

Higher Education Costs: How To Get The Best Tax Treatment

Various tax benefits, including tax exemption, tax deferral, tax credits, and deductions, are available if you are paying or saving for college or other higher education costs. This Guide suggests ways to take advantage of these benefits.

Table of Contents

Many tax benefits are available to help you pay higher education costs, whether for your children or yourself. Because of the variety of benefits and programs, this area is one of the most complex that an individual can face. This Financial Guide discusses strategies you can use to build savings for higher education, and tax credits currently available to help ease the financial burden of paying for education.

Eligibility rules vary for education credits and savings plans and most are subject to income limitations.

Coverdell Education Savings Accounts (Section 530 Programs)

Starting in 2013, you can contribute up to $2,000 to a Coverdell Education Savings account (a Section 530 program formerly known as an Education IRA) for a child under 18. These contributions are not deductible, but they grow tax-free until withdrawn. Contributions for any year can be made through the (unextended) due date for the return for that year.

> There is no adjustment for inflation; therefore the $2,000 contribution limit is expected to remain at $2,000 for tax years 2012 and beyond.

Only cash can be contributed to a Section 530 account and you cannot contribute to the account after the child reaches his or her 18th birthday.

Anyone can establish and contribute to a Section 530 account, including the child. You may establish 530s for as many children as you wish, but the amount contributed during the year to each account cannot exceed $2,000. The child need not be a dependent, and, in fact, does not even need to be related to you. The maximum contribution amount for each child is subject to a phase-out limitation with a modified AGI between $190,000 and $220,000 for joint filers and $95,000 and $110,000 for single filers.

> A 6 percent excise tax (to be paid by the beneficiary) applies to excess contributions. These are amounts in excess of the applicable contribution limit ($2,000 or phase out amount) and contributions for a year that amounts are contributed to a qualified tuition program for the same child. A qualified tuition program (QTP), sometimes called a Section 529 program, is a tax-favored state program to prepay education costs (see below). The 6 percent tax continues for each year the excess contribution stays in the 530 account.

The child must be named (designated as beneficiary) in the Coverdell document, but the beneficiary can be changed to another family member (for example, to a sibling where the first beneficiary gets a scholarship or drops out). And funds can be rolled over tax-free from one child's account to another's. Funds must be distributed not later than 30 days after the beneficiary's 30th birthday (or 20 days after the beneficiary's death if earlier). For special needs beneficiaries, age limits (i.e., no contributions after age 18, distribution by age 30) don't apply.

Withdrawals are taxable to the person who gets the money, with these major exceptions: Only the earnings portion is taxable (the contributions come back tax-free). Also, even that part isn't taxable income, as long as the amount withdrawn doesn't exceed a child's qualified higher education expenses; for that year. The definition of qualified higher education expenses" includes room and board and books, as well as tuition. In figuring whether withdrawals exceed qualified expenses, expenses are reduced by certain scholarships and by amounts for which tax credits (see Educational Credits, below) are allowed. If the amount withdrawn for the year exceeds the education expenses for the year, the excess is partly taxable under a complex formula. There's another formula if the sum of withdrawals from this 530 program and from the qualified tuition (Section 529) program exceed education expenses.

As the person who sets up the Section 530 account, you may change the beneficiary (the child who will get the funds) or roll the funds over to the account of a new beneficiary, tax-free, if the new beneficiary is a member of your family. But funds you take back (for example, withdrawal in a year when there are no qualified higher education expenses, because the child is not enrolled in higher education) are taxable to you, to the extent of earnings on your contributions, and you will generally have to pay an additional 10 percent tax on the taxable amount. However, you won't owe tax on earnings on amounts contributed that are returned to you by June 1 of the year following contribution.

Investment Policy

In contrast to Section 529 programs and Series EE bonds, you are able to choose and change Section 530 investments as you see fit.

> Check with your financial adviser about using both the Section 530 program, which has wide investment options but limited ($2,000 or less) contribution/investment amounts, and the Section 529 program, which has limited investment options but allows higher contribution/investment amounts.

Elementary and Secondary Schools

Section 530 programs can be used to build up funds for primary and secondary education. The tax rules are similar to those for higher education: withdrawals taxable to the extent of earnings on contributions, except tax-free up to the child's qualified elementary and secondary education expenses. These expenses qualify whether the child attends a private, religious or public school. Expenses such as room, board, tuition, transportation, and uniforms will qualify only where connected with private or religious schools, but some expenses - books, computers, educational software and internet access - apply as well to children in public school living at home.

The age limits for higher education apply here too: no contribution after a child reaches age 18, distribution at age 30 except for special needs beneficiaries. Withdrawals in excess of qualified education expenses are taxable under a special formula.

Qualified Tuition Programs (Section 529 Programs)

Every state now has a program allowing persons to prepay for future higher education, with tax relief. Starting in 2018, funds in 529 Plans can also be used for K-12 education.

There are two basic plan types, with many variations among them:

1. The prepaid education arrangement. Here one is essentially buying future education at today's costs, by buying education credits or certificates. This is the older type of program and tends to limit the student's choice to schools within the state. Private colleges and universities may now offer this type.
2. Education savings accounts. Here, contributions are made to an account to be used for future higher education.

In approaching state programs one must distinguish between what the federal tax law allows and what an individual state's program may impose.

You may open a Section 529 program in any state, but when buying prepaid tuition credits (less popular than savings accounts), you will want to know which institutions the credits will be applied to.

Unlike certain other tax-favored higher education programs, such as the American Opportunity Tax Credit and the Lifetime Learning Credit, federal tax law doesn't limit the benefit to tuition, but can also extend it to room, board, and books (individual state programs could be narrower).

The two key individual parties to the program are the Designated Beneficiary (the student-to-be) and the Account Owner, who is entitled to choose and change the beneficiary and who is normally the principal contributor to the program. There are no income limits on who may be an account owner. There's only one designated beneficiary per account. Thus, a parent with three college-bound children might set up 3 accounts. (Some state programs don't allow the same person to be both beneficiary and account owner.)

Contributions must be in cash, and must not total more than reasonably needed for higher education (as determined initially by the state). Neither account owner or beneficiary may direct investments, but the state may allow the owner to select a type of investment fund (e.g., fixed income securities), and to change the investment annually, and when the beneficiary is changed. The account owner decides who gets the funds (can pick and change the beneficiary) and is legally allowed to withdraw funds at any time, subject to tax and penalty discussed later.

Funds in the account not yet distributed at the account owner's death pass as part of the probate estate under state law though this is not the result for federal estate tax purposes, see below.

Federal Tax Rules

Income tax. Contributions made by the account owner or other contributor are not deductible for federal income tax purposes. Earnings on contributions grow tax-free while in the program.

Distributions from the fund are tax-free to the extent used for qualified higher education expenses. Distributions used otherwise are taxable to the extent of the portion which represents earnings.

A Section 529 distribution can be tax-free even though the student is claiming an American Opportunity Tax Credit or the Lifetime Learning Credit. Section 530 Coverdell distributions are also tax-free if the programs aren't covering the same specific expenses.

Distribution for a purpose other than qualified education is taxed to the one getting the distribution. In addition, a 10 percent penalty must be imposed on the taxable portion of the distribution, comparable to the 10 percent penalty in Section 530 Coverdell plans.

The account owner may change the beneficiary designation from one to another in the same family. Funds in the account roll over tax-free for the benefit of the new beneficiary.

Gift Tax. For gift tax purposes, contributions are treated as completed gifts even though the account owner has the right to withdraw them. Thus, they qualify for the up-to-$16,000 annual gift tax exclusion in 2022 ($15,000 in 2021). One contributing more than $16,000 may elect to treat the gift as made in equal installments over the year of the gift and the following four years so that up to $80,000 can be given tax-free in the first year.

A rollover from one beneficiary to another in a younger generation is treated as a gift from the first beneficiary, an odd result for an act the "giver" may have had nothing to do with.

Estate tax. Funds in the account at the designated beneficiary's death are included in the beneficiary's estate, another odd result, since those funds may not be available to pay the tax. Funds in the account at the account owner's death are not included in the owner's estate, except for a portion thereof where the gift tax exclusion installment election is made for gifts over $15,000. For example, if the account owner made the election for a gift of $80,000 in 2022, a part of that gift is included in the estate if he or she dies within five years.

> A Section 529 program can be an especially attractive estate-planning move for grandparents. There are no income limits, the account owner giving up to

$80,000 avoids gift tax, and estate tax by living five years after the gift, yet has the power to change the beneficiary.

State Tax: For specifics of each state's program, see College Savings Plans Network (CSPN).

Traditional and Roth IRAs

You can use a traditional IRA or Roth IRA as a savings plan to pay qualified higher education expenses. Withdrawals before age 59 1/2 to pay qualified higher education expenses are not subject to the additional tax on early withdrawals. To escape the 10 percent tax, however, you must pay education costs that at least equal your withdrawal amount. The education costs must be "qualified", that is, used for tuition, fees, books, room and board, supplies, or equipment at a qualified institution of learning and they must be for yourself, your spouse, or the children or grandchildren or yourself or your spouse. The qualified institution of learning may be any college, university, vocational school, or any other post-secondary school that is eligible to participate in federal Department of Education aid programs.

> You do not actually have to use the IRA funds to pay education costs. That is, the tax relief doesn't require you to trace the IRA withdrawal dollars to a specific education expense payment. You can pay the costs with your own earnings or savings, with a loan, or with a gift or inheritance received by the student or the person making the withdrawal. You can use savings accumulated in a Section 529 (state-sponsored) program.

However, you cannot count education costs paid with proceeds from the following in determining whether your IRA withdrawal is to be free of the 10 percent tax:

- Tax-free distributions from a Coverdell education savings account (Section 530 program);
- Tax-free scholarships, such as a Pell grant;
- Tax-free employer education assistance program;
- Any tax-free payment (other than a gift or bequest) that is due to enrollment at the qualified institution.

Education Savings Bonds

You can exclude from your gross income interest on qualified U.S. savings bonds if you have qualified higher education expenses during the year in which you redeem the bonds. For tax year 2022, the exclusion begins phasing out at $85,800 ($83,200 in 2021) modified adjusted gross income ($76,000 indexed for inflation) and is eliminated for adjusted gross incomes of more than $100,800 ($98,200 in 2021). For married taxpayers filing jointly, the tax exclusion begins phasing out at $128,650 ($124,800 in 2021) and is eliminated for adjusted gross incomes of more than $158,650 ($154,800 in 2021). The exclusion is unavailable to married filing separately.

The education must be of the bondholder, his or her spouse or dependent. Qualified higher education expenses are tuition and fees, and contributions to Section 529 and 530 programs, reduced for tax-free scholarships and other relief.

A qualified U.S. savings bond means a Series EE bond issued after 1989. The bond must be either in your name or in the names of both you and your spouse, and you must be at least 24 years old before the bond's issue date.

Education Credits

Two tax credits are available for education costs - the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available only to taxpayers with adjusted gross income below specified amounts (see Income Phase-Outs below).

How These Credits Work

The amount of the credit you can claim depends on (1) how much you pay for qualified tuition and other expenses for students and (2) your adjusted gross income (AGI) for the year.

You must report the eligible student's name and Social Security number on your return to claim the credit. You subtract the credits from your federal income tax. If the credit reduces your tax below zero, you cannot receive the excess as a refund. If you receive a refund of education costs for which you claimed a credit in a later year, you may have to repay ("recapture") the credit.

If you file married-filing separately, you cannot claim these credits.

Which costs are eligible? Qualifying tuition and related expenses refer to tuition and fees, and course materials required for enrollment or attendance at an eligible education institution. They now include books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance.

"Related" expenses do not include room and board, student activities, athletics (other than courses that are part of a degree program), insurance, equipment, transportation, or any personal, living, or family expenses. Student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance. For expenses paid with borrowed funds, count the expenses when they are paid, not when borrowings are repaid.

> If you pay qualified expenses for a school semester that begins in the first three months of the following year, you can use the prepaid amount in figuring your credit.
>
> You pay $6,500 of tuition in December 2022 for the winter 2023 semester, which begins in January 2023. You can use the $6,500 in figuring your 2022 credit. If you paid in January instead, you would take the credit on your 2023 return.
>
> As future year-end tax planning, this rule gives you a choice of the year to take the credit for academic periods beginning in the first three months of the year; pay by December and take the credit this year; pay in January or later and take the credit next year.

Eligible students. You, your spouse, or an eligible dependent (someone for whom you can claim a dependency exemption, including children under age 24 who are full-time students) can be an eligible student for whom the credit can apply. If you claim the student as a dependent, qualifying expenses paid by the student are treated as paid by you, and for your credit purposes are added to expenses you paid. A person claimed as another person's dependent can't claim the credit. The student must be enrolled at an eligible education institution (any accredited public, non-profit or private post-secondary institution eligible to participate in student Department of Education aid programs) for at least one academic period (semester, trimester, etc.) during the year.

No "double-dipping." The tax law says that you can't claim both a credit and a deduction for the same higher education costs. It also says that if you pay education costs with a tax-free scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts.

Income Limits. For 2022, the amount of both the American Opportunity Tax Credit and Lifetime Learning Credit begins to phase out when modified adjusted gross income (MAGI) is between $80,000 and $90,000 ($160,000 and $180,000 for joint returns). The credit cannot be claimed if your MAGI is $90,000 or more ($180,000 or more for joint returns).

"Modified AGI" generally means your adjusted gross income. The "modifications" only come into play if you have income earned abroad.

> Under the Consolidated Appropriations Act (CAA), the Lifetime Learning Credit and American Opportunity tax credit now have the same credit amounts and phase out ranges.

The American Opportunity Tax Credit

The American Opportunity Tax Credit (AOTC) was made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH). The maximum credit, available only for the first four years of post-secondary education, is $2,500. You can claim the credit for each eligible student you have for which the credit requirements are met.

Special Qualification Rules. In addition to being an eligible student, he or she:

- Must be enrolled in a program leading to a degree, certificate, or other recognized credential;
- Must be taking at least half of a normal full-time load of courses, for at least one semester or trimester beginning in the year for which the credit is claimed; and
- May not have any drug-related felony convictions.

Amount of credit. The maximum amount of the AOTC credit is $2,500. Generally, 40 percent of the AOTC is now a refundable credit for most taxpayers, which means that you can receive up to $1,000 even if you owe no taxes.

The Lifetime Learning Credit

You may be able to claim a Lifetime Learning credit of up to $2,500 in 2022 (Consolidated Appropriations Act) for eligible students (subject to reduction based on your AGI). In years prior to 2021, this amount was $2,000 or 20 percent of the first $10,000 of qualified expense. Only one Lifetime Learning Credit can be taken per tax return, regardless of the number of students in the family.

- The credit can help pay for undergraduate, graduate and professional degree courses, including courses to improve job skills.
- For courses taken to acquire or improve job skills, there are no requirements as to course loads, so that even one or two courses can qualify.
- The number of years for which this credit can be claimed is not limited.

Choosing the Credit. You can't claim both credits for the same person in the same year. But you can claim one credit for one or more family members and the other credit for expenses for one or more others in the same year - for example, an American Opportunity Tax Credit for your child and a Lifetime Learning Credit for yourself.

Electing Not To Take the Credit. There are situations in which the credit is not allowed, or not fully available, if some other education tax benefit is claimed - where the higher education expense deduction is claimed for the same student, see below, or where credit and tax exemption (under a Section 529 or 530 program) are claimed for the same expense. In that case, the taxpayer - or, more likely, the taxpayer's tax adviser - will determine which tax rule offers the greater benefit and if it's not the credit, elect not to take the credit.

Qualified Tuition and Related Expenses Deduction

> The Taxpayer Certainty and Disaster Tax Relief Act of 2020 repealed the tuition and fees deduction for tax years beginning after 2020. Income limitations for the lifetime learning credit have been increased to help tax filers transition to the lifetime learning credit.

For tax years before 2021, a limited deduction was allowed for "qualified higher education expenses" - tuition and related expenses under the same definition as for tuition credits, above. A $4,000 above the line deduction (Form 8917) was allowed for qualified tuition expenses in 2020, as in 2019 and 2018. The deduction was allowed if a taxpayer's (modified) adjusted gross income was $80,000 or less ($160,000 or less on a joint return). This tax deduction reduced your amount of income, thereby reducing the amount of tax you paid. You did not need to itemize deductions on Schedule A (Form 1040) in order to take this deduction, which benefited higher earners who could not take the Lifetime Learning Credit because their income exceeded the limits.

For distributions made from qualified tuition programs (QTPs) after 2018, qualified higher education expenses may include:

- Certain expenses required for a designated beneficiary's participation in certain apprenticeship programs.
- No more than $10,000 paid as principal or interest on a qualified student loan of the designated beneficiary or the designated beneficiary's sibling.

Business expense deduction is allowed, without dollar limit, for education that serves the taxpayer's business, including employment. a deduction is also allowed for student loan interest, but a taxpayer may not take more than one deduction for the same item. In addition, you cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return.

"Qualified higher education expenses" must be reduced by any such expense paid with an amount treated as tax-free under the rules for excluding income from Series EE bonds, or Section 529 or 530 programs.

Employer-Provided Education Assistance

If your employer paid education assistance benefits (e.g., reimbursements of tuition), part or all of them may be tax-free. You can exclude up to $5,250 per year of the benefits you receive under a qualified educational assistance program. This means your employer shouldn't include those benefits with your wages, tips and other compensation shown on your Form W-2, box 1. This also means that you don't have to include the benefits on your income tax return.

You can't both exclude and deduct the same item, even if it's otherwise deductible. In order to qualify, your employer must have established an educational assistance plan that does not discriminate in favor of highly paid employees or owners. The exclusion applies to undergraduate level courses other than those involving sports, game, and hobbies. The courses do not need to relate to your job. The exclusion is available for tuition, fees, books, and supplies but not meals, lodging or transportation. And it applies to benefits for graduate-level courses.

In addition to the exclusion for qualifying education plans, your employer can provide reimbursement for business related courses, including graduate courses. Prior to tax year 2018, if your employer did not reimburse you for these expenses, you were entitled to deduct them as a miscellaneous itemized deduction on Schedule A, *Itemized Deductions*, subject to the two percent deduction floor. To qualify, the expense must meet the requirement of your employer or the law or maintain or improve skills in your current job. The course must not meet minimum education requirements for your job or qualify you for a new trade or business.

However, under the Tax Cuts and Jobs Act of 2017 ("tax reform"), for tax years 2018 through 2025, employee business-related deductions (including education expenses) are disallowed. That is, there are no miscellaneous deductions on Schedule A as there were previously. Self-employed individuals are still able to deduct qualifying educational expenses on Schedule C.

Student Loans

You may be able to deduct interest on student loans. You may also be able to exclude income that you would otherwise have to report if a student loan is canceled.

Interest Deduction. You may deduct student loan interest you pay, including interest paid that's not currently due because payment is deferred.

Deduction is allowed even though it would otherwise be nondeductible personal interest. But you may deduct only if you are the one legally bound to pay the interest, and only on loans solely for qualified expenses (so not under open credit lines).

The student-loan deduction (up to $2,500 starting in 2013), was made permanent by AFTRA, but only to taxpayers whose AGI is below $160,000 (joint filers) or $80,000 (single filers). Married couples filing separately can't take the deduction.

The student-loan interest deduction is an "above the line" deduction. In other words, you don't have to itemize in order to claim it. The loan must have been taken out to cover education expenses of at least half-time study for yourself, your spouse, or a person who was your dependent when you took out the loan.

> You cannot deduct interest on a loan from a related person, for example, a relative, or a business entity in which you have an ownership interest as defined by the tax law. And you can't deduct if you are claimed as a dependent.
>
> Where interest fails to qualify under these tests, consider a home equity loan, interest on which is generally deductible.

Cancellation of Student Loan. If certain requirements are met, cancellations of student loans that are intended to induce students to perform certain services do not increase the student's gross income. This relief extends to certain private programs, as well as government and public programs.

Selling Your Home: How To Minimize the Tax On the Gain

Many tax benefits are available to you when you sell your principal residence. However, the rules are complex and personal guidance is necessary to take full advantage of these benefits so that you and your tax advisor can best work together to minimize the tax on the gain. This financial guide discusses the key rules so that you and your tax advisor can best work together to minimize the tax on the gain.

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The IRS allows an exclusion of up to $250,000 of the gain on the sale of your main home ($500,000 if you are married and file a joint return. Most taxpayers can take advantage of the exclusion and will not have to pay any tax on the sale of a main home as long as they meet the IRS ownership and use tests (see below).

> If you do have a loss from the sale, it is a personal loss. You cannot deduct the loss.

If you don't qualify for the exclusion, your gain exceeds the exclusion, or you used part of the property in business or for rent, you have a taxable gain and must report the sale of your main home on your tax return on IRS Form 8949, *Sales and Other Dispositions of Capital Assets* and Schedule D, *Capital Gains and Losse*.

Principal Residence

Usually, the home you live in most of the time is your main home. In addition to a standard dwelling unit, your home can also be a houseboat, mobile home, cooperative apartment, or condominium.

> **Example 1:** You own and live in a house in town. You also own beach property, which you use in the summer months. The town property is your main home; the beach property is not.
>
> **Example 2:** You own a house, but you live in another house that you rent. The rented home is your main home.
>
> Where a second residence has soared in value and you want to sell, some tax advisors have suggested moving to the second residence for the required period to qualify for exclusion on its sale. If this is your situation, please consult with a tax professional.

How to Figure Gain or Loss

Key information for determining gain or loss is 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. Next, you deduct the selling expenses such as commissions, advertising, legal fees, and loan charges paid by the seller from the selling price.

The difference is the "amount realized." If the amount realized is more than your home's "adjusted basis," discussed later, the difference is your gain. If the amount realized is less than the adjusted basis, the difference is your loss.

However, it does not include amounts you received for personal property sold with your home. Personal property is property that is not a permanent part of the home, such as furniture, draperies, and lawn equipment.

Non-Traditional Sales

The following discussion covers how to determine your gain or loss if you trade one home for another, if your home is foreclosed on or repossessed or if you transfer a jointly owned home.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure and report your gain or loss as one taxpayer. If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the exclusion rules individual basis.

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have what the IRS calls a disposition and will need to determine if you have ordinary income, gain, or loss. The amount of your gain or loss depends on whether you were personally liable for repaying the debt secured by the home and whether the outstanding loan balance is more than the fair market value (FMV) of the property.

If you were not personally liable for repaying the debt secured by the home, the amount you realize includes the full amount of the outstanding debt immediately before the transfer. This is true even if the FMV of the property is less than the outstanding debt immediately before the transfer.

If you were personally liable for repaying the debt secured by the home and the debt is canceled, the amount realized on the foreclosure or repossession includes the smaller of the outstanding debt immediately before the transfer reduced by any amount for which you remain personally liable immediately after the transfer, or the Fair Market Value (FMV) of the transferred property.

In addition to any gain or loss, if you were personally liable for the debt you may have ordinary income. If the canceled debt is more than the home's fair market value, you have ordinary income equal to the difference. However, the income from the cancellation of debt is not taxed to you if the cancellation is intended as a gift, or if you are insolvent or bankrupt.

> You owned and lived in a home with an adjusted basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new house priced at $80,000 (its fair market value). You are considered to have sold your old home for $50,000 and to have had a gain of $9,000 ($50,000

minus $41,000). If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, $50,000 would still be considered the sales price of the old home (the trade-in allowed plus the mortgage assumed).

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss, even if you receive cash or other consideration for the home. Therefore, the rules explained in this Guide do not apply.

If you owned your home jointly with your spouse and transfer your interest in the home to your spouse, or to your former spouse incident to your divorce, the same rule applies. You have no gain or loss.

If you buy or build a new home, its basis will not be affected by the transfer of your old home to your spouse, or to your former spouse incident to divorce. The basis of the home you transferred will not affect the basis of your new home.

Basis

You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you acquired it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

Cost as Basis

The cost of property is the amount you pay for it in cash or other property.

Purchase. If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Your cost includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home.

Seller-paid points. If you bought your home after April 3, 1994, you must reduce the basis of your home by any points the seller paid, whether or not you deducted them. If you bought your home after 1990 but before April 4, 1994, you must reduce your basis by the amount of seller-paid points only if you chose to deduct them as home mortgage interest in the year paid.

Settlement fees or closing costs. When buying your home, you may have to pay settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs that are for buying the home. You cannot include in your basis the fees and costs that are for getting a mortgage loan. A fee is for buying the home if you would have had to pay it even if you paid cash for the home.

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

Some of the settlement fees or closing costs that you can include in the basis of your property are:

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

Some settlement fees and closing costs not included in your basis are:

- Fire insurance premiums.
- Rent for occupancy of the house before closing.
- Charges for utilities or other services relating to occupancy of the house before closing.
- Any item that you deducted as a moving expense (settlement fees and closing costs incurred after 1993 cannot be deducted as moving expenses).
- Fees for refinancing a mortgage.
- Charges connected with getting a mortgage loan, such as mortgage insurance premiums (including VA funding fees), loan assumption fees, cost of a credit report, and fee for an appraisal required by a lender.

Real estate taxes. Real estate taxes for the year you bought your home may affect your basis, as follows:

If you pay taxes that the seller owed on the home up to the date of sale and the seller does not reimburse you, then the taxes are added to the basis of your home.

If you pay taxes that the seller owed on the home up to the date of sale and the seller does reimburse you, then the taxes do not affect the basis of your home.

If the seller pays taxes for you (taxes owed beginning on the date of sale) and you do not reimburse the seller, then the taxes are subtracted from the basis of your home.

If the seller pays taxes for you (taxes owed beginning on the date of sale) and you reimburse the seller, then the taxes do not affect the basis of your home.

Construction. If you contracted to have your house built on land you own; your basis is the cost of the land plus the amount it cost you to complete the house. This amount includes the cost of labor and materials, or the amounts paid to the contractor, and any architect's fees, building permit charges, utility meter, and connection charges, and legal fees directly connected with building your home. Your cost includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller or builder. It also includes certain settlement or closing costs. You may have to reduce the basis by points the seller paid for you. If you built all or part of your house yourself, its basis is the total amount it cost you to complete it. Do not include the value of your own labor or any other labor you did not pay for, in the cost of the house.

Cooperative apartment. Your basis in the apartment is usually the cost of your stock in the co-op housing corporation, which may include your share of a mortgage on the apartment building.

Condominium. Your basis is generally its cost to you. The same rules apply as for any other home.

Basis Other Than Cost

If your home was acquired in a transaction other than a traditional purchase (such as gift, inheritance, trade, or from a spouse), you may have to use a basis other than cost, such as fair market value.

> Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell and both having reasonable knowledge of the relevant facts. Sales of similar

property, on or about the same date, may be helpful in figuring the fair market value of the property.

Home received as gift. If your home was a gift, its basis to you is the same as the donor's adjusted basis when the gift was made. However, if the donor's adjusted basis was more than the fair market value of the home when it was given to you, you must use that fair market value as your basis for measuring any loss on its sale.

If you use the donor's adjusted basis to figure a gain and get a loss, and then use the fair market value to figure a loss and get a gain, you have neither a gain nor a loss on the sale or disposition.

If you received your home as a gift and its fair market value was more than the donor's adjusted basis at the time of the gift, you may be able to add to your basis any federal gift tax paid on the gift. If the gift was before 1977, the basis cannot be increased to more than the fair market value of the home when it was given to you. On the other hand, if you received your home as a gift after 1976, you would add to your basis the part of the federal gift tax paid that is due to the home's "net increase" in value (value less donor's adjusted basis).

Home received from spouse. You may have received your home from your spouse or from your former spouse incident to your divorce.

- If you received the home after July 18, 1984, you had no gain or loss on the transfer. Your basis in this home is generally the same as your spouse's (or former spouse's) adjusted basis just before you received it. This rule applies even if you received the home in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.
- If you owned a home jointly with your spouse and your spouse transferred his or her interest in the home to you, your basis in the half interest received from your spouse is generally the same as your spouse's adjusted basis just before the transfer. This rule also applies if your former spouse transferred his or her interest in the home to you incident to your divorce. Your basis in the half interest you already owned does not change. Your new basis in the home is the total of these two amounts.
- If you received your home before July 19, 1984, in exchange for your release of marital rights, your basis in the home is generally its fair market value at the time you received it.
- **Home acquired from a decedent who died before or after 2010.** If you inherited your home from a decedent who died before or after 2010, your basis is the fair market value of the property on the date of the decedent's death (or the later alternate valuation date chosen by the personal representative of the estate). If an estate tax return was filed or required to be filed, the value of the property listed on

the estate tax return is your basis. If a federal estate tax return did not have to be filed, your basis in the home is the same as its appraised value at the date of death, for purposes of state inheritance or transmission taxes.

- **Surviving spouse.** If you are a surviving spouse and you owned your home jointly, your basis in the home will change. The new basis for the interest your spouse owned will be its fair market value on the date of death (or alternate valuation date). The basis of your interest will remain the same. Your new basis in the home is the total of these two amounts.

Your jointly owned home had an adjusted basis of $50,000 on the date of your spouse's death, and the fair market value on that date was $100,000. Your new basis in the home is $75,000 ($25,000 for one-half of the adjusted basis plus $50,000 for one-half of the fair market value).

In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half of the community property. When either spouse dies, the fair market value of the community property becomes the basis of the entire property, including the portion belonging to the surviving spouse. For this to apply, at least, half of the community interest must be included in the decedent's gross estate, whether or not the estate must file a return.

Home received in trade. If you acquired your home in a trade for other property, the basis of your home is generally its fair market value at the time of the trade. If you traded one home for another, you have made a sale and purchase. In that case, you may have realized a capital gain.

Adjusted Basis

Adjusted basis is your cost or other basis increased or decreased by certain amounts.

Increases to basis include:

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

Decreases to basis include:

- Discharge of qualified principal residence indebtedness that was excluded from income (but not below zero).

- Gain from the sale of your old home before May 7, 1997 on which tax was postponed.
- Insurance payments for casualty losses.
- Deductible casualty losses not covered by insurance.
- Payments received for granting an easement or right-of-way.
- Depreciation allowed or allowable if you used your home for business or rental purposes.
- 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.
- Adoption credit you claimed for improvements that you added to the basis of your home.
- Nontaxable payments from an employer's adoption assistance program that you used for improvements you added to the basis of your home.
- Nonbusiness energy property credit (allowed beginning in 2006 but not for 2008) claimed for making certain energy-saving improvements you added to the basis of your home.
- Residential energy efficient property credit (allowed beginning in 2006) claimed for making certain energy-saving improvements you added to the basis of your home.
- First-time home buyer's credit (allowed to certain first-time buyers in the District of Columbia--beginning on August 5, 1997).
- Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after December 31, 1992, to buy or install any energy conservation measure. An energy conservation measure includes an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

Discharges of qualified principal residence indebtedness. You may be able to exclude from gross income a discharge of qualified principal residence indebtedness. This exclusion applies to discharges made after 2006 through the end of 2025 (Consolidated Appropriations Act, 2021) and also applies to debts forgiven as the result of a written agreement entered into before January 1, 2026, even if the actual discharge happens later. If you choose to exclude this income, you must reduce (but not below zero) the basis of your principal residence by the amount excluded from gross income.

Amount eligible for the exclusion. The exclusion applies only to debt discharged after 2006 and before 2025. The maximum amount you can treat as qualified principal residence indebtedness is $750,000 ($375,000 if married and filing separately). Prior to December 31, 2020, this amount was $2 million ($1 million if married filing separately). You cannot exclude from gross income discharge of qualified principal residence indebtedness if the discharge was for services performed for the lender or on account of any other factor not directly related to a decline in the value of your residence or to your financial condition.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of improvements to the basis of your property.

> Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway are improvements.

Here are some other examples:

- Additions: Bedroom, bathroom, deck, garage, porch, patio
- Lawn and grounds: Landscaping, driveway, walkway, fence, retaining wall, sprinkler system, swimming pool
- Miscellaneous: Storm windows or doors, new roof, central vacuum, wiring upgrades, satellite dish, security system
- Heating and air conditioning: Heating system, central air, furnace, duct work, central humidifier, filtration system
- Plumbing: Septic system, water heater, soft water system, filtration system
- Interior: Built-in appliances, kitchen modernization, flooring, wall-to-wall carpet
- Insulation: attic, walls, floor, pipes, duct work
- Improvements no longer part of home. Your home's adjusted basis does not include the cost of any improvements that are no longer part of the home.

> You put wall-to-wall carpeting in your home 15 years ago. Later, you replaced that carpeting with new wall-to-wall carpeting. The cost of the old carpeting you replaced is no longer part of your home's adjusted basis.

Repairs. These maintain the good condition of your home. They do not add to its value or prolong its life, and you do not add their costs to the basis of your property.

> Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.
>
> The entire job is considered an improvement, however, if items that would otherwise be considered repairs are done as part of an extensive remodeling or restoration of your home.

Recordkeeping. You should keep records of your home's purchase price and purchase expenses. Furthermore, you should also save receipts and other records for all improvements, additions, and other items that affect the basis of your home.

> You must keep records for 3 years after the due date for filing your return for the tax year in which you sold, or otherwise disposed of, your home. But if the basis

of your old home affects the basis of your new one, such as when you sold your old home before May 7, 1997, and postponed tax on any gain, you should keep those records forever.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses;
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis;
- Any worksheets or other computations you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain;
- Any Form 982 you filed to exclude any discharge of qualified principal residence indebtedness;
- Any Form 2119, Sale of Your Home, you filed to postpone gain from the sale of a previous home before May 7, 1997;
- Any worksheets you used to prepare Form 2119

Exclusion for Sales After May 6, 1997

If you sell your main home after May 6, 1997, you may qualify to exclude up to $250,000 of the gain ($500,000 if married filing jointly) on the sale of your main home; however, 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:

- Owned the home for at least 2 years (the ownership test)
- Lived in the home as your main home for at least 2 years (the use test)
- During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.
- **Exception.** If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. However, the maximum amount you may be able to exclude will be reduced.
  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.
  If you have more than one home, only the sale of your main home qualifies for excluding the gain. If you have two homes and live in both of them, your main home is the one you live in most of the time.
  If you owned and used the property as your main home for less than 2 years, you may be able to claim a reduced exclusion.
  The two years of ownership and use during the five-year period don't have to be continuous. You meet the tests if you can show that you owned and lived in the

property as your main home for either 24 full months or 730 days during the five-year period. Short temporary absences, e.g., for vacations, are counted as periods of use, even if you rent out the property during that time.

From 1994 through August 2007, Anne lived with her parents in a house that her parents owned. On September 29, 2007, she bought this house from her parents. She continued to live there until December 15 of 2007 when she sold it at a gain. Although Anne lived in the property as her main home for more than 2 years, she did not own it for the required 2 years. Therefore, she cannot exclude any part of her gain on the sale, unless she sold the property due to a change in health or place of employment.

Professor Moore bought and moved into a house on January 4, 2005. He lived in it as his main home continuously until October 1, 2006, when he went abroad for a one-year sabbatical. During part of the leave, the house was unoccupied, and during the rest of the time, he rented it out. On October 1, 2007, he sold the house. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test.

Ownership and Use Tests Met at Different Times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

In 1996, Harry was 60 years old and lived in a rental apartment. When the apartment building went co-op, he bought his apartment on December 1, 1999. Harry then went to live with his daughter on April 14, 2001, because he became ill. On July 10, 2003, he sold his co-op while still living with his daughter. Harry can exclude gain on the sale of his co-op because he met the ownership and use tests. His 5-year period runs from July 11, 1998, to July 10, 2003, the date he sold the co-op. Even though he only owned the co-op from December 1, 1999, to July 10, 2003--over two years, he lived in the apartment from July 11, 1997 (the beginning of the five-year period) to April 14, 2001 (over two years).

Special Situations. There are a number of special situations that may result in exceptions to the general rules.

Individuals with Disabilities. There is an exception to the 2-out-of-5-year use test if you become physically or mentally unable to care for yourself at any time during the 5-year period. You qualify for this exception to the use test if, during the 5-year period before the sale of your home:

- You become physically or mentally unable to care for yourself, and
- You owned and lived in your home as a main home for a total of at least one year during the 5-year period before the sale of your home.

Under this exception, you are considered to live in your home during any time that you live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Gain postponed on sale of previous home. For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home because of buying the home on which you wish to exclude gain.

Also, if buying the previous home enabled you to postpone all or part of the gain on the sale of a home you owned earlier, you can also include the time you owned and lived in that earlier home.

Previous home destroyed or condemned. For the ownership and use test, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

Members of the uniformed services or Foreign Service, employees of the intelligence community, or employees or volunteers of the Peace Corps. You can choose to have the 5-year test period for ownership and use suspended during any period you or your spouse serve on qualified official extended duty (defined later) as a member of the uniformed services or Foreign Service of the United States, or as an employee of the intelligence community.

You can choose to have the 5-year test period for ownership and use suspended during any period you or your spouse serve outside the United States either as an employee of the Peace Corps on qualified official extended duty (defined later) or as an enrolled volunteer or volunteer leader of the Peace Corps. This means that you may be able to meet the 2-year use test even if, because of your service, you did not actually live in your home for at least the required 2 years during the 5-year period ending on the date of sale.

The period of suspension cannot last more than 10 years. Together, the 10-year suspension period and the 5-year test period can be as long as, but no more than, 15 years. You cannot suspend the 5-year period for more than one property at a time. You can revoke your choice to suspend the 5-year period at any time.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain (up to $500,000) if either spouse meets the ownership and use tests.

Mary sells her home in June of this year and marries John later in the year. She meets the ownership and use tests, but John does not. Emily can exclude up to $250,000 of gain on a separate or joint return for this year.

Now assume that John also sells a home. He meets the ownership and use tests on his home. Mary and John can each exclude $250,000 of gain.

Death of spouse before sale. If your spouse died before the date of sale, you are considered to have owned and used the property as your main home during any period of time when your spouse owned and used it as his or her main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), 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 use it under a divorce or separation instrument. Such use is added to your own use before or after divorce.

Special Exceptions Affecting Exclusions

Home destroyed or condemned. If your home is destroyed or condemned after May 6, 1997, any gain (e.g., due to insurance proceeds) qualifies for the exclusion.

Expatriates. You cannot claim the exclusion if the expatriate tax applies to you because you have renounced their citizenship and one of the primary purposes was to avoid U.S. taxes.

More Than One Home Sold During the Two-Year Period. You cannot exclude gain on the sale of your home if, during the two-year period ending on the date of the sale, you sold another home at a gain and are excluding all or part of that gain. If you cannot exclude the gain, you must include it in your income.

However, you can claim a reduced exclusion if you sold the home due to a change in health or place of employment or experienced unforeseen circumstances such as natural disasters, death, or unemployment (eligible unemployment compensation). When counting the number of sales during a two-year period, do not count sales before May 7, 1997.

The $250,000 (or $500,000) exclusion is reduced according to a formula whose numerator is the number of days of qualified ownership or use (or between sales of the homes) and the denominator is 730 days (for 2 years). If married filing jointly, duplicate the same calculation for your spouse's ownership and use (or days between sales).

You owned and used your main home for 400 days before selling it at a $150,000 gain following your move to a new job location. Your exclusion is $136,986, that is, 400/730 x $250,000.

Change in Place of Employment. You may qualify for a reduced exclusion if the primary reason for the sale of your main home is a change in the location of employment of a qualified individual.

Health. You may qualify for a reduced exclusion if the sale of your main home is because of health if your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury.

Unforeseen Circumstances. You may qualify for a reduced exclusion if the sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated before buying and occupying that home. You are not considered to have an unforeseen circumstance if the primary reason you sold your home was that you preferred to get a different home or because your finances improved.

Home used in business. So long as the business use takes place in the same dwelling

unit as your main home, the exclusion is not affected by business use, with this exception: You cannot exclude the part of your gain that is equal to any depreciation allowed or allowable for the business use of your home after May 6, 1997. The 2 out of 5-year use-as-the-main-home test is not applied to deny exclusion for gain allocable to business use in the same dwelling unit, except for allowable depreciation.
You bought a home in 1997 and used it throughout 3/4 as your residence and 1/4 as your home office. On December 30, 2002, you sold it. The gain qualifies for exclusion except that you cannot exclude the part of your gain that is equal to any depreciation allowed or allowable for the business use of your home after May 6, 1997.

Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. You may have to pay this recapture tax even if you can exclude your gain from income under the rules discussed earlier; that exclusion does not affect the recapture tax.

Glossary

Adjusted basis: This is your basis in the property increased or decreased by certain amounts. See Adjusted Basis, earlier in this Guide, for a list of items that increase or decrease your basis in the property.
Amount realized: This is the selling price of your old home minus your selling expenses.
Basis: Your basis in the property is determined by how you got it. If you bought or built the property, your basis is what it cost you. If you got the property in some other way, your basis will be determined differently. See Cost as Basis and Basis Other Than Cost earlier in this Guide for more information.
Date of sale: If you received a Form 1099-S, Proceeds From Real Estate Transactions, the date should be shown in box 1. If you did not receive this form, the date of sale is the earlier of (a) the date title transferred or (b) the date the economic burdens and benefits of ownership shifted to the buyer. In most cases, these dates are the same.
Fair market value: Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell and both having reasonable knowledge of the relevant facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.
Fixing-up expenses: These are costs you pay for decorating or repairing your home to make it easier to sell. You may be able to deduct fixing-up expenses from the amount realized on the sale of your old home.
Gain: Your gain on the sale of your home is the amount realized minus the adjusted basis of the home you sold.

Improvements: These add to the value of your home, prolong the life of the property or allow the property to be used for new purposes. The cost of improvements increases your basis in the property.
Main home: This is the home you live in most of the time. It can be a house, houseboat, cooperative apartment, condominium, etc.
Repairs: These maintain your property in good condition. They differ from Improvements in that they do not add much to the value or life of the property and their cost does not increase your basis in the property.
Seller-financed mortgage: This is a mortgage from the buyer of your home. The buyer makes mortgage payments to you.
Selling expenses: Selling expenses include items such as sales commissions and advertising and legal fees you pay to sell your home. Selling expenses also usually include loan charges you pay on the buyer's behalf as an aid in selling your home, such as loan placement fees or "points."
Settlement fees (or closing costs): These are amounts paid in purchasing your property in addition to the contract price. Some of these amounts are added to the basis of the property and some are deductible as itemized deductions. Certain amounts are neither deductible nor added to the basis of the property. See Settlement fees or closing costs under Basis, earlier in this Guide, for more details.

The Deductibility of Points

This Financial Guide explains when and to what extent points paid on the purchase of a home or refinancing are deductible. It explains the rules for deducting points and discusses special circumstances and situations.

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- Mortgage Ends Early
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What Are Points?

The term "points" is used to describe certain charges paid or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

Points are prepaid interest and may be deductible as home mortgage interest if you itemize deductions on Form 1040, Schedule A. Generally, if you can deduct all of the interest on your mortgage, you may be able to deduct all of the points paid on the mortgage. If your acquisition debt exceeds $750,000 for tax years 2018-2025 or your home equity debt exceeds $100,000, you cannot deduct all the interest on your mortgage, and you cannot deduct all your points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See "Points Paid by Seller," later.

Tests for Deductibility

Generally, you cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage.

However, you can fully deduct points in the year paid if you meet all of the following tests.

1. Your loan is secured by your main home (the one you live in most of the time).
2. Paying points is an established business practice in the area where the loan was made.
3. The points paid were not more than the points generally charged in that area.
4. You use the cash method of accounting (the method used by most individual taxpayers).

5. The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6. You use your loan to buy or build your main home.
7. The points were computed as a percentage of the principal amount of the mortgage.
8. The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
9. The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home if statements (1) through (5) above are true.

Non-Deductible Amounts

Amounts charged by the lender for specific services connected to the loan are not considered interest. Examples of these charges are:

1. Appraisal fees
2. Notary fees
3. Preparation costs for the mortgage note or deed of trust
4. Mortgage insurance premiums
5. VA funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage.

Points Paid by Seller

The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer. The *seller* ***cannot*** deduct these fees as interest. But they are a selling expense that reduces the seller's amount realized. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests explained earlier are met, the buyer can deduct the points in the year paid. If any of those tests are not met, the buyer deducts the points over the life of the loan.

Funds Provided Are Less than Points

If you meet all the tests referred to earlier; except that the funds you provided were less than the points charged to you (test 9), you can deduct the points in the year paid, up to the amount of funds you provided. You can also deduct any points paid by the seller.

> **Example 1:** When you took out a $100,000 mortgage loan to buy your home in December, you were charged one point ($1,000). You meet all the nine tests for deducting points in the year paid, except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in the year paid. You spread the remaining $250 over the life of the mortgage.
>
> **Example 2:** The facts are the same as in the example above except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You must reduce the basis of your home by the $1,000 paid by the seller.

Excess Points

If you meet all the tests except that the points paid were more than generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Points Paid on Second Home

The general rule of instant deductibility does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Mortgage Ends Early

If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

> **Example:** Dan paid $3,000 in points in 2008 that he had to spread out over the 15-year life of the mortgage. He deducts $200 points per year. Through 2019, Dan has deducted $2,200 of the points. Dan prepaid his mortgage in full in 2019. He can deduct the remaining $800 of points in 2019.

Points Paid on Refinancing

Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.

However, if you use part of the refinanced mortgage proceeds to ***improve your main home*** and you meet the first five tests listed earlier; you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the rest of the points over the life of the loan.

> **Example 1:** In 1999, Bill Fields got a mortgage to buy a home. In 2019, Bill refinanced that mortgage with a 15-year $100,000 mortgage loan. The mortgage is secured by his home. To get the new loan, he had to pay three points ($3,000). Two points ($2,000) were for prepaid interest, and one point ($1,000) was charged for services, in place of amounts that ordinarily are stated separately on the settlement statement. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice in the area and the points charged are not more than the amount generally charged there. Bill's first payment on the new loan was due July 1. He made six payments on the loan in 2019 and is a cash basis taxpayer.
>
> Bill used the funds from the new mortgage to repay his existing mortgage. Although the new mortgage loan was for Bill's continued ownership of his main home, it was not for the purchase or improvement of that home. For that reason,

Bill does not meet all the tests, and he cannot deduct all of the points in 2019. He can deduct two points ($2,000) ratable over the life of the loan. He deducts $67 [($2,000 ÷ 180 months) x 6 payments] of the points in 2019. The other point ($1,000) was a fee for services and is not deductible.

Example 2: The facts are the same as in Example 1, except that Bill used $25,000 of the loan proceeds to improve his home and $75,000 to repay his existing mortgage. Bill deducts 25 percent ($25,000 ÷ $100,000) of the points ($2,000) in 2019. Therefore, his deduction is $500 ($2,000 x 0.25).

Bill also deducts the ratable part of the remaining $1,500 ($2,000 - $500) prepaid interest that must be spread over the life of the loan. This is $50 [($1,500 ÷ 180 months) x 6 payments] in 2018. The total amount Bill deducts in 2019 is $550 ($500 + $50).

Limits on Home Mortgage Interest Affect Points

You cannot fully deduct points paid on a mortgage that exceeds the limits on home mortgages for purposes of the home mortgage interest deduction.

Form 1098

The mortgage interest statement (Form 1098) you receive should show not only the total interest paid during the year but also your deductible points.

The statement will show the total interest you paid during the year. If you purchased a main home during the year, it also will show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See the earlier discussion of Points to determine whether you can deduct points not shown on Form 1098.

Annuities: How They Work and When You Should Use Them

Annuities may help you meet some of your mid and long-range goals such as planning for your retirement and for a child's college education. This Financial Guide tells you how annuities work, discusses the various types of annuities, and helps you determine which annuity product (if any) suits your situation. It also discusses the tax aspects of annuities and explains how to shop for both an insurance company and an annuity, once you know which type you'll need.

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How Annuities Work

While traditional life insurance guards against "dying too soon," an annuity, in essence, can be used as insurance against "living too long." In brief, when you buy an annuity (generally from an insurance company, that invests your funds), you in turn receive a series of periodic payments that are guaranteed as to amount and payment period. Thus, if you choose to take the annuity payments **over your lifetime** (keep in mind that there are many other options), you will have a guaranteed source of "income" until your death. If you "die too soon" (that is, you **don't** outlive your life expectancy), you will get back from the insurer far **less** than you paid in. On the other hand, if you "live too long" (and **do** outlive your life expectancy), you may get back far **more** than the cost of your annuity (and the resultant earnings). By comparison, if you put your funds into a traditional investment, you may run out of funds before your death.

The earnings that occur during the term of the annuity are tax-deferred. You are not taxed on them until they are paid out. Because of the tax deferral, your funds have the chance to grow more quickly than they would in a taxable investment.

How Annuities Best Serve Investors

> **Tip:** Assess the costs of an annuity relative to the alternatives. Separate purchase of life insurance and tax-deferred investments may be more cost effective.

The two primary reasons to use an annuity as an investment vehicle are:

1. You want to save money for a long-range goal, and/or
2. You want a guaranteed stream of income for a certain period of time.

Annuities lend themselves particularly well to funding retirement and, in certain cases, education costs.

One negative aspect of an annuity is that you cannot get to your money during the growth period without incurring taxes and penalties. The tax code imposes a 10 percent premature-withdrawal penalty on money taken out of a tax-deferred annuity before age 59½, and insurers impose penalties on withdrawals made before the term of the annuity is up. The insurers' penalties are termed "surrender charges," and they usually apply for the first seven years of the annuity contract.

These penalties lead to a de facto restriction on the use of annuities primarily as an investment. It only makes sense to put your money into an annuity if you can leave it there for at least ten years and the withdrawals are scheduled to occur after age 59½. These restrictions explain why annuities work well for either retirement needs or for cases of education funding where the depositor will be at least 59½ when withdrawals begin.

> **Tip:** The greater the investment return, the less punishing the 10 percent penalty on withdrawal under age 59½ will appear. If your variable annuity investments have grown substantially, you may want to consider taking some of those profits (despite the penalty, which applies only to the taxable portion of the amount withdrawn).

Annuities can also be effective in funding education costs where the annuity is held in the child's name under the provisions of the Uniform Gifts to Minors Act. The child would then pay tax (and 10 percent penalty) on the earnings when the time came for withdrawals.

> **Caution:** A major drawback is that the child is free to use the money for any purpose, not just education costs.

Types Of Annuities

The available annuity products vary in terms of (1) how money is paid into the annuity contract, (2) how money is withdrawn, and (3) how the funds are invested. Here is a rundown on some of the annuity products you can buy:

- **Single-Premium Annuities:** You can purchase a single-premium annuity, in which the investment is made **all at once** (perhaps using a lump sum from a retirement plan payout). The minimum investment is usually $5,000 or $10,000.
- **Flexible-Premium Annuities:** With the flexible-premium annuity, the annuity is funded with a **series** of payments. The first payment can be quite small.
- **Immediate Annuities**: The immediate annuity starts payments right after the annuity is funded. It is usually funded with a single premium and is usually purchased by retirees with funds they have accumulated for retirement.
- **Deferred Annuities**: With a deferred annuity, payouts begin many years after the annuity contract is issued. You can choose to take the scheduled payments either in a lump sum or as an annuity, that is, as regular annuity payments over some guaranteed period. Deferred annuities are used as long-term investment vehicles by retirees and non-retirees alike. They are used to fund tax-deferred retirement plans and tax-sheltered annuities. They may be funded with a single or flexible premium.
- **Fixed Annuities**: With a fixed annuity contract, the insurance company puts your funds into conservative fixed income investments such as bonds. Your principal is guaranteed and the insurance company gives you an interest rate that is guaranteed for a certain minimum period from a month to several years. This guaranteed interest rate is adjusted upwards or downwards at the end of the guarantee period. Thus, the fixed annuity contract is similar to a CD or a money market fund, depending on the length of the period during which interest is guaranteed. The fixed annuity is considered a low-risk investment vehicle. All fixed annuities also guarantee you a certain minimum rate of interest of 3 to 5 percent for the entirety of the contract. The fixed annuity is a good choice for investors with a low-risk tolerance and a short-term investing time horizon. The growth that will occur will be relatively low. Fixed annuity investors benefit if interest rates fall, but not if they rise.

- **Variable Annuities**: The variable annuity, which is considered to carry with it higher risks than the fixed annuity--about the same risk level as a mutual fund investment--gives you the ability to choose how to allocate your money among several different managed funds. There are usually three types of funds: stocks, bonds, and cash-equivalents. Unlike the fixed annuity, there are no guarantees of principal or interest. However, the variable annuity does benefit from tax deferral on the earnings.

  Tip: You can switch your allocations from time to time for a small fee or sometimes for free.

The variable annuity is a good annuity choice for investors with a moderate to high-risk tolerance and a long-term investing time horizon.

> **Caution:** Variable annuities have higher costs than similar investments that are not issued by an insurance company.
>
> **Caution:** The taxable portion of variable annuity distributions is taxable at full ordinary rates, even if they are based on stock investments. Unlike dividends from stock investments (including mutual funds), there is no capital gains relief.
>
> **Tip:** Annuities are available that combine both fixed and variable features.
>
> **Tip:** Before buying an annuity, contribute as much as possible to other tax-deferred options such as IRA's and 401 (k) plans. The reason is that the fees for these plans are likely to be lower than those of an annuity and early-withdrawal fees on annuities tend to be steep.
>
> **Tip:** IRA contributions are sometimes invested in flexible premium annuities with IRA deduction, if otherwise available. You may prefer to use IRAs for non-annuity assets. Non-annuity assets gain the ability to grow tax-free when held in an IRA. The IRA regime adds no such benefit to annuity assets which grow tax-free in or outside IRAs.

Choosing A Payout Option

When it's time to begin taking withdrawals from your deferred annuity, you have a number of choices. Most people choose a monthly annuity-type payment, although a lump sum withdrawal is also possible.

Caution: Once you have chosen a payment option, you cannot change your mind.

The size of your payout (settlement option) depends on:

1. The size of the amount in your annuity contract
2. Whether there are minimum required payments
3. Your life expectancy (or other payout period)
4. Whether payments continue after your death

Here are summaries of the most common forms of payout:

Fixed Amount

This type gives you a fixed monthly **amount** (chosen by you) that continues until your annuity is used up. The risk of using this option is that you may live longer than your money lasts. Thus, if the annuity is your only source of income, the fixed amount is not a good choice. And, if you die before your annuity is exhausted, your beneficiary gets the rest.

Fixed Period

This option pays you a fixed amount over the time **period** you choose. For example, you might choose to have the annuity paid out over ten years. If you are seeking retirement income before some other benefits start, this may be a good option. If you die before the period is up, your beneficiary gets the remaining amount.

Lifetime or Straight Life

This type of payment continues until you die. There are no payments to survivors. The life annuity gives you the highest monthly benefit of the options listed here. The risk is that you will die early, thus leaving the insurance company with some of your funds. The life annuity is a good choice if (1) you do not need the annuity funds to provide for the needs of a beneficiary and (2) you want to maximize your monthly income.

Life With Period Certain

This form of payment gives you payments as long as you live (as does the life annuity) but with a minimum period during which you or your beneficiary will receive payments, even if you die earlier than expected. The longer the guarantee period, the lower the monthly benefit.

Installment-Refund

This option pays you as long as you live and guarantees that, should you die early, whatever is left of your original investment will be paid to a beneficiary. Monthly payments are less than with a straight life annuity.

Joint And Survivor

In one joint and survivor option, monthly payments are made during the annuitants' joint lives, with the same or a lesser amount paid to whoever is the survivor. In the option typically used for retired employees (employment model), monthly payments are made to the retired employee, with the same or a lesser amount to the employee's surviving spouse or another beneficiary. The difference is that with the employment model, the spouse's (or other co annuitant's) death before the employee won't affect what the survivor employee collects. The amount of the monthly payments depends on the annuitants' ages, and whether the survivor's payment is to be 100 percent of the joint amount or some lesser percentage.

How Payouts Are Taxed

The way your payouts are taxed differs for qualified and non-qualified annuities.

Qualified Annuity

A tax-qualified annuity is one used to fund a qualified retirement plan, such as an IRA, Keogh plan, 401(k) plan, SEP (simplified employee pension), or some other retirement plan. The tax-qualified annuity, when used as a retirement savings vehicle, is entitled to all of the tax benefits (and penalties) that Congress saw fit to attach to such qualified plans.

The tax benefits are:

1. Any nondeductible or after-tax amount you put into the plan is not subject to income tax when withdrawn
2. The earnings on your investment are not taxed until withdrawal

If you withdraw money from a qualified plan annuity before the age of 59½, you will have to pay a 10 percent penalty on the amount withdrawn in addition to paying the regular income tax. There are exceptions to the 10 percent penalty, including an exception for taking the annuity out in a series of equal periodic payments over the rest of your life.

Once you reach age 70½, you will have to start taking withdrawals in certain minimum amounts specified by the tax law (with exceptions for Roth IRAs and for employees still working after age 70½).

Non-Qualified Annuity

A non-qualified annuity is purchased with **after-tax** dollars. You still get the benefit of tax deferral on the earnings; however, you pay tax on the part of the withdrawals that represent earnings on your original investment.

If you make a withdrawal before the age of 59½, you will pay the 10 percent penalty only on the portion of the withdrawal that represents earnings.

With a non-qualified annuity, you are not subject to the minimum distribution rules that apply to qualified plans after you reach age 70½.

Tax on Your Beneficiaries or Heirs

If your annuity is to continue after your death, other taxes may apply to your beneficiary (the person you designate to take further payments) or your heirs (your estate or those who take through the estate if you didn't designate a beneficiary).

Income tax: Annuity payments collected by your beneficiaries or heirs are subject to tax on the same principles that would apply to payments collected by you.

Exception: There's no 10 percent penalty on withdrawal under age 59½ regardless of the recipient's age, or your age at death.

Estate tax: The present value at your death of the remaining annuity payments is an asset of your estate, and subject to estate tax with other estate assets. Annuities passing to your surviving spouse or to charity would escape this tax.

If a particular fund has a great track record, ascertain whether the same management is still in place. Although past performance is no guarantee, consistent management will grant you better odds.

How To Shop For An Annuity

Although annuities are typically issued by insurance companies, they may also be purchased through banks, insurance agents, or stockbrokers.

There is considerable variation in the amount of fees that you will pay for a given annuity as well in the quality of the product. Thus, it is important to compare costs and quality before buying an annuity.

First, Check Out The Insurer

Before checking out the product itself, it is important to make sure that the insurance company offering it is financially sound. Because annuity investments are not federally guaranteed, the soundness of the insurance company is the only assurance you can rely on. Consult services such as A.M. Best Company, Moody's Investor Service, or Standard & Poor's Ratings to find out how the insurer is rated.

Next, Compare Contracts

The way you should go about comparing annuity contracts varies with the type of annuity.

- *Immediate annuities*: Compare the settlement options. For each $1,000 invested, how much of a monthly payout will you get? Be sure to consider the interest rate and any penalties and charges.
- *Deferred annuities*: Compare the rate, the length of guarantee period, and a five-year history of rates paid on the contract. It is important to consider all three of these factors and not to be swayed by high interest rates alone.
- *Variable annuities*: Check out the past performance of the funds involved.

If a particular fund has a great track record, ascertain whether the same management is still in place. Although past performance is no guarantee, consistent management will grant you better odds.

Costs, Penalties, And Extras

Be sure to compare the following points when considering an annuity contract:

Surrender Penalties

Find out the surrender charges (that is, the amounts charged for early withdrawals). The typical charge is seven percent for first-year withdrawals, six percent for the second year, and so on, with no charges after the seventh year. Charges that go beyond seven years, or that exceed the above amounts, should not be acceptable.

Tip: Be sure the surrender charge "clock" starts running with the date your contract begins, not with each new investment.

Fees And Costs

Be sure to ask about all other fees. With variable annuities, the fees must be disclosed in the prospectus. Fees lower your return, so it is important to know about them. Fees might include:

- Mortality fees of 1 to 1.35 percent of your account (protection for the insurer in case you live a long time)
- Maintenance fees of $20 to $30 per year
- Investment advisory fees of 0.3 percent to 1 percent of the assets in the annuity's portfolios.

Extras

These provisions are not costs per se, but should be asked about before you invest in the contract.

Some annuity contracts offer "bail-out" provisions that allow you to cash in the annuity if interest rates fall below a stated amount without paying surrender charges.

There may also be a "persistency" bonus which rewards annuitants who keep their annuities for a certain minimum length of time.

In deciding whether to use annuities in your retirement planning (or for any other reason) and which types of annuities to use, professional guidance is advisable.

Risk To Retirees of Using An Immediate Annuity

At first glance, the immediate annuity would seem to make sense for retirees with lump-sum distributions from retirement plans. After all, an initial lump-sum premium can be converted into a series of monthly, quarterly, or yearly payments that represent a portion of principal plus interest and is guaranteed to last for life. The portion of the periodic payout that constitutes a return of principal is excluded from taxable income.

However, this strategy contains risks. For one thing, when you lock yourself into a lifetime of level payments, you fail to guard against inflation. Furthermore, you are gambling that you will live long enough to get your money back. Thus, if you buy a $150,000 annuity and die after collecting only $60,000, the insurer often gets to keep the rest. Unlike other investments, the balance doesn't go to your heirs. Finally, since the interest rate is fixed by the insurer when you buy it, you may be locking yourself into low rates.

You can hedge your bets by opting for a "period certain," or "term certain" which, in the event of your death, guarantees payment for some years to your beneficiaries. There are also "joint-and-survivor" options (which pay your spouse for the remainder of his or her life after you die) or a "refund" feature (in which some or all of the remaining principal is resumed to your beneficiaries).

Some plans offer quasi-inflation adjusted payments. One company offers a guaranteed increase in payments of $10 at three-year intervals for the first 15 years. Payments then get an annual cost-of-living adjustment with a three percent maximum. However, for these enhancements to apply, you will have to settle for much lower monthly payments than the simple version.

Recently, a few companies have introduced immediate annuities that offer potentially higher returns in return for some market risk. These "variable immediate annuities" convert an initial premium into a lifetime income; however, they tie the monthly payments to the returns on a basket of mutual funds.

Older seniors--75 years of age and up--may have fewer worries about inflation or liquidity. Nevertheless, they should question whether they really need such annuities at all.

If you want a comfortable retirement income, consider a balanced portfolio of mutual funds. If you want to guarantee that you will not outlive your money, you can plan your withdrawals over a longer time horizon.

Retirement Plan Distributions: When To Take Them

When must you start withdrawing the funds in your retirement plans? And what happens if the funds aren't withdrawn before you die? To what extent will your heirs be taxed? The rules are complex but there are ways the savvy taxpayer can maximize the tax shelter.

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- Withdrawal After You Die
- Tax Planning

The basic rule is that you must begin withdrawing funds - and incurring taxes on these withdrawals - no later than April 1 of the year after you turn 72. This rule exists so that retirement funds will be distributed whether or not spent during what for most people is their retirement years.

> Due to tax law changes made by the SECURE Act, if your 70th birthday is July 1, 2019 or later, you do not have to take withdrawals until you reach age 72. Roth IRAs do not require withdrawals until after the death of the owner. In other words, If you turned age 70 1/2 prior to January 1, 2020, your RMDs are based on age 70 1/2, not age 72.

An exception to this general rule is that, where your retirement plan permits, you do not need to begin these mandatory withdrawals until you retire if you are still employed when you reach the mandatory withdrawal age. The exception doesn't apply where you're a five percent or more owner of the business that provides the plan, or to withdrawals from traditional IRAs - in those cases, you are subject to the mandatory withdrawal rules.

Preserving the tax shelter. Your funds grow sheltered from tax while they are in the retirement plan. So the longer your financial situation lets you prolong the distribution or the smaller the amount you must withdraw the more your assets grow. Some taxpayers choose to defer withdrawals for as long as the law allows, to maximize assets and the shelter, for the next generation.

The law has specific rules about how fast the money must be taken out of the plan after your death. These rules curtail the ability to prolong a tax shelter that started out to aid your retirement.

The rules are complex, but here's a general overview of the timing of retirement plan distributions which will help avoid unnecessary tax headaches for you and your heirs. Because of the complexity of the rules, professional guidance in this area is strongly suggested.

Withdrawal While You're Alive

Before You Reach Age 72

Until the year you reach 72, you need not take your money out of your retirement account, although your employer's plan might require you to do so. In fact, there will usually be a 10 percent early-withdrawal penalty if you make withdrawals from an IRA before age 59 1/2. Between the ages of 59 1/2 and 72; you pay only the income tax on any amounts you decide to withdraw, with no tax on the return of after-tax contributions you made.

> Taxpayers affected by the coronavirus are able to withdraw up to $100,000 and will not be subject to the 10 percent penalty for early withdrawals. Distributions can be taken through December 31, 2020. The amount withdrawn is considered income, however, and taxpayers have three years to pay the tax on the additional income and replace the funds in-kind. If you need to withdraw funds from a retirement plan, please call a tax and accounting professional to discuss how it could impact your financial situation.
> **Eligible taxpayer.** Anyone who has been diagnosed with SARS-CoV-2 virus or COVID-19 disease or whose spouse or dependent has been diagnosed with the same. In addition, any taxpayer experiencing financial hardship from any of the following situations:
>
> - Quarantined
> - Furloughed
> - Laid off
> - Work hours reduced
> - Unable to work due to lack of child care

Once You Reach Age 72

Once you hit 72, withdrawals must begin. Technically they can be postponed until April 1 of the year following the year you reach 72, but waiting until April 1 of the following year means you must withdraw for two years. To avoid this income bunching and a possible higher marginal tax rate, tax advisers generally suggest withdrawing in the year you reach 72.

> Required minimum distributions were suspended for tax year 2020 only due to the coronavirus pandemic (CARES Act).

IRS has greatly simplified and relaxed the withdrawal rules over the years to increase the retirement plan tax shelter, by lengthening, in most cases, the period over which plan withdrawals may be stretched.

The rules allow you, automatically, to spread your withdrawals over a period substantially longer than your life expectancy.

Under these rules the taxpayer (say, an IRA owner) first determines his or her retirement plan asset values as of the end of the preceding year. Then the owner takes the number for his or her age from an IRS table (the table is unisex). The number corresponds to the period over which the withdrawals may be spread. The owner divides that number into the retirement asset total. The result is the amount to be withdrawn for the year.

> **Example 1:** Joe reaches age 72 in October of this year. Retirement plan assets in his IRA totaled $600,000 at the end of last year. The IRS number for age 72 is 25.6. Joe must withdraw $23,437 ($600,000/25.6) this year.
>
> **Example 2:** Two years from now Joe is 74 and his IRA was $602,000 at the end of the preceding year (when Joe reached age 73). The IRS number for age 74 is 23.8. Joe must withdraw $25,294 two years hence.
>
> The distribution period in the IRS table in effect assumes distribution over a period based on your life expectancy plus that of a beneficiary 10 years younger than you. Distribution after your death is based on the actual life span or life expectancy of your actual beneficiary (see "Withdrawal after You Die" below). Only where your designated beneficiary is a spouse more than 10 years younger than you is his or her actual life expectancy used to figure the withdrawal period during your lifetime. You may use these rules to prolong distribution for 2003 and after, even though you have been taking withdrawals over a shorter period under previous rules.
>
> Under the current rules, the life expectancy of your designated beneficiary (if you have one) is irrelevant in figuring your withdrawal period (except for a beneficiary spouse more than 10 years younger). Thus, you can change your designated beneficiary at will, or replace one who died, without affecting your withdrawal period (except for a change to or from a spouse more than 10 years younger).
>
> You can always take out money faster than required and pay tax on these withdrawals; however, the tax code is strict about minimum withdrawals. If you or your beneficiaries or heirs fail to take out what's required, a tax penalty will take 50 percent of what should have been withdrawn but wasn't.

Withdrawal after You Die

The rules as to how fast your beneficiaries or heirs must withdraw funds from your account and pay the income tax-differ, depending on your beneficiary choice.

Under the SECURE Act of 2019, and starting in 2020, there is a new beneficiary category - the eligible designated beneficiary (EDB). An EDB can include the IRA owner's surviving spouse or minor child, a person who is chronically ill or disabled, or another individual (e.g., parent, sibling, and unmarried partner) who is not more than 10 years younger than the IRA owner at the time of his/her death. If an individual inherits an IRA in 2020 (or in years beyond) but does not meet the definition of an EDB they may be required to take full distribution of the inherited IRA within 10 years after the IRA owner's year of death.

Of course, designating a beneficiary is wise as a matter of planning for the disposition of your assets. You may change the beneficiary later without affecting the amount you withdraw (except for a change to or from a spouse more than 10 years younger).

Eligible Designated Beneficiaries: Your Spouse. Naming your spouse as beneficiary carries the most flexibility. A surviving spouse has options that no other beneficiary has such as:

- **Leave the money in the IRA account.** If your spouse, for example, is the sole beneficiary, he or she may elect to treat the balance in the IRA as if it were their own. Depending on their age, they may be required to take required minimum distributions.
- **Rollover to another IRA.** A spouse beneficiary of your IRA can elect to roll the IRA balance over to their own IRA. This provides the optimal extension of the withdrawal period if your spouse is younger than you since your spouse doesn't have to start withdrawing funds until he or she turns 72. At age 72, your spouse can then use the period in the IRS table or a longer one if he or she then has a spouse more than 10 years younger. A rollover isn't allowed if a trust is a beneficiary, even if the spouse is the trust's sole beneficiary. A similar extension is allowed for a balance you might leave in a qualified retirement plan: your spouse can roll it over into his or her IRA. And your spouse can roll over a distribution from your retirement plan to another retirement plan in which he or she participates, as well as to an IRA.
- **Remaining a beneficiary.** Instead of a rollover, a surviving spouse can simply leave the money in the deceased participant's account. There's no 10 percent early-withdrawal penalty if the spouse takes funds out of **your** account, but that penalty **would** apply if the spouse rolled over the money into his or her own IRA and tapped it before reaching 59 1/2.

Leaving the money in your account makes sense if your spouse is under age 59 1/ 2 and needs the money soon after your death. If your spouse remains a beneficiary, he or she doesn't have to start withdrawals until you would have reached age 72 after which withdrawals will be taken under the IRS table. Generally, there will not be an estate tax on retirement plan assets left to a spouse and the spouse will pay income taxes only as funds are withdrawn.

Eligible Designated Beneficiaries: Your Minor Child. If you name your child you should be aware that upon reaching the age of majority (18 in most states, 19 in Alabama and Nebraska, and 21 in Mississippi) your child will become a *non-eligible designated beneficiary* and subject to the 10-year rule - i.e., required to take full distribution of the inherited IRA within 10 years.

Non-Designated Beneficiaries. This type of beneficiary does not have a life expectancy. As such, distributions are different depending on whether the IRA account owner dies before, during, or after the start of the required beginning date for required minimum distributions (RMDs). If a traditional IRA owner passes away after his/her RBD, the beneficiary must continue distributions using the decedent's life expectancy. If before, then the entire account balance must be taken by the end of 5th year following year of death. Beneficiaries of Roth IRA account owners who have died must distribute the assets within five years.

> The required payout schedules set the minimum that can be withdrawn. The beneficiary can always take out more.

No beneficiary. If you die before April 1 after the year you reach age 72 having named no beneficiary or, in most cases, where your beneficiary is not a human being (such as an estate or a charity), all funds must be distributed and income taxes paid within five to six years of your death. Heirs don't get the option of using their own life expectancy.

If you die on or after that April 1 date without having named a beneficiary or having named your estate as the beneficiary, the money must come out by the end of the period remaining under the IRS table. For example, at age 80 the table period is 18.7. On a death at age 80, the estate or heirs would have 18.7 years to complete withdrawal.

Death before distributions begin. If you should die before the time (age 72) required distributions are to begin, minimum distributions to your beneficiary can be spread over his or her life expectancy.

Estate tax. There may be an estate tax on retirement funds left to someone other than your spouse, who will also owe an income tax as funds are withdrawn. Where an estate tax is imposed, the taxpayer who received the retirement funds is entitled to a partial income tax deduction for the estate tax paid.

Tax Planning

The above discussion covered the general rules as to the withdrawal of retirement plan distributions both before and after you die. Now let's look at some specific tax planning techniques, particularly as regards the estate tax, for minimizing the tax bite when the funds accumulated in your retirement accounts (including pension and profit-sharing plans, 401(k) plans, IRAs and rollover IRAs) are passed on to your heirs.

How Your Heirs Are Taxed

The general rule is that, while there may be a estate tax bite at your death, inherited assets are received income-tax-free by your heirs. Unfortunately, however, this general rule doesn't apply to money in a retirement plan. Whoever gets the money will incur income tax on it, unless it's left to charity (more on giving retirement assets to charity below).

> If you gave your wife a $500,000 stock-and-bond portfolio, she will not pay income tax on receipt of the portfolio. Or if you leave your son a $150,000 vacation home, he will not pay income tax when he receives it. But if you leave your daughter the $150,000 in your IRA, she will be subject to income tax on it, more or less as you would be if you had received the distributions yourself. (Moreover, there may be a further estate tax as well.)

The basic income tax rule is that retirement plan distributions to heirs are taxable at ordinary rates, except for after-tax investments, which come out tax-free. There are, however, the following key exceptions or qualifications:

- On a lump sum distribution, heirs of persons born before 1936 can sometimes claim tax relief.
- Life insurance proceeds paid in a lump sum are tax-exempt. However, if they are paid in installments, the interest element is taxable.
- The value of a stock bonus is taxable when received as ordinary income, less unrealized appreciation, and after-tax investment. Any appreciation is taxable as capital gain when the stock is sold.
- Your spouse can roll over from your retirement account (IRA or other) to his or her IRA. No other heir can roll over from your account.
- There's no early withdrawal penalty on what your heir withdraws after your death, even if the heir is under age 59½, but in general, if your spouse is your heir and rolls over your retirement account to his or her IRA, a withdrawal from the IRA while under age 59 1/2 is subject to the penalty.

Some Tax Planning Opportunities

The federal estate tax isn't a major problem for most Americans. Less than one percent (0.80) of those who die in any year leave an estate that's hit by the estate tax; but the larger a taxpayer's retirement account, the more likely it will be cut down by the federal estate tax on top of the federal income tax described above.

Unlike the income tax, which is collected only as amounts are distributed - and thus is deferred on annuities and the like - the estate tax is collected up front, at the owner's death, on the present value of the annuity.

One common planning technique - making lifetime gifts to reduce your taxable estate is impractical for retirement accounts. Even where you might be able to give part of your retirement account away (as with an IRA, for example), your gift is a taxable distribution to you and no IRA tax shelter survives for your donee. But there are more practical techniques:

- Make your spouse the beneficiary of your retirement plan assets and leave non-retirement plan assets to non-spouse beneficiaries. This reduces estate taxes and permits deferral of income taxes for the longest period possible.
- If you plan on leaving assets to charity, use retirement plan assets. You can eliminate estate and income taxes on this amount while achieving charitable goals.
- A charitable remainder trust is a sophisticated way to benefit family, as well as charity at a reduced tax cost. Typically, your children or other non-spouse beneficiaries will draw the income from the retirement assets for a period, after which the remainder goes to charity. An estate tax deduction is allowed for the present value of what will go to the charity.
- Consider buying life insurance to pay estate tax that can't be avoided (perhaps because you want a large retirement account to go to someone other than a spouse or charity). The insurance proceeds will be exempt from income tax (while funds withdrawn from the account to pay estate tax will be subject to income tax). With proper planning, the withdrawn funds can escape estate tax as well.

Retirement Plan Distributions: How To Take Them

If you are thinking of retiring soon, you are about to make a major financial decision: how to take distributions from your retirement plan. This Financial Guide will discuss your various options. And, since the tax treatment of these distributions will influence your decision, we will also review the tax rules.

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You may have a number of options as to HOW you can take retirement plan distributions, i.e., your share of company or Keogh pension or profit-sharing plans (including thrift and savings plans), 401(k)s, IRAs, and stock bonus plans. Your options depend (1) on what type of plan you are in and (2) whether your employer has limited your choices. Essentially, you can:

- Take everything in a lump sum.
- Take some kind of annuity.
- Roll over the distribution.
- Take a partial withdrawal.
- Do some combination of the above.

> As you will see, the rules on retirement plan distributions are quite complex. They are offered here only for your general understanding. Professional guidance is advised before taking retirement distributions or other major withdrawals from your retirement plan.

Before discussing the specific withdrawal options, let's consider the general tax rules affecting (1) tax-free withdrawals and (2) early withdrawals.

Tax-free Withdrawals. If you paid tax on money that went into the plan, that is if it was made with after-tax funds that money will come back to you tax-free. Typical examples of after-tax investments are:

- Your **non**-deductible IRA contributions.

- Your **after**-tax contributions to company or Keogh plans (usually, thrift, savings or other profit-sharing plans, but sometimes pension plans).
- Your **after**-tax contributions to 401(k)s (in excess of the pre-tax deferral limit).

Early Withdrawals. Tax-favored retirement plans are meant primarily for retirement. If you withdraw funds before reaching what the law considers a reasonable retirement age - age 59 1/2 - you usually will face a 10 percent penalty tax in addition to whatever tax would ordinarily apply.

> At age 47, you withdraw $10,000 from your retirement account (and do not roll over the funds). That $10,000 is ordinary income on which you'll owe regular tax at your applicable rate plus a 10 percent penalty tax ($1,000).

As with any other tax on withdrawal, the 10 percent penalty doesn't apply to any part of a withdrawal that would be tax-free as a return of after-tax investment

There are several ways to avoid this penalty tax. The most common are:

- You're age 59 ½ or older.
- You're retired and are age 55 or older (however, this does not apply to IRAs).
- You're withdrawing in roughly equal installments over your life expectancy or your joint-and-survivor life expectancy (discussed later).
- You're disabled.
- The withdrawal is required by a divorce or separation settlement (here, too, this does not apply to IRAs).
- The withdrawal is for certain medical expenses.
- The withdrawal is for health insurance while unemployed (also available to self-employed).
- For IRAs only: The withdrawal is for certain higher education expenses and for first-time home purchases (up to $10,000).

> Taxpayers affected by the coronavirus are able to withdraw up to $100,000 and will not be subject to the 10 percent penalty for early withdrawals. Distributions can be taken through December 31, 2020. The amount withdrawn is considered income, however, and taxpayers have three years to pay the tax on the additional income and replace the funds in-kind. If you need to withdraw funds from a retirement plan, please call a tax and accounting professional to discuss how it could impact your financial situation.
> **Eligible taxpayer.** Anyone who has been diagnosed with SARS-CoV-2 virus or COVID-19 disease or whose spouse or dependent has been diagnosed with the same. In addition, any taxpayer experiencing financial hardship from any of the following situations:
>
> - Quarantined

- Furloughed
- Laid off
- Work hours reduced
- Unable to work due to lack of child care

Now let's review the basics for each of the options for taking retirement plan distributions and then discuss the tax planning for each option.

Take Everything In A Lump Sum

The Basics

You might want to withdraw all retirement funds in a lump sum, perhaps to spend them on a retirement home or assisted living arrangement, on a second home, or to buy or invest in a business. Or you might want to take everything out of a company account because you mistrust leaving funds with a former employer or to take control of investment decisions, although here a rollover (discussed later) might be preferred. Maybe you have to take a lump sum, as some employers will require, though here, too, a rollover option is probably available.

Lump sum is the standard form of retirement distribution for profit-sharing, 401(k) and stock bonus plans, but may also happen in other plans. Put another way, while plans generally allow lump sum distribution, the employer may have decided to preclude the lump sum form.

> While your funds remain in the plan, earnings on the investment assets grow tax-free. The tax shelter ends once the funds are withdrawn. Preserving this tax shelter is one reason to decide not to withdraw the funds at all or to decide against withdrawing everything in a lump sum. The tax shelter continues, in one form or another, for funds withdrawn as annuities and for funds left in the plan when there's a partial withdrawal of funds. And the shelter continues on rollovers.

Tax Planning

Special tax relief applies, in certain cases, for those who withdraw their pension assets in a lump sum. For most, this relief comes in the form of "forward averaging," which is also known as the 10-year tax option.

Forward averaging reduces your tax below what it would be if figured at regular progressive rates. You will pay tax in one year (for the year you receive it) as if the lump sum amount was received in equal installments over 10 years. Forward averaging isn't allowed if any part of the account is or was rolled over to an IRA.

Capital gain treatment for lump sums is available only for those born before 1936 and only with respect to plan participation before 1974. You will need to report the taxable part of the distribution from participation before 1974 as a capital gain (if you qualify) and the taxable part of the distribution from participation after 1973 as ordinary income using the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).

It's a "lump sum" if you take out everything left in your account in a single calendar year. If you took $50,000 last year and $250,000 this year, and nothing is left, $250,000 is the lump sum. If you took $250,000 last year and $50,000 this year and nothing is left, $50,000 is the lump sum. In general, lump sum relief is available only once in a worker's lifetime.

You may also report the entire taxable part as ordinary income or roll over all or part of the distribution. No tax would be due on the part rolled over and any part of the distribution that is not rolled over is reported as ordinary income.

> Because lump sum withdrawal ends the tax shelter, it's rarely the road to maximizing wealth. Retirees will usually do better with arrangements that preserve the shelter, through rollovers, annuities or partial withdrawals.

Roll Over The Distribution

The Basics

Rollovers are transfers of funds from one plan to another (from one company or Keogh plan to another, from a company or Keogh to an IRA, or from one IRA to another, or from an IRA to a company or Keogh plan.

Rollovers are usually distributions from a company or Keogh plan that are put into an IRA. You might do this (1) to transfer control of the funds from your employer to yourself or (2) because your employer forces the distribution when you leave so as to close its books on your plan participation. In your own Keogh plan, you might make the rollover as part of a decision to terminate your plan or your business.

> A rollover to your own IRA can give you flexibility in dealing with the funds (for example, so you can invest in options or create a separate IRA for each beneficiary) that would not be available for funds left in your employer's plan. Rollovers can be of the entire retirement account or only part of the account.

Rollovers can be made from one IRA to another. Apart from Roth IRA situations, these are usually done to expand investment options or to create several IRA accounts. Rollovers also can be made from one pension, profit-sharing or 401(k) plan to another or between types of plan. This might happen if you change jobs or set up a new Keogh plan because of starting a new business after you retire.

Rollovers from company or Keogh plans preserve the retirement plan tax shelter while postponing retirement distributions, thereby often prolonging the tax-free buildup of retirement funds. They have other consequences, some undesirable:

Federal law grants a person no rights in his or her spouse's IRA. Thus, a plan participant's rollover will strip the participant's spouse of rights the spouse had under the plan from which the assets are being removed. In the case of a pension plan, the spouse has a measure of protection because the spouse must approve the transfer that will forfeit his or her rights. However, no such approval is required in the case of 401(k)s or profit-sharing plans. Thus, a rollover from such plans can eliminate spousal rights. (Employers sometimes provide spousal rights that federal law does not require.)

A rollover will eliminate the chance of lump sum tax relief, unless the IRA was just a conduit for the movement of funds between retirement plans.

In some cases, a rollover from an IRA to a retirement plan can extend the tax shelter period. IRA distributions must begin at age 72, but distributions from a retirement plan can be postponed beyond that until the participant retires, unless he or she is an owner of the business.

A rollover from an IRA to a retirement plan could also get greater creditor protection than if left in an IRA.

Tax Planning

Rollovers are tax-free when properly handled, but consider these qualifications and exceptions:

- After-tax investments can be rolled over from a company or Keogh plan to an IRA and, in some cases, to defined contribution plans, but not to defined benefit plans.
- You can't roll over amounts you're required to withdraw after reaching age 72 or amounts you're due to receive under a fixed annuity.

If you do the rollover yourself-personally withdrawing funds from one plan and moving them to another-the plan you're withdrawing from must withhold tax at a 20 percent rate on the withdrawal. To avoid tax on the 20 percent withheld, you'll have to come up with that amount from elsewhere and add it to the rollover IRA. (The tax withheld can be taken as a credit against the year's tax liability.) On the other hand, a direct rollover (having the funds transferred directly from the transferring plan to the receiving plan) avoids withholding.

If you do the rollover yourself, the withdrawn funds are taxable if they don't reach the rollover destination within the deadline (generally, 60 days).

Therefore, the least risky way to roll over funds is a direct rollover.

Where the plan holds specific assets for your account, a rollover may (1) transfer the specific asset or (2) sell it and transfer the cash.

The rollover is not tax-free if cash is withdrawn, used to buy investment assets, and the new assets are then transferred to the new plan.

Take A Partial Withdrawal

The Basics

Partial withdrawals are withdrawals that aren't rollovers, annuities or lump sums or don't qualify for lump sum forward averaging or capital gain relief. They include certain withdrawals that you can make while you are still working as well as withdrawals at or after retirement. They may be made for investment or consumption, including education and health care. Because they are partial, the amount not withdrawn continues its tax shelter.

A partial withdrawal will usually leave open the option for other types of withdrawal (annuity, lump sum, rollover) of the balance left in the plan.

Before retirement, partial withdrawals are fairly common with profit-sharing plans, 401(k)s, and stock bonus plans. After retirement, they are fairly common in all types of plans (though least common with defined-benefit pension plans).

Tax Planning

A partial withdrawal is taxable (and can be subject to the penalty tax on early withdrawal) except to the extent it consists of after-tax funds. The withdrawal is generally tax-free in the proportion the after-tax investment bears to the total retirement account.

Your retirement account totals $100,000, which includes an after-tax investment of $10,000. You withdraw $5,000. The withdrawal is tax-free to the extent of $500 ($10,000/$100,000x$5,000).
The tax-free portion is computed differently for plan participants who were in the plan on 5/5/86.

Do Some Combination Of The Above

Combination withdrawals are quite complex and beyond the scope of this Financial Guide.

For an overview of how states tax retirement plan withdrawals, see *State Taxes On Retirement Plan Distributions.*

Life Insurance Options

Here are your typical options where whole life insurance is held for you in a retirement plan:

- Your employer surrenders the policy to the insurance company for its cash surrender value, which it pays over to you.
- Your employer trades in the policy for an annuity on your life.
- Your employer distributes the policy to you.
- Some mix of the above, such as getting some cash proceeds and an annuity.

The tax shelter ends when cash is received. Otherwise, it continues, to some degree.

Assets Withdrawn In Kind

In general, assets withdrawn in kind (i.e., withdrawn in the form held by the retirement plan, rather than withdrawn in cash) are taxed at their fair market value when received, reduced by after-tax investment. Exceptions:

- *Stock distributed by a stock bonus plan.* Your after-tax investment in the stock comes back tax-free and you pay no tax on the stock's appreciation in value until you sell it. But you have the option to pay tax on the value when received.
- *Annuity contract.* These aren't taxed when distributed. You're taxed under the annuity rules above on annuity payments as received.
- *Insurance policy.* If you convert the policy to an annuity contract within 60 days, the distribution is tax-free. However, you're taxed under the annuity rules as payments are received. If you keep the policy, you're taxed on the policy's cash value (less your after-tax investment).

The Economics Of Retirement Annuities

Retirement annuity economics are built around the straight life annuity, where the retiree receives a certain amount for life, however, long or short that might be. This amount stops at the retiree's death. The cost of such an annuity is computed, and that's the cost the employer is obligated to provide.

However, you may want, or be obliged to take, something other than a straight life annuity, such as:

- A fixed-term annuity, whereby the annuity will continue for a fixed term (say, ten years) even though you die before the end of this term. (This additional benefit is called a "refund feature.")
- A joint and survivor annuity, where the annuity is payable over two lives instead of one.

These types of annuity are worth more than the straight life annuity. But the employer isn't obliged to pay for more than the cost of a straight single life annuity. So if you opt for something other than straight life, the amount you collect each period will be correspondingly reduced to the "actuarial equivalent" of straight life.

Can Creditors Reach Your Retirement Assets?

Federal law generally protects your retirement assets or accounts against claims of your creditors so long as the assets remain in the retirement plan, except for unpaid federal taxes. Generally, this protection is in federal labor law (ERISA). Protection denied under labor law is provided under bankruptcy law (if the case is begun after October 16, 2005) to:

- Keogh plans where the Keogh owner (or owner and spouse) are the only ones in the plan and
- IRA plans, up to the amount rolled over from retirement plans, plus up to $1 million (which the bankruptcy court may increase where appropriate).

State Taxes On Retirement Plan Distributions

With 50 different state tax systems, only an overview is possible on how states tax retirement plan withdrawals. Here are the highlights:

- A state cannot tax a retirement plan distribution if it imposes no income tax on individuals (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming).
- A state from which a pension is paid, by an employer or former employer in the state, can't tax the pension recipient in another state. In other cases, states generally follow the basic federal approach of taxing retirement distributions as ordinary income (and treating return of after-tax investment as tax-free). But some states don't follow the federal rules for Keogh or IRA investment. Hence, withdrawals from such plans can get state tax relief not allowed under federal law.

- Some states grant tax relief for a certain dollar amount of retirement income, relief that extends to retirement plan withdrawals. In some states the relief may look something like the federal credit for the elderly.
- Rarely if ever, would a state impose a penalty tax on early withdrawal or on inadequate withdrawals after age 72.

Roth IRAs: How They Work and How To Use Them

Roth IRAs differ from other tax-favored retirement plans, including other IRAs (called "traditional IRAs"), in that they promise complete tax exemption on distribution. There are other important differences as well, and many qualifications about their use. This Financial Guide shows how they work, how they compare with other retirement devices--and why YOU might want one, or more.

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With most tax-favored retirement plans, the contribution to (i.e., investment in) the plan is deductible, the investment compounds tax-free until distributed, and distributions are taxable as received. There are variations from this pattern, as with 401(k)s where the exemption for salary diverted to a 401(k) takes the place of a deduction and for after-tax investments where invested capital is tax-free when distributed.

With a Roth IRA, there's never an up-front deduction for contributions. Funds contributed compound tax-free until distributed (standard for all tax-favored plans) and distributions are completely exempt from income tax.

How Contributions Are Treated

The 2022 annual contribution limit to a Roth IRA is $6,000 (same as 2021). An additional "catch-up" contribution of $1,000 (same as 2021) is allowed for people age 50 or over bringing the contribution total to $7,000 for certain taxpayers. To make the full contribution, you must earn at least $6,000 ($7,000 if age 50 or older) from personal services and have income (modified adjusted gross income or MAGI) below $129,000 if single or $204,000 on a joint return in 2022. The $6000 limit in 2022 phases out on incomes between $129,000 and $144,000 (single filers) and $204,000 and $214,000 (joint filers). Also, the $6,000 limit is reduced for contributions to traditional IRAs though not SEP or SIMPLE IRAs.

You can contribute to a Roth IRA for your spouse, subject to the income limits above. So assuming earnings (your own or combined with your spouse) of at least $12,000, up to $12,000 ($6,000 each) can go into the couple's Roth IRAs. As with traditional IRAs, there's a six percent penalty on excess contributions. The rule continues that the dollar limits are reduced by contributions to traditional IRAs.

How Withdrawals Are Treated

You may withdraw money from a Roth IRA at any time; however, taxes and penalty could apply depending on the timing of contributions and withdrawals.

Qualified Distributions

Since all your investments in a Roth IRA are after-tax, your withdrawals, whenever you make them, are often tax-free. But the best kind of withdrawal, which allows earnings, as well as contributions and conversion, amounts to come out completely tax-free, are qualified distributions. These are withdrawals meeting the following conditions:

1. At least, five years have elapsed since the first year a Roth IRA contribution was made or, in the case of a conversion since the conversion occurred and

2. At least **one** of these additional conditions is met:

- The owner is age 59 1/2.
- The owner is disabled.
- The owner has died (distribution is to estate or heir).
- Withdrawal is for a first-time home that you build, rebuild, or buy (lifetime limit up to $10,000).

A distribution used to buy, build or rebuild a first home must be used to pay qualified costs for the main home of a first-time home buyer who is either yourself, your spouse or you or your spouse's child, grandchild, parent or another ancestor.

Non-Qualified Distributions

To discourage the use of pension funds for purposes other than normal retirement, the law imposes an additional 10 percent tax on certain early distributions from Roth IRAs unless an exception applies. Generally, early distributions are those you receive from an IRA before reaching age 59 1/2.

Exceptions. You may not have to pay the 10 percent additional tax in the following situations:

- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You use the distribution to pay certain qualified first-time homebuyer amounts.
- The distributions are part of a series of substantially equal payments.
- You have significant unreimbursed medical expenses.
- You are paying medical insurance premiums after losing your job.
- The distributions are not more than your qualified higher education expenses.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Part of any distribution that is not a qualified distribution may be taxable as ordinary income and subject to the additional 10 percent tax on early distributions. Distributions of conversion contributions within a 5-year period following a conversion may be subject to the 10 percent early distribution tax, even if the contributions have been included as income in an earlier year.

Ordering Rules for Distributions

If you receive a distribution from your Roth IRA, that is not a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Order the distributions as follows.

1. Regular contributions.
2. Conversion contributions, on a first-in-first-out basis (generally, total conversions from the earliest year first). See Aggregation (grouping and adding) rules, later. Take these conversion contributions into account as follows:
    - Taxable portion (the amount required to be included in gross income because of conversion) first, and then the

    - Nontaxable portion.
3. Earnings on contributions.

Disregard rollover contributions from other Roth IRAs for this purpose.

Aggregation (grouping and adding) rules.

Determine the taxable amounts distributed (withdrawn), distributions, and contributions by grouping and adding them together as follows.

- Add all distributions from all your Roth IRAs during the year together.
- Add all regular contributions made for the year (including contributions made after the close of the year, but before the due date of your return) together. Add this total to the total undistributed regular contributions made in prior years.
- Add all conversion and rollover contributions made during the year together.

For years prior to 2018, add any recharacterized contributions that end up in a Roth IRA to the appropriate contribution group for the year that the original contribution would have been taken into account if it had been made directly to the Roth IRA. Disregard any recharacterized contribution that ends up in an IRA other than a Roth IRA for the purpose of grouping (aggregating) both contributions and distributions. Also, disregard any amount withdrawn to correct an excess contribution (including the earnings withdrawn) for this purpose.

> On October 15, 2016, Justin converted all $80,000 in his traditional IRA to his Roth IRA. His Forms 8606 from prior years show that $20,000 of the amount converted is his basis. Justin included $60,000 ($80,000 - $20,000) in his gross income. On February 23, 2017, Justin makes a regular contribution of $4,000 to a Roth IRA. On November 7, 2017, at age 60, Justin takes a $7,000 distribution from his Roth IRA.
>
> - The first $4,000 of the distribution is a return of Justin's regular contribution and is not includible in his income.
> - The next $3,000 of the distribution is not includible in income because it was included previously.

Distributions after Owner's Death

Qualified distributions after the owner's death are tax-free to heirs. Nonqualified distributions after death, which are distributions where the 5-year holding period wasn't met, are taxable income to heirs as they would be to the owner (the earnings are taxed), except there's no penalty tax on early withdrawal. However, an owner's surviving spouse can convert an inherited Roth IRA into his or her own Roth IRA. This way, distribution can be postponed, so that nonqualified amounts can become qualified, and the tax shelter prolonged.

Roth IRA assets left at death are subject to federal estate tax, just as traditional IRA assets are.

Converting from a Traditional IRA or Other Eligible Retirement Plan to a Roth IRA

The conversion of your traditional IRA to a Roth IRA was the feature that caused most excitement about Roth IRAs. Conversion means that what would be a taxable traditional IRA distribution can be made into a tax-exempt Roth IRA distribution. Starting in 2008, further conversion or rollover opportunities from other eligible retirement plans were made available to taxpayers.

Conversion Methods

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

You can convert amounts from a traditional IRA to a Roth IRA in any of the following three ways.

- **Rollover.** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
- **Trustee-to-trustee transfer.** You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
- **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

  Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Prior to 2008, you could only roll over (convert) amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You can now roll over amounts from the following plans into a Roth IRA.

- A qualified pension, profit-sharing or stock bonus plan (including a 401(k) plan),
- An annuity plan,
- A tax-sheltered annuity plan (section 403(b) plan),
- A deferred compensation plan of a state or local government (section 457 plan), or
- An IRA.

Any amount rolled over is subject to the same rules for converting a traditional IRA to a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

There is a cost to the rollover. The amount converted is fully taxable in the year converted, except for the portion of after-tax investment in the traditional IRA. So you must pay tax now (though there's no early withdrawal penalty) for the opportunity to withdraw tax-free later, an opportunity that can extend to your heirs.

Undoing a Conversion to a Roth IRA

> The information in this section only applies to taxable years beginning after December 31, 2017.
> Under tax reform (Tax Cuts and Jobs Act of 2017), if a contribution to a regular IRA has been converted into a contribution to a Roth IRA, it can no longer be converted back into a contribution to a regular IRA. This provision prevents a taxpayer from using recharacterization to unwind a Roth conversion.

Since everyone recognizes that conversion is a high-risk exercise, the law, and liberal IRS rules provide an escape hatch: You can undo a Roth IRA conversion by what IRS calls a "recharacterization." This move, by which you move your conversion assets from a Roth IRA back to a traditional IRA, makes what would have been a taxable conversion into a tax-free rollover between traditional IRAs. Re-characterization can be done any time until the due date for the return for the year of conversion.

> If your assets are worth $180,000 at conversion and fall to $140,000 later, you're taxed on up to $180,000, which is $40,000 more than you now have. Undoing-re-characterization-avoids the tax, and gets you out of the Roth IRA.
>
> One reason to do this, dramatized by a volatile stock market, is where the value of your portfolio drops sharply after the conversion.

Can you undo one Roth IRA conversion and then make another one a reconversion? Yes, but only one time and subject to the following requirements: Reconversion must take place in the tax year following the original conversion to Roth IRA, and the reconversion date must also be more than 30 days after the previous recharacterization transfer from the Roth IRA back to the traditional IRA.

Withdrawal Requirements

You are not required to take distributions from your Roth IRA once you reach a particular age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs

Also, unlike traditional IRAs (but like other tax-favored retirement plans), a Roth IRA owner who continues working may continue to contribute to the Roth IRA.

Retirement Savings Contributions Credit (Saver's Credit)

Also known as the saver's credit, this credit helps low and moderate-income workers save for retirement. Taxpayers age 18 and over who are not full-time students and can't be claimed as dependents, are allowed a tax credit for their contributions to a workplace retirement plan, traditional or Roth IRA if their modified adjusted gross income (MAGI) in 2022 for a married filer is below $68,000 ($66,000 in 2021). For heads-of-household MAGI is below $51,000 ($49,500 in 2021) and for others (single, married filing separately) it is below $34,000 ($33,000 in 2021). These amounts are indexed for inflation each year. The credit, up to $1,000, is a percentage from 10 to 50 percent of each dollar placed into a qualified retirement plan up to the first $2,000 ($4,000 married filing jointly). The lower the MAGI is, the higher the credit percentage, resulting in the maximum credit of $1,000 (50 percent of $2,000).

> Both you and your spouse may be eligible to receive this credit if you both contributed to a qualified retirement plan and meet the adjusted gross income limits.

The following table details the percentage of Saver's credit based on Adjusted Gross Income (AGI):

2022 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$20,500	$0-$30,750	$0-$41,000
20% of contribution	$20,501 - $22,000	$30,751 - $33,000	$41,001- $44,000

10% of contribution	$22,001 - $34,000	$33,001 - $51,000	$44,001 - $68,000
Credit Not Available	more than $34,000	more than $51,000	more than $68,000

2021 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$19,750	$0-$29,625	$0-$39,500
20% of contribution	$19,751-$21,500	$29,626-$32,500	$39,501-$43,000
10% of contribution	$21,501-$33,000	$32,251-$49,500	$43,001-$66,000
Credit Not Available	more than $33,000	more than $49,500	more than $66,000

2020 Saver's Credit	**Single Filers AGI**	**Head of Household AGI**	**Joint Filers AGI**
50% of contribution	$0-$19,500	$0-$29,250	$0-$39,000
20% of contribution	$19,501-$21,500	$29,250-$31,875	$39,001-$42,500

10% of contribution	$21,251-$32,500	$31,876-$48,750	$42,501-$65,000
Credit Not Available	more than $32,500	more than $48,750	more than $65,000

The saver's credit is available in addition to any other tax savings that apply. Further, IRA contributions can be made until April 15 of the following year and still be considered in the current tax year.

Use in Estate Planning

Though Roth IRAs enjoy no estate tax relief, they are already figuring in estate plans. The aim is to build a large Roth IRA fund largely through conversion of traditional IRAs-to pass to beneficiaries in later generations. The beneficiaries will be tax exempt on withdrawals (of qualified distributions) and the Roth IRA tax shelter continues by spreading withdrawal over their lifetimes.

Long-term planning with Roth IRAs. If you would be allowed a deduction for a contribution to a traditional IRA, contributing to a Roth IRA means surrendering current tax reduction for future tax reduction (to zero) for qualified distributions. This can be presented as an after-tax return-on-investment calculation involving assumed future tax rates. The higher the projected tax rate at withdrawal, the more tax Roth IRA saves.

Comparable considerations apply to conversions to Roth IRAs. Here the taxpayer incurs substantial current tax cost (directly or indirectly reducing the amount invested) for future tax relief to the taxpayer or an heir. So the return on investment resulting from conversion increases as projected future rates rise.

A key element in making such projections is the possibility that current and future federal deficits will lead to future tax rate increases a factor which would tend to encourage current Roth IRA investment and conversion. On the other hand, there's the question whether Roth IRA benefits currently promised will survive into future decades.

Highly sophisticated planning is required for Roth IRA conversions. Consultation with a qualified advisor is a must. Please call if you have any questions.

Mutual Fund Taxation: How To Cut The Tax Bite

How are distributions from mutual funds taxed? What happens when they are reinvested? How are capital gains on sales of mutual funds determined? This Financial Guide provides you with tips on reducing the tax on mutual fund activities.

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A basic knowledge of mutual fund taxation and careful record-keeping can help you cut the tax bite on your mutual fund investments.

You must generally report as income any mutual fund distributions, whether or not they are reinvested. The tax law generally treats mutual fund shareholders as if they directly owned a proportionate share of the fund's portfolio of securities. Thus, all dividends and interest from securities in the portfolio, as well as any capital gains from the sales of securities, are taxed to the shareholders.

> The fund itself is not taxed on its income if certain tests are met and substantially all of its income is distributed to its shareholders.

Taxable Distributions

There are two types of taxable distributions: (1) ordinary dividends and (2) capital gain distributions:

1. **Ordinary Dividends**. Distributions of ordinary dividends, which come from the interest and dividends earned by securities in the fund's portfolio, represent the net earnings of the fund. They are paid out periodically to shareholders. Like the return on any other investment, mutual fund dividend payments decline or rise from year to year, depending on the income earned by the fund in accordance with its investment policy. These dividend payments are considered ordinary income and must be reported on your tax return.
   Qualified dividends. Qualified dividends are ordinary dividends that are subject to the same tax rates that apply to net long-term capital gains. Dividends from mutual funds qualify where a mutual fund is receiving qualified dividends and distributing the required proportions thereof. Dividends from foreign corporations are qualified where their stock or ADRs are traded on U.S. exchanges or with IRS approval where the dividends are covered by U.S. tax treaties.
2. **Capital gain distributions**. When gains from the fund's sales of securities exceed losses, they are distributed to shareholders. As with ordinary dividends, these capital gain distributions vary in amount from year to year. They are treated as long-term capital gain, regardless of how long you have owned your fund shares. A mutual fund owner may also have capital gains from selling mutual fund shares.

Capital gains rates

The beneficial long-term capital gains rates on sales of mutual fund shares apply only to profits on shares held more than a year before sale. Profit on shares held a year or less before the sale is ordinary income, but capital gain distributions are long-term regardless of the length of time held before the distribution.

In 2022, tax rates on capital gains and dividends remain the same as 2021 rates (0%, 15%, and a top rate of 20%); however, threshold amounts are different in that they don't correspond to new tax bracket structure as they did in the past. The maximum zero percent rate amounts are $41,675 for individuals and $83,350 for married filing jointly. For an individual taxpayer whose income is at or above $459,750 ($517,200 married filing jointly), the rate for both capital gains and dividends is capped at 20 percent. All other taxpayers fall into the 15 percent rate amount (i.e., above $41,675 and below $459,750 for single filers).

> In 2022, say your taxable income, apart from long-term capital gains and qualified dividends, is $87,000. Even though you're in a middle-income tax bracket (22 percent on a joint return in 2022) you'll get the benefit of a lower capital gains tax rate, in this case, 15 percent for long-term gains and qualified dividends.
>
> For tax years 2013-2017 dividend income that fell in the highest tax bracket (39.6%) was taxed at 20 percent. For the middle tax brackets (25-35%) the dividend tax rate was 15 percent, and for the two lower ordinary income tax brackets of 10% and 15%, the dividend tax rate was zero.

At tax time, your mutual fund will send you a Form 1099-DIV, which tells you what earnings to report on your income tax return, and how much of it is qualified dividends. Because tax rates on qualified dividends are the same as for capital gains distributions and long-term gains on sales, Congress wants these items combined in your tax reporting, that is, qualified dividends added to long-term capital gains. Also, capital losses are netted against capital gains before applying favorable capital gains rates. Losses will not be netted against dividends.

Undistributed capital gains. Mutual funds sometimes retain a part of their capital gain and pay tax on them. You must report your share of such gains and can claim a credit for the tax paid. The mutual fund will report these amounts to you on Form 2439. You increase your shares' "cost basis" (more about this in Tip No. 5, below) by 65 percent of the gain, representing the gain reduced by the credit.

Medicare Tax

Starting with tax year 2013, an additional Medicare tax of 3.8 percent is applied to net investment income for individuals with modified adjusted gross income above $200,000 (single filers) and $250,000 (joint filers). These amounts are not indexed for inflation.

Now that you have a better understanding of how mutual funds are taxed, here are 13 tips for minimizing the tax on your mutual fund activities:

Keep Track of Reinvested Dividends

Most funds offer you the option of having dividend and capital gain distributions automatically reinvested in the fund - a good way to buy new shares and expand your holdings. While most shareholders take advantage of this service, it is not a way to avoid being taxed. Reinvested ordinary dividends are still taxed (at long-term capital gains rates if qualified), just as if you had received them in cash. Similarly, reinvested *capital gain distributions* are taxed as long-term capital gain.

Be Aware That Exchanges of Shares Are Taxable Events

The "exchange privilege," or the ability to exchange shares of one fund for shares of another, is a popular feature of many mutual fund "families," i.e., fund organizations that offer a variety of funds. For tax purposes, exchanges are treated as if you had sold your shares in one fund and used the cash to purchase shares in another fund. In other words, you must report any capital gain from the exchange on your return. The same tax rules used for calculating gains and losses when you redeem shares apply when you exchange them.

> Gains on these redemptions and exchanges are taxable whether the fund invests in taxable or tax-exempt securities.

Be Wary of Buying Shares Just Before Ex-Dividend Date

Tax law requires that mutual funds distribute at least 98 percent of their ordinary and capital gain income annually. Thus, many funds make disproportionately large distributions in December. The date on which a fund's shareholders become entitled to future payment of a distribution is referred to as the ex-dividend date. On that date, the fund's net asset value (NAV) is reduced on a per-share basis by the exact amount of the distribution. Buying mutual fund shares just before this date can trigger an unexpected tax.

> You buy 1,000 shares of Fund XYZ at $10 a share. A few days later, the fund goes ex-dividend, entitling you to a $1 per share distribution. Because $1 of your $10 NAV is being distributed to you, the value of your 1,000 shares is reduced to $9,000. As with any fund distribution, you may receive the $1,000 in cash or reinvest it and receive additional shares. In either case, you must pay tax on the distribution.

If you reinvest the $1,000, the distribution has the appearance of a wash in your account since the value of your fund investment remains $10,000. The $1,000 reinvestment results in the acquisition of 111.1 new shares with a $9 NAV and increases the cost basis of your total investment to $11,000. If you were to redeem your shares for $10,000 (their current value), you would realize a $1,000 capital loss.

In spite of these tax consequences, in some instances it may be a good idea to buy shares right before the fund goes ex-dividend. For instance, the distribution could be relatively small, with only minor tax consequences. Or the market could be moving up, with share prices expected to be higher after the ex-dividend date.

> To find out a fund's ex-dividend date call the fund directly.
>
> If you regularly check the mutual fund quotes in your daily newspaper and notice a decline in NAV from the previous day, the explanation may be that the fund has just gone ex-dividend. Newspapers generally use a footnote to indicate when a fund goes ex-dividend.

Do Not Overlook the Advantages of Tax-Exempt Funds

If you are in the higher tax brackets and are seeing your investment profits taxed away, then there is a good alternative to consider: tax-exempt mutual funds. Distributions from such funds that are attributable to interest from state and municipal bonds are exempt from federal income tax (although they may be subject to state tax).

The same is true of distributions from tax-exempt money market funds. These funds also invest in municipal bonds, but only in those that are short-term or close to maturity, the aim being to reduce the fluctuation in NAV that occurs in long-term funds.

Many taxpayers can ease their tax bite by investing in municipal bond funds. The catch with municipal bond funds is that they offer lower yields than comparable taxable bonds. For example, if a U.S. Treasury bond yields 2.8 percent, then a quality municipal bond of the same maturity might yield 2.45 percent. If an investor is in a higher tax bracket, the tax advantage makes it worthwhile to invest in the lower-yielding tax-exempt fund. Whether the tax advantage actually benefits a particular investor depends on that investor's tax bracket.

To figure out how much you would have to earn on a taxable investment to equal the yield on a tax-exempt investment, use this formula: Tax-exempt yield divided by (1 minus your tax bracket) = equivalent yield of a taxable investment.

> You are planning for the 32% bracket. The yield of a tax-exempt investment is 2.8 percent. Applying the formula, we get .028 divided by .68 (1 minus .32) =

.041. Therefore, 4.1 percent is the yield you would need from a taxable investment to match the tax-exempt yield of 2.8 percent.

In limited cases based on the types of bonds involved, part of the income earned by tax-exempt funds may be subject to the federal alternative minimum tax.

Although income from tax-exempt funds is federally tax-exempt, you must still report on your tax return the amount of tax-exempt income you received during the year. This is an information-reporting requirement only and does not convert tax-exempt earnings into taxable income.

Your tax-exempt mutual fund will send you a statement summarizing its distributions for the past year and explaining how to handle tax-exempt dividends on a state-by-state basis.

Capital gain distributions paid by municipal bond funds (unlike distributions of interest) are not free from federal tax. Most states also tax these capital gain distributions.

Keep Records of Your Mutual Fund Transactions

It is very important to keep the statements from each mutual fund you own, especially the year-end statement.

By law, mutual funds must send you a record of every transaction in your account, including reinvestments and exchanges of shares. The statement shows the date, amount, and number of full and fractional shares bought or sold. These transactions are also contained in the year-end statement.

In addition, you will receive a year-end Form 1099-B, which reports the sale of fund shares, for any non-IRA mutual fund account in which you sold shares during the year.

Why is record keeping so important? When you sell mutual fund shares, you will realize a capital gain or loss in the year the shares are sold. You must pay tax on any capital gain arising from the sale, just as you would from the sale of individual securities. (Losses may be used to offset other gains in the current year and deducted up to an additional $3,000 of ordinary income. Remaining loss may be carried for comparable treatment in later years.)

The amount of the gain or loss is determined by the difference between the cost basis of the shares (generally the original purchase price) and the sale price. Thus, in order to figure the gain or loss on a sale of shares, it is essential to know the cost basis. If you have kept your statements, you will be able to figure this out.

> In 2012, you purchased 100 shares of Fund JKL at $10 a share for a total purchase price of $1,000. Your cost basis for each share is $10 (what you paid for the shares). Any fees or commissions paid at the time of purchase are included in the basis, so since you paid an up-front commission of two percent, or $20, on the purchase, your cost basis for each share is $10.20 ($1,020 divided by 100). Let's say you sell your Fund JKL shares this year for $1,500. Assume there are no adjustments to your $ 1,020 basis, such as basis attributable to shares purchased through reinvestment (for an example of the effect of reinvestment on the cost basis, see Tip #6.). On this year's income tax return, you report a capital gain of $480 ($1,500 minus $1,020).
>
> Since they are taken into account in your cost basis, commissions or brokerage fees are not deductible separately as investment expenses on your tax return.

One of the advantages of mutual fund investing is that the fund provides you with all of the records that you need to compute gains and losses--a real plus at tax time. Some funds even provide cost basis information or compute gains and losses for shares sold. That is why it is important to save the statements. However, you are not required to use the fund's gain or loss computations in your tax reporting.

Re-investing Dividends & Capital Gain Distributions when Calculating

Make sure that you do not pay any unnecessary capital gain taxes on the sale of mutual fund shares because you forgot about reinvested amounts. When you reinvest dividends and capital gain distributions to buy more shares, you should add the cost of those shares (that is, the amount invested) to the cost basis of the shares in that account because you have already paid tax on those shares. Failure to include reinvested dividends and capital gain distributions in your cost basis is a costly mistake.

> You bought 500 shares in Fund PQR 15 years ago for $10,000. Over the years, you reinvested dividends and capital gain distributions in the amount of $8,000, for which you received 100 additional shares. This year, you sell all 600 of those shares for $40,000. If you forget to include the price paid for the 100 shares purchased through reinvestment (even though the fund sent you a statement recording the shares you received in each transaction), you will unwittingly report on your tax return a capital gain of $30,000 ($40,000 - $ 10,000) on your redemption of 600 shares, rather than the correct capital gain of 22,000 ($40,000 - [$10,000 + $8,000]).

Adjust Cost Basis for Non-Taxable Distributions

Sometimes mutual funds make distributions to shareholders that are not attributable to the fund's earnings. These are nontaxable distributions, also known as returns of capital. Because a return of capital is a return of part of your investment, it is not taxable. Your mutual fund will show any return of capital on Form 1099-DIV in the box for nontaxable distributions.

If you receive a return-of-capital distribution, your basis in the shares is reduced by the amount of the return.

> Fifteen years ago, you purchased 1,000 shares of Fund ABC at $10 a share. The following year you received a $1-per-share return-of-capital distribution, which reduced your basis in those shares by $1, to give you an adjusted basis of $9 per share. This year you sell your 1,000 shares for $15 a share. Assuming no other transactions during this period, you would have a capital gain this year of $6 a share ($15 - $9) for a total reported capital gain of $6,000.

Nontaxable distributions cannot reduce your basis below zero. If you receive returns of capital that, taken together, exceed your original basis, you must report the excess as a long-term capital gain.

Your *overall* basis will not change if non-taxable distributions are reinvested. However, your per-share basis will be reduced.

Use the Best Method of Identifying Sold Shares

Calculating the capital gain or loss on shares you sell is somewhat more complicated if, as is usually the case, you are selling only some of your shares. You then must use some accounting method to identify which shares were sold to determine your capital gain or loss. The IRS recognizes several methods of identifying the shares sold:

- First-in, first-out (FIFO),
- Average cost (single category and double category), and
- Specific identification.

Reports from your funds may include a computation of gain or loss on your sale of mutual fund shares. Typically, these will use the average cost method, single category rule. This is done as a convenience. You are allowed to adopt one of the other methods.

First-In, First-Out (FIFO)

Under this method, the first shares bought are considered the first shares sold. Unless you specify that you are using one of the other methods, the IRS will assume you are using FIFO.

Average Cost

This approach allows you to calculate an average cost for each share by adding up the total cost of all the shares you own in a particular mutual fund and dividing by the number of shares. If you elect to take an average cost approach, you must then choose whether to use a single-category method or a double-category method.

- With the *single category* method, you simply group all shares together, add up the cost, and divide by the number of shares. Under this method, you are deemed to have sold first the shares you have held the longest.
- The *double category* method enables you to separate short-term and long-term shares. Shares held for one year or less are considered short-term; shares held for more than one year are considered long-term. You average the cost of shares in each category separately. In this way, you may specify whether you are redeeming long-term or short-term shares.

Keep in mind that once you elect to use either average cost method, you must continue to use it for all transactions in that fund unless you receive IRS approval to change your method.

Specific Identification

Under this method, you specify the individual shares that are sold. If you have kept track of the purchase prices and dates of all your fund shares, including shares purchased with reinvested distributions, you will be able to identify, for example, those shares with the highest purchase prices and indicate that they are the shares you are selling. This strategy gives you the smallest capital gain and could save you a significant amount on your taxes.

To take advantage of this method, you must, at the time of the sale or exchange, indicate to your broker or to the mutual fund itself the particular shares you are selling. The IRS also insists that you receive written confirmation of your instructions.

> To see the advantages and disadvantages of these methods of identifying sold shares, see *How The Various Identification Methods Compare* (below).

Money market funds present a very simple case when you redeem shares. Because most money market funds maintain a stable net asset value of $1 per share, you have no capital gain or loss when you sell shares. Thus, you only pay tax on any earnings distributed.

Avoid Backup Withholding

One way the IRS makes sure it receives taxes owed by taxpayers is through backup withholding. In the mutual fund context, this means that a mutual fund company is required to deduct and withhold a specified percentage (see below) of your dividend and redemption proceeds if one of the following situations has occurred:

- You have not supplied your taxpayer identification number (Social Security number) to the fund company;
- You supplied a TIN that the IRS finds to be wrong;
- The IRS finds you have underreported your interest and dividend payments; or
- You failed to tell the fund company you are not subject to backup withholding.

The backup withholding percentage is 24 percent for tax years 2018-2025 (28 percent in prior years).

Don't Forget State Taxation

Many states treat mutual fund distributions the same way the federal government does. There are, however, some differences. For example,:

- If your mutual fund invests in U.S. government obligations, states generally exempt from state taxation dividends attributable to federal obligation interest.
- Most states do not tax income from their own obligations, whether held directly or through mutual funds. On the other hand, the majority of states do tax income from the obligations of other states. Thus, in most states, you will not pay state tax to the extent you receive, through the fund, income from obligations issued by your state or its municipalities.
- Most states don't grant reduced rates for capital gains or dividends.

Don't Overlook Possible Tax Credits for Foreign Income

If your fund invests in foreign stocks or bonds, part of the income it distributes may have been subject to foreign tax withholding. If so, you may be entitled to a tax deduction or credit for your pro-rata share of taxes paid. Your fund will provide you with the necessary information.

> Because a tax credit provides a dollar-for-dollar offset against your tax bill, while a deduction reduces the amount of income on which you must pay tax, it is generally advantageous to claim the foreign tax credit. If the foreign tax doesn't exceed $300 ($600 on a joint return), then you may not need to file IRS form 1116 to claim the credit.

Be Careful About Trying the "Wash Sale" Rule

If you sell fund shares at a loss (so you can take a capital loss on your return) and then repurchase shares in the same fund shortly thereafter, beware of the wash sale rule. This rule bars a loss deduction when a taxpayer buys "substantially identical" shares within 30 days before or after the date of sale.

> Be sure to wait more than thirty (30) days before reinvesting.

Choose Tax-Efficient Funds

Many investors who hold mutual funds directly may hold others through tax-sheltered accounts such as 401(k)s, IRAs, and Keoghs. Your aggressive high-turnover funds and high-income funds should be in tax-sheltered accounts. These generate more current income and gains, currently taxable if held directly but tax-deferred in tax-sheltered accounts. Buy-to-hold funds and low activity funds such as index funds should be owned directly (as opposed to a tax-sheltered account). With relatively small currently distributable income, such investments can continue to grow with only a modest reduction for current taxes.

For some investors, the simpler approach may be to hold mutual funds personally and more highly taxed income (such as bond interest) in the tax-sheltered account.

As you can see, there are many tax pitfalls that await the unwary mutual fund investor. Professional guidance should be considered to minimize the tax impact.

How The Various Identification Methods Compare.

To illustrate the advantages and disadvantages of the various methods of identifying the shares that you sell, assume that you bought 100 shares of Fund PQR in January 2005 at $20 a share, 100 shares in January 2006 at $30 a share, and 100 shares in November 2010 at $46 a share. You sell 50 shares in June of this year for $50 a share. Here are your alternative ways to determine cost basis.

1. ***First-In, First-Out (FIFO)***.The FIFO method identifies the 50 shares sold as among the first 100 shares purchased. Your cost basis per share is $20. This rate gives you a capital gain of $1,500 ($2,500 - (50 x $20)).
2. ***Advantages/Disadvantages***. In this example, this method produces the highest amount of capital gain on which you are taxed. FIFO provides the lowest capital gain amount when the fund's net asset value has declined, and the first shares purchased were the most expensive. It can also sometimes save tax when shares bought later weren't held long enough to qualify for long-term capital gains treatment.
3. ***Average Cost/Single Category***. Average cost/single category allows you to calculate the average price paid for all shares in the fund. Here, your cost basis per share is $32 (your 300 shares cost $9,600: $9,600 divided by 300 = $32), giving you a capital gain of $900 ($2,500 - (50 x $32)).
4. ***Advantages/Disadvantages.:*** Compared to FIFO, this method can reduce the amount of your capital gain if the fund's net asset value has increased over time. You could generate a lower long-term capital gain by using specific identification, but average cost/single category is useful if you did not designate shares at the time of sale or you simply do not want to do the record-keeping required to use the specific identification method.
5. ***Average Cost/Double Category***. Under this method, you average the cost of the short-term shares (those held for one year or less) and the cost of the long-term shares (those held for more than one year) separately. Thus, in the long-term category, you have 200 shares at $5,000 for an average cost of $25 per share ($5,000 x 200), and in the short-term category, you have 100 shares at $4,600 for an average cost of $46 per share ($4,600 divided by 100). Comparing the two categories, your taxable gain using the long-term shares would be $1,250 ($2,500 - (50 x $25)), to be taxed at up to 20 percent, while your taxable gain using the short-term shares would be $200 ($2,500 - (50 x $46)), to be taxed at up to 37 percent (top rate for 2022).

6. ***Advantages/Disadvantages***. In this example, using the average cost of short-term shares produces a better result. However, because of the current spread between the top marginal income tax rates and the maximum rate on long-term capital gains, it could make sense in some instances to choose the long-term shares. Furthermore, as with specific identification, you must plan ahead to use this method by specifying to the broker or mutual fund company at the time of sale that you are selling short-term or long-term shares, and you must receive confirmation of your specification in writing. If you have elected to use average cost-double category but do not specify for a particular redemption whether you are redeeming short-term or long-term shares, the IRS will deem you to have redeemed the long-term shares first.
7. ***Specific identification.*** With this method, you designate which shares you are selling. To reduce your capital gains tax bill the most, you would select the shares with the highest purchase price. In this case, you would identify the 50 shares sold as among those purchased in 1999. Your cost basis, therefore, is $46 per share, giving you a capital gain of $200 ($2,500 - (50 x $46)).
8. ***Advantages/Disadvantages:*** This method can produce favorable results in lowering the capital gain, but IRS regulations require you to think ahead by providing instructions before the sale and then receiving confirmation of your specification in writing. The IRS will not let you designate shares after the fact.

Government and Non-Profit Agencies

- **US Securities and Exchange Commission (SEC)**

Securities and Exchange Commission

100 F Street, NE

Washington, D.C. 20549

(202) 942-8088

The SEC has public reference rooms at its headquarters in Washington, D.C., and at its Northeast and Midwest Regional offices. Copies of the text of documents filed in these reference rooms may be obtained by visiting or writing the Public Reference Room (at a standard per page reproduction rate) or through private contractors (who charge for research and/or reproduction).

Other sources of information filed with the SEC include public or law libraries, securities firms, financial service bureaus, computerized on-line services, and the companies themselves.

Most companies whose stock is traded over the counter or on a stock exchange must file "full disclosure" reports on a regular basis with the SEC. The annual report (Form 10-K) is the most comprehensive of these. It contains a narrative description and statistical information on the company's business, operations, properties, parents, and subsidiaries; its management, including their compensation and ownership of company securities: and significant legal proceedings which involve the company. Form 10-K also contains the audited financial statements of the company (including a balance sheet, an income statement, and a statement of cash flow) and provides management's discussion of business operations and prospects for the future.

Quarterly financial information on Form 8-K may be required as well.

Anyone may search the **SEC's Company Filings database** for information regarding to including quarterly and annual reports, registration statements for IPOs and other offerings, insider trading reports, and proxy materials.

American Association of Individual Investors

(Offers an annual guide to low-load mutual funds):

625 North Michigan Avenue

Chicago, IL 60611

Tel: 312-280-0170 or 800-428-2244

Investment Company Institute

(Publishes an annual directory of mutual funds):

1401 H Street NW, Suite 1200

Washington, DC 20005

Tel: 202-326-5800

Investment Management Education Alliance

(Offers a free Portfolio tool, complete with data from Morningstar, Inc.):

2345 Grand Boulevard

Kansas City, MO 64108

Tel: 816-454-9427

Advanced Charity Techniques: Maximizing Your Deduction

There are a number of tax vehicles for turning charitable desires into tax deductions. While these techniques are quite complex, they can with the proper guidance provide substantial tax deductions. This Financial Guide provides an introductory view of the ways to maximize your tax deduction while satisfying your charitable goals.

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When an organization claims to be tax-exempt, it does not necessarily mean that contributions are deductible. Tax-exempt means that the organization does not have to pay federal income taxes while tax-deductible means the donor can deduct contributions to the organization. The Internal Revenue Code defines more than 20 different categories of tax-exempt organizations, but only a few of these offer tax-deductibility for donations.

The well-known mainstream charities generally provide deductibility for donations. But, surprisingly, some well-known organizations do not. If deductibility is a factor in your decision to make a contribution to a tax-exempt organization, especially if the amount is substantial, you might want to determine whether the organization qualifies for deductibility. IRS Publication 78, the *Cumulative List of Organizations*, is an annual list of those charities eligible for deductibility. You can also call the IRS (800-829-1040) about the deductibility of a contribution if you're in doubt.

You can obtain three documents on a specific charity by sending a written request to the attention of the Disclosure Officer at your nearest IRS District Office. The IRS will charge a per-page copying fee for these items. To speed your request, have the full, official name of the charity, as well as the city and state location. These three publicly available documents are:

- *Form 1023*: the application filed by the charity to obtain tax-exempt status.
- *IRS Letter of Determination*: the two-page IRS letter that notifies the organization of its tax-exempt status.
- *Form 990*: the financial/income tax form filed with the IRS annually by the charity. (Charities with a gross income of less than $25,000 and churches are not required to file this form). Among other things, Form 990 includes information on the charity's income, expenses, assets, liabilities and net assets in the past fiscal year. Form 990 also identifies the salaries of the charity's five highest-paid employees. When contacting the IRS for copies, specify the fiscal year.

> **Tip:** If your request for information involves only Forms 990, you can get a faster response by writing directly to the IRS Service Center where the charity files its return. Contact your nearest IRS office for the address of the appropriate Service Center.
>
> **Tip:** The charity registration office in your state (usually a division of the state attorney general's office) may also have a copy of the charity's latest Form 990, along with other publicly available information on charities soliciting in your state.

Even though the charity qualifies for deductibility, taxpayers are often disappointed to learn that their expected deductions are not allowed. Here are some of the common misconceptions about the deductibility of charitable contributions:

- If you go to a charity affair or buy something to benefit a charity (e.g., a magazine subscription or show tickets), you cannot deduct the full amount you pay. Only the part above the fair market value of the item you purchase is fully deductible. For example, if you pay $500 for a charity luncheon worth $200, only $300 can be deducted. An exception allows you to deduct the full amount if what you get in return is insubstantial in value (e.g., 2 percent of the value of your contribution) and the charity tells you the deductible amount.

- Since contributions are deductible only for the year in which they are actually paid or delivered, pledges are not deductible until they are paid.
- It's a mistake to believe you can deduct *estimated* cash contributions. This was widely done though IRS required you to make a record of some kind at or around the time of the gift. But cash contributions in 2007 and after aren't deductible at all unless substantiated by a receipt from the charity, a canceled check, a credit card statement or other supporting documentation from the charity.
- No donation of $250 or more is deductible unless the taxpayer has a receipt from the charity substantiating the donation.
- Since contributions must be made to qualified organizations to be tax-deductible, donations made directly to needy individuals are not deductible.

Note: The amount of the deduction you can get for the garden-variety charitable contribution (we'll talk about more sophisticated techniques in a moment) depends on the type of charity and the type of contribution, as well as on the specific tax situation of the donor (since there are percentage-of-income limitations). For these reasons, tax planning for charitable contributions requires the assistance of your tax advisor.

Planned or Deferred Giving

There are a number of sophisticated techniques for giving money to a charity that differ substantially from the usual method of just writing a check. You've probably been approached by a number of charitable organizations suggesting ways you can save tax dollars through the use of planned or deferred giving techniques. Indeed, much of the revenue of many charities comes from the use of such techniques. However, not all charities have the resources to be able to offer sophisticated arrangements. Briefly stated, these various techniques, discussed below, work as follows:

A planned or deferred gift is a present commitment to make a gift in the future, either during your lifetime or pursuant to your will. Aside from assuring your favorite charities of a contribution, planned or deferred giving brings with it certain tax benefits. Charitable gifts made pursuant to your will reduce the amount of your estate that is subject to estate tax. Lifetime gifts have the same estate tax effect (by removing the assets from your estate), but also might offer a current income tax deduction. If you have property that has significantly appreciated in value but does not bring in current income, you may be able to use one of these techniques to convert it into an income-producing asset. Further, you will be able to avoid or defer the capital gains tax that would be due on its sale - all the while helping a charity.

> **Tip:** Many variables affect the type of planned or deferred giving arrangement you choose, such as the amount of your income, the size of your estate and the type of asset transferred (e.g., cash, investments, business interests, real estate, retirement plan) and its appreciated value. Professional guidance is even more important here than in the garden-variety type of contribution program because these of the complexity of these gifts.

Types of Planned and Deferred Gifts

There are several types of planned and deferred gifts: (1) life insurance, (2) charitable remainder annuity trust, (3) charitable remainder unitrust, (4) charitable lead annuity trust, (5) charitable lead unitrust, (6) charitable gift annuity, (7) pooled income fund. These are discussed briefly below:

Life Insurance

You name a charity as a beneficiary of a life insurance policy. With some limitations, both the contribution of the policy itself and the continued payment of premiums may be income-tax deductible.

Charitable Remainder Annuity Trust

You transfer assets to a trust that pays a set amount each year to non-charitable beneficiaries (for example, to yourself or your children) for a fixed term or for the life or lives of the beneficiaries, after which time the remaining assets are distributed to one or more charitable organizations. You get an immediate income tax deduction for the value of the remainder interest that goes to the charity on the trust's termination, even though you keep a life-income interest. In effect, you or your beneficiaries get current income for a specified period and the remainder goes to the charity.

Charitable Remainder Unitrust

This is the same as the charitable remainder annuity trust, except the trust pays the actual income or a set percentage of the current value (rather than a set amount) of the trust's assets each year to the non-charitable beneficiaries. Here, too, you or your beneficiaries get current income for a specified period and the remainder goes to the charity.

Charitable Lead Annuity Trust

You transfer assets to a trust that pays a set amount each year to charitable organizations for a fixed term or for the life of a named individual. At the termination of the trust, the remaining assets will be distributed to one or more non-charitable beneficiaries (for example, you or your children).

You get a deduction for the value of the annual payments to the charity. You may still be liable for tax on the income earned by the trust. You keep the ability to pass on most of your assets to your heirs. Unlike the two trusts above, the charity gets the current income for a specified period and your heirs get the remainder.

Charitable Lead Unitrust

This is the same as the lead annuity trust, except the trust pays the actual income or a set percentage of the current value (rather than a set amount) of the trust's assets each year to the charities.

Here, too, the charity gets the current income for a specified period and your heirs get the remainder.

Charitable Gift Annuity

You and a charity have a contract in which you make a present gift to the charity and the charity pays a fixed amount each year for life to you or any other specified person. Your charitable deduction is the value of your gift minus the present value of your annuity.

Pooled Income Fund

You put funds into a pool that operates like a mutual fund but is controlled by a charity. You, or a designated beneficiary, get a share of the actual net income generated by the entire fund for life, after which your share of the assets is removed from the pooled fund and distributed to the charity. You get an immediate income tax deduction when you contribute the funds to the pool. The deduction is based on the value of the remainder interest.

Should You Make a Planned or Deferred Gift?

When determining whether to make a planned or deferred gift to a charity, ask whether you are ready to make a commitment to invest in a charitable organization. Keep in mind that despite the tax benefits, you will still be out-of-pocket after the deduction.

Some questions you should consider are:

- Does the gift fit into your estate and family plan?
- Is the charity viable, reputable, creditable, and reliable?
- Do you wish to support its programs?

Government and Non-Profit Agencies

- Most state governments regulate charitable organizations. To obtain information on these regulations, which vary from state to state, contact the appropriate government agency (usually a division of the Attorney General or the Secretary of State).
- Contact the appropriate state government agency to verify a charity's registration and to obtain financial information on a soliciting charity.
- Contact your local Better Business Bureau to find out whether a complaint has been lodged against a charity.

Charitable Contributions of Property: Maximizing the Deduction

This Financial Guide discusses the rules that apply when you contribute property - as opposed to money - to charity and is meant to provide general information. Contact your tax advisor if you need tax planning assistance.

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- Food Inventory
- Bargain Sales
- Penalty

The rules in this area are extremely complex. We urge you not to act on any transaction without seeking the proper advice.

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the **fair market value** of the property at the time of the contribution. However, if the property fits into one of the categories discussed here, the amount of your deduction must be decreased.

After discussing how to determine the fair market value of something you donate, we'll discuss the following categories of charitable gifts of property:

- Contributions subject to special rules
- Property that has decreased in value;
- Property that has increased in value;
- Food Inventory.
- Bargain Sales.

Determining Fair Market Value

Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all of the relevant facts.

Used Clothing and Household Items.

The fair market value of used clothing and used household goods, such as furniture and furnishings, electronics, appliances, linens, and other similar items is usually much lower than the price paid when new. These items may have little or no market value because they are in a worn condition, out of style, or no longer useful. Claim as the value of used clothing the price that buyers of used items actually pay clothing stores, such as consignment or thrift shops.

Be prepared to support your valuation of other household items with photographs, canceled checks, receipts from your purchase of the items, or other evidence. Magazine or newspaper articles and photographs that describe the items and statements by the recipients of the items may be useful. This documentation does not get filed with your return; it is kept on hand as proof.

> No deduction is allowed after August 17, 2006 for household items in less than "good used condition." However, deduction *is* allowed where the amount claimed for the item in less than good condition is more than $500 and a qualified appraisal supporting the valuation is filed with the return.

Cars, Boats, and Aircraft

If you donate a car, a boat, or an aircraft to a charitable organization, you must determine the FMV.

The FMV of a donated car, boat, or airplane is generally the amount listed in a used vehicle pricing guide for a private party sale, not the dealer retail value, of a similar vehicle. The FMV may be less than that, however if the vehicle has engine trouble, body damage, high mileage, or any type of excessive wear.

Similar is defined as the same make, model, and year, sold in the same area, in the same condition, with the same or similar options or accessories, and with the same or similar warranties as the donated vehicle.

Boats. Except for inexpensive small boats, the valuation of boats should be based on an appraisal by a marine surveyor because the physical condition is so critical to the value.

If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than $500, you can deduct the smaller of the gross proceeds from the sale of the vehicle by the organization or the vehicle's fair market value on the date of the contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to figure the deductible amount.

Paintings, Antiques, and Other Objects of Art.

Deductions for contributions of paintings, antiques, and other objects of art should be supported by a written appraisal from a qualified and reputable source unless the deduction is $5,000 or less.

1. **Art valued at $20,000 or more.** If you claim a deduction of $20,000 or more for donations of art, you must attach a complete copy of the signed appraisal to your return. For individual objects valued at $20,000 or more, a photograph of a size and quality fully showing the object, preferably an 8 x 10-inch color photograph or a color transparency no smaller than 4 x 5 inches, must be provided upon request.
2.
   Art valued at $50,000 or more. If you donate an item of art that has been appraised

at $50,000 or more, you can request a Statement of Value for that item from the IRS. You must request the statement before filing the tax return that reports the donation.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

> **Example:** You purchase 20 rare books for $1,000. The person who sells them to you says the retail value of these books is $3,000. If you contribute these rare books to a qualified organization, you can claim a deduction only for the price at which similar numbers of the same book are currently being sold. Your charitable contribution is $1,000 unless you can show that similar numbers of that book were selling at a different price at the time of the contribution.

Contributions Subject to Special Rules

Special rules apply if you contribute:

- Clothing or household items,
- A car, boat, or airplane,
- Taxidermy property,
- Property subject to a debt,
- A partial interest in property,
- A fractional interest in tangible personal property,
- A qualified conservation contribution,
- A future interest in tangible personal property,
- Inventory from your business, or
- A patent or other intellectual property.

These special rules are described here briefly.

Used clothing or household items. You cannot take a deduction for clothing or household items you donate unless the clothing or household items are in good used condition or better. However, there is an exception. You can take a deduction for a contribution of an item of clothing or a household item that is not in good used condition or better if you deduct more than $500 for it and include a qualified appraisal of it with your return.

Car, boat, or airplane. A qualified vehicle is defined as a car or any motor vehicle manufactured mainly for use on public streets, roads, and highways, a boat, or an airplane. If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than $500, you can deduct the smaller of:

- The gross proceeds from the sale of the vehicle by the organization, or
- The vehicle's fair market value on the date of the contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to figure the deductible amount

Taxidermy property. If you donate taxidermy property to a qualified organization, your deduction is limited to your basis in the property or its fair market value, whichever is less. This applies if you prepared, stuffed, or mounted the property or paid or incurred the cost of preparing, stuffing, or mounting the property.

Your basis for this purpose includes only the cost of preparing, stuffing, and mounting the property. Your basis does not include transportation or travel costs. It also does not include direct or indirect costs for hunting or killing an animal, such as equipment costs. In addition, it does not include the value of your time.

Taxidermy property means any work of art that:

- Is the reproduction or preservation of an animal, in whole or in part,
- Is prepared, stuffed, or mounted to recreate one or more characteristics of the animal, and
- Contains a part of the body of the dead animal.

Property subject to a debt. If you contribute property subject to a debt (such as a mortgage), there are two possible ways your deduction might be reduced. First, special rules require you to reduce your deduction by certain interest payments you make. These rules prevent a double deduction of the same amount as both investment interest and a charitable contribution.

Second, if the debt is assumed by the recipient (or another person), you must reduce the fair market value of the property by the amount of the outstanding debt.

> If you sold the property to a qualified organization at a bargain price (discussed later), the amount of the debt is also treated as an amount realized on the sale or exchange of property.

Partial interest in property. Generally, you cannot deduct a charitable contribution (not made by a transfer in trust) of less than your entire interest in property. A contribution of the right to use property is a contribution of less than your entire interest in that property, and is not deductible.

There are important exceptions to this rule. You can deduct a charitable contribution of a partial interest in property if that interest fits one of the following categories:

1. A remainder interest in your personal home or farm. A remainder interest is one that passes to a beneficiary after the end of an earlier interest in the property.

> **Example:** You keep the right to live in your home during your lifetime and give your church a remainder interest that begins upon your death.

2. An undivided part of your entire interest. This must consist of a part of every substantial interest or right you own in the property and must last as long as your interest in the property lasts.

> **Example:** You contribute voting stock to a qualified organization but keep the right to vote the stock. The right to vote is a substantial right in the stock. You have not contributed an undivided part of your entire interest and cannot deduct your contribution.

Where it's an undivided interest in tangible personal property (defined below) the donee must have possession of the property for a part of the year consistent with its interest in the property. Special rules apply for contributions after August 17, 2006, of further undivided interests in the same property by the same donor. And, for contributions after August 17, 2006, of undivided interests in tangible personal property, the deduction is "recaptured" if the donee doesn't get all of the donor's interest in the property by the earlier of 10 years from the first gift or the donor's death. "Recapture" means the deduction is added back to the donor's income (say, in the 11th year), with interest due from the year of contribution and a tax penalty of 10 percent of the recaptured income.

3. A partial interest that would be deductible if transferred in trust.

4. A qualified conservation contribution (as specifically defined in the tax law).

Fractional Interest in Tangible Personal Property. A fractional interest in property is an undivided portion of your entire interest in the property. You cannot deduct a charitable contribution of a fractional interest in tangible personal property unless all interests in the property are held immediately before the contribution by you or you and the qualifying organization receiving the contribution.

Qualified Conservation Contribution. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization such as a governmental unit or publicly supported charitable, religious, scientific, literary or educational organization that is to be used only for conservation purposes.

The organization also must have a commitment to protect the conservation purposes of the donation and must have the resources to enforce the restrictions. Conservation purposes are defined as:

- Preserving land areas for outdoor recreation by, or for the education of, the general public.
- Protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem.
- Preserving open space, including farmland and forest land, if it yields a significant public benefit. It must be either for the scenic enjoyment of the general public or under a clearly defined federal, state, or local governmental conservation policy.
- Preserving a historically important land area or a certified historic structure.

If a building in a registered historic district is a certified historic structure, a contribution of a qualified real property interest that is an easement or other restriction on the exterior of the building is deductible only if it meets all of the following three conditions:

Future interest in tangible personal property. You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or a related organization.

Related persons include your spouse, children, grandchildren, brothers, sisters, and parents. Related organizations may include a partnership or corporation that you have an interest in, or an estate or trust that you have a connection with.

Tangible personal property. This is any property, other than land or buildings, that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars.

Future interest. This is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

> **Example:** You own an antique car that you contribute to a museum. You give up ownership, but retain the right to keep the car in your garage with your personal collection. Since you keep an interest in the property, you cannot deduct the contribution. If you turn the car over to the museum in a later year, giving up all rights to its use, possession, and enjoyment, you can take a deduction for the contribution in that later year.

Inventory. If you contribute inventory (property that you sell in the course of your business), the amount you can claim as a contribution deduction is the smaller of its fair market value on the day you contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that you would otherwise include in your opening inventory for the year of the contribution. You must remove the amount of your contribution deduction from your opening inventory. It is not part of the cost of goods sold.

If the cost of donated inventory is not included in your opening inventory, the inventory's basis is zero and you cannot claim a charitable contribution deduction. Treat the inventory's cost as you would ordinarily treat it under your method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year.

A special rule applies to donations of food inventory (see *Food Inventory* below)

Patents and Other Intellectual Property. If you donate a patent or other intellectual property to a qualified organization, your deduction is limited to the basis of the property or the fair market value of the property, whichever is less. After the legal life of the patent or other intellectual property ends, or after the 10th anniversary of the donation, no additional deduction is allowed. Also, additional deductions cannot be taken for patents or other intellectual property donated to certain private foundations. Intellectual property means any of the following:

- Patents.
- Copyrights (other than a copyright described in Internal Revenue Code sections 1221(a)(3) or 1231(b)(1)(C)).
- Trademarks.
- Trade names.
- Trade secrets.
- Know-how.
- Software (other than software described in Internal Revenue Code section 197(e)(3)(A)(i)).
- Other similar property or applications or registrations of such property.

Donating Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it (generally, less than what you paid for it), your deduction is limited to its fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

Common examples of property that decreases in value include clothing, furniture, appliances, and cars.

Donating Property That Has Increased in Value

If you contribute property with a fair market value that is more than your basis in it, you may have to **reduce the fair market value** by the amount of appreciation (increase in value) when you figure your deduction.

Again, your basis in property is generally what you paid for it. Different rules apply to figuring your deduction, depending on whether the property is:

1. Ordinary income property, or

2. Capital gain property.

Ordinary Income Property

Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Equipment or other property used in a trade or business is considered ordinary income property to the extent of any gain that would have been treated as ordinary income under the tax law, had the property been sold at its fair market value at the time of contribution.

Amount of deduction. The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

> **Example:** You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Exception. Do not reduce your charitable contribution if you include the ordinary or capital gain income in your gross income in the same year as the contribution.

Capital Gain Property

Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. Capital gain property includes capital assets held more than 1 year.

Capital assets. Capital assets include most items of property that you own and use for personal purposes or investment. Examples of capital assets are stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes.

For purposes of figuring your charitable contribution, capital assets also include certain real property and depreciable property used in your trade or business and, generally, held more than 1 year.

Real property. Real property is land and generally, anything that is built on, growing on, or attached to land.

Depreciable property. Depreciable property is property used in business or held for the production of income and for which a depreciation deduction is allowed.

Amount of deduction - general rule. When figuring your deduction for a gift of capital gain property, you usually can use the **fair market value** of the gift.

However, in certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

This can happen where the charity's use of tangible personal property is not in connection with its exempt purpose. For contributions after September 1, 2006, of more than $5,000, the deduction is generally reduced to basis if the charity disposes of the property within 3 years of the donation. If disposition takes place after the donation, the appreciation (fair market value less basis) is recaptured as ordinary income in the year of the disposition (absent certification from the charity that use for its exempt purpose occurred or was intended). The charity must notify IRS and the donor of the disposition (and the certification, if applicable).

Ordinary or capital gain income included in gross income. You do not reduce your charitable contribution if you include the ordinary or capital gain income in your gross income in the same year as the contribution. This may happen when you transfer installment or discount obligations or when you assign income to a charitable organization.

Example: You donate an installment note to a qualified organization. The note has a fair market value of $10,000 and a basis to you of $7,000. As a result of the donation, you have a short-term capital gain of $3,000 ($10,000 - $7,000), which you include in your income for the year. Your charitable contribution is $10,000.

Food Inventory

Special rules apply to certain donations of food inventory to a qualified organization. These rules apply if all of the following conditions are met.

1. You made a contribution of apparently wholesome food from your trade or business. Apparently wholesome food is food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.
2. The food is to be used only for the care of the ill, the needy, or infants.
3. The use of the food is related to the organization's exempt purpose or function.
4. The organization does not transfer the food for money, other property, or services.
5. You receive a written statement from the organization stating it will comply with requirements (2), (3), and (4).
6. The organization is not a private non-operating foundation.
7. The food satisfies any applicable requirements of the Federal Food, Drug, and Cosmetic Act and regulations on the date of transfer and for the previous 180 days.

Bargain Sales

A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange.

The part of the bargain sale that is a sale or exchange may result in a taxable gain.

Penalty

The IRS may impose a penalty if you overstate the value or adjusted basis of donated property.

Charitable Contributions: How To Give Wisely

Since charities ask for larger and more frequent donations from the public these days, soliciting by mail, telephone, television, and radio, for example, they should be checked out before you donate money or time. Here are some tips on how to maximize your charity dollar and avoid scams.

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Here are some basic, common-sense suggestions for avoiding rip-offs in making charitable contributions:

- Do not contribute cash. All contributions should be in the form of a check or money order made out to the charity never to the individual soliciting the donation.

- Do not be misled by a charity that resembles or mimics the name of a well-known organization--all charities should be checked out.
- Ignore pressure to donate immediately. Wait until you are sure that the charity is legitimate and deserving of a donation.
- When appropriate, ask for written descriptions of the charity's programs and/or finances, especially if the intended contribution is substantial.
- If you have any doubt about the legitimacy of a charity, check it out with the local charity registration office (usually a division of the state attorney's general office) and with the Better Business Bureau (BBB).

You should, of course, keep receipts, canceled checks and bank statements so you will have records of your charitable giving at tax time.

Giving Your Time

Volunteering your time can be personally rewarding, but it is important to consider the following factors before committing yourself:

- Make sure you are familiar with the charity's activities. Ask for written information about the charity's programs and finances.
- Be aware that volunteer work may require special training and the devotion of a scheduled number of hours each week to the charity.
- If you are considering assisting with door-to-door fund-raising, be sure to find out whether the charity has financial checks and balances in place to help ensure control over collected funds.

Although the value of your time as a volunteer is not deductible, out-of-pocket expenses (including transportation costs) are generally deductible.

Mail Solicitations

Many charities use direct mail to raise funds. While the overwhelming majority of these appeals are accurate and truthful, be aware of the following:

- The mailing piece should clearly identify the charity and describe its programs in specifics. If a fund-raising appeal brings tears to your eyes but tells you nothing about the charity's functions, investigate it carefully before responding.
- It is against the law to demand payment for unsolicited merchandise-e.g., address labels, stamps, bumper stickers, greeting cards, calendars, and pens. If such items

are sent to you with an appeal letter, you are under no obligation to pay for or return them.

- Appeals that include sweepstakes promotions should disclose that you do not have to contribute to be eligible for the prizes offered. To require a contribution would make the sweepstakes illegal as a lottery operated by mail.
- Appeals that include surveys should not imply that you are obligated to return the survey.
- Beware of fund-raising appeals that are disguised as bills or invoices. It is illegal to mail a bill, invoice or statement of account that is, in fact, an appeal for funds unless it has a clear and noticeable disclaimer stating that it is an appeal and that you are under no obligation to pay unless you accept the offer.

> Deceptive-invoice appeals are most often aimed at businesses, not individuals. If you receive one of these, contact your local Better Business Bureau.

Public Education Solicitations

If you respond to mail appeals, you should be aware that certain charities consider this to be a significant part of their educational budgets. In a recent survey, half of 150 well-known national charities included their direct mail and other fund-raising appeals in their public education programs. This practice makes fund-raising drives look like a smaller part of a charity's expenses than they are. These 75 charities allocated $160 million of their direct mail and other appeal costs to public education programs.

> A charity whose purpose is to combat cruelty to animals uses direct mail to raise funds. The cost of a nationwide direct mail campaign is $1 million much more than the $200,000 the charity has budgeted for its program of research grants. This embarrassingly high allotment for fund-raising costs can be significantly reduced if the direct mail pieces include some information about cruelty to animals. Since the information is considered educational, the charity calls it a program expense and allots half the cost of the mailing to public education, thus reducing fund-raising expenses from $1 million to only $500,000, and bumping up program spending from $200,000 to $700,000.

The line between pure fund-raising and genuine public education activities is not always clear. However, if the charity is confident that the fund-raising appeal truly serves its educational purposes, it should be willing to disclose this fact in the appeal. This disclosure allows donors to make an informed decision about whether to support the activity.

Telephone, Door-To-Door, And Street Solicitations

When you are approached for a contribution of time or money, ask questions - and do not give until you are satisfied with the answers. Charities with nothing to hide will encourage your interest. Be wary of any reluctance to answer reasonable questions.

- Ask for the charity's full name and address. Demand identification from the solicitor.
- Ask if the contribution is tax-deductible.
- Ask if the charity is licensed by state and local authorities. Registration or licensing is required by most states and some local governments.

  Contributions to tax-exempt organizations are not always tax-deductible.

  Registration, by itself, does not mean that the state or local government endorses the charity.

- Do not give in to pressure to make an immediate donation or allow a runner to pick up a contribution.
- Statements such as "all proceeds will go to charity" may mean money left after expenses, such as the cost of fund-raising efforts, will go to the charity. These expenses can be big ones, so check carefully.
- When asked to buy candy, magazines, or tickets to benefit a charity, be sure to ask what the charity's share will be. Sometimes the organization will receive less than 20 percent of the amount you pay.
- If a fund raiser uses pressure tactics- intimidation, threats, or repeated and harassing calls or visits-call your local Better Business Bureau to report the actions.

Sweepstakes Appeals

Sweepstakes mailings, used by businesses for many years to promote their products, have recently become popular with charities. Here are some points to consider when reviewing a sweepstakes appeal.

- The sweepstakes mailing should clearly disclose that no contribution is necessary to participate.
- * If you wish to participate, read the sweepstakes promotion and direct mail contents carefully. Your entry may be discarded if the rules are not followed to the letter.If the charity sweepstakes promotion says you are a pre-selected winner, you will usually receive a prize only if you respond to the sweepstakes. Most "pre-selected winners" receive just pennies per person.

- Both donor and non-donor sweepstakes participants must have an equal chance of winning a prize.

For a national campaign, the probability of winning the big prize may be quite low. Some campaigns involve mailings of a half-million to ten million or more letters.

If you are considering a donation, check out the appeal as you would any other request for funds. Does it clearly specify the programs your gift would be supporting? Do not hesitate to ask for more information on the charity's finances and activities.

Charity Thrift Stores

Since all charity thrift stores do not necessarily operate the same way, it is important to find out if the charity is benefiting from thrift sales. There are three major types of thrift store operations:

- *Conduit-type shops run by volunteer church and civic groups.* These thrift stores generally distribute most of their proceeds to various charitable organizations, often community-based.
- Thrift operations are represented by service organizations such as *The Salvation Army and Goodwill Industries.* Here, the thrift stores are operated as part of their program activities through the goal of "rehabilitation through employment."
- *Charities that collect and sell used merchandise to raise funds for their own use.* This arrangement is popular for a number of veterans organizations and other charities. Such arrangements generally work one of two ways: (1) the charity owns and operates the store or (2) more commonly, variously charities solicit and collect used items, which are then sold to independently managed stores for an agreed-upon amount.

The fair market value of goods donated to a thrift store is deductible as a charitable donation, as long as the store is operated by a charity. To determine the fair market value, visit a thrift store and check the going rate for comparable items. If you are donating directly to a for-profit thrift store or if your merchandise is sold on a consignment basis whereby you get a percentage of the sale, the thrift contribution is not deductible.
Remember to ask for a receipt that is properly authorized by the charity. It is up to the donor to set a value on the donated item.

If you plan to donate a large or unusual item, check with the charity first to determine if it is acceptable.

If you are approached to donate goods for thrift purposes, ask how the charity will benefit financially. If the goods will be sold by the charity to a third party such as an independently managed thrift store, then ask what the charity's share will be.

Sometimes the charity receives a small percentage, e.g., 5 to 20 percent of the gross or a flat fee per bag of goods collected.

Fund-Raising Dinners, Variety Shows, And Other Events

Dinners, luncheons, galas, tournaments, circuses, and other events are often put on by charities to raise funds. Here are some points to consider before deciding to participate in such events.

- Check out the charity. The fact that you are receiving a meal or theater tickets should not justify less scrutiny.
- Your purchase of tickets to such events is generally not fully deductible. Only the portion of your gift above the fair market value of the benefit received (i.e., the meal, show, etc.) is deductible as a charitable donation. This rule holds true even if you decide to give your tickets away for someone else to use.

If you decide not to use the tickets, give them back to the charity. In order to be able to deduct the full amount paid, you must either refuse to accept the tickets or return them to the charitable organization. In this way, you will not have received value for your payment.

Make donations by check or money order out to the full name of the charity and not to the sponsoring show company or to an individual who may be collecting donations in person.

- Watch out for statements such as "all proceeds will go to the charity." This can mean the amount after expenses have been taken out, such as the cost of the production, the fees for the fund-raising company hired to conduct the event, and other related expenses. These expenses can make a big difference and sometimes result in the charity receiving 20 percent or less of the price paid.

Ask the charity what anticipated portion of the purchase price will benefit the organization.

- Solicitors for some fund-raising events such as circuses, variety shows, and ice skating shows may suggest that if you are not interested in attending the event you can purchase tickets that will be given to handicapped or underprivileged children. If such statements are made, ask the solicitor how many children will attend the event, how they will be chosen, how many tickets have been already distributed to these children, and if transportation to the event will be provided for them.

  It has happened that the number of children eligible to receive free tickets has been limited or transportation has not been arranged. So, in effect, free tickets given to the few needy children who attend the event are paid for many times over by businesses and individuals who purchase tickets.

Charity-Affinity Credit Cards

You may receive an offer to apply for an affinity credit card bearing the name and logo of a particular charity. Sometimes offered exclusively to an organization's donors or members, these cards are issued by banks and credit card companies under agreements worked out with individual charities. These cards are just like other credit cards, but the specified charity gets some kind of financial benefit.

All affinity credit cards are not created equal. Offers vary in terms of how the charity benefits as well as the terms of the credit agreement with consumers. So check the terms carefully!

> Consider the specific terms as you would any credit card offer: the amount of the interest rate/finance charges, the amount of the annual fee, if any, the amount of late fees and over-the-limit fees, if any, and the length of the grace period, or amount of time after which finance charges begin to accrue on any unpaid balance.

The charity usually receives a benefit in one or more of the following ways:

- The charity receives a certain percentage of each purchase or a specified amount every time the consumer makes a purchase with the card,
- The charity receives a certain dollar amount every time a new customer signs up for a card, or
- The charity receives a portion of the annual renewal fee for the card.

  Make sure the promotional literature states exactly how the charity benefits. For example, one affinity card offer declared that a specified national charity would receive half of one percent of all transactions made with the card (that works out to 5 cents for every $10 worth of purchases). If the financial benefit for the charity is not spelled out, then ask.

Contributions made by a bank and/or credit card company through the use of an affinity credit card are not deductible to consumers as charitable donations for federal income tax purposes.

Remember also to consider your interest in the charity and not to hesitate to seek out more information on the charity's programs and finances.

If saving money is your bottom line, make a direct donation to the charity and seek a credit card with the best terms and lowest interest rates, regardless of affinity.

Charity/Business Marketing

The following points should be kept in mind when considering promotions that partner charities and businesses:

1. Charity/business marketing campaigns should clearly disclose the actual or estimated portion of the purchase price that will benefit the specified cause. Without such information, you cannot know how much of your purchase will aid a charity participating in such a campaign.
2. Read the disclosure carefully. Some charity/business marketing campaigns have an expiration period (for example, ten cents goes to the charity for all purchases made until October 31.) If there is no disclosure, be aware that the amount that goes to the charity is usually between one and ten percent of the retail price.
3. In schemes during the Gulf War, businesses made no arrangements with the named charity and no contributions were given. Various items and services were sold with the false promise that a donation would be made to the USO or other organizations helping members of the armed services or their families. Similar advertising abuses commonly occur in the wake of hurricanes, floods and other natural disasters.
4. Some advertisements falsely imply the existence of a direct connection between the consumers' purchase and the charity when, in fact, the charity was guaranteed a "flat" contribution regardless of the level of the resulting purchases.

Disaster Appeals

The tragedy of a flood, massive fire, hurricane, earthquake, or another disaster always triggers an outpouring of public support and concern. During such crises, watch out for fraudulent appeals by some who see disasters as an opportunity to take advantage of American concern and generosity.

Examine your options instead of giving to the first charity from which you receive an appeal. There will be a variety of relief efforts responding to the diverse needs of disaster victims. Be wary of appeals that are long on emotion and short on what the charity will do to address the specific disaster.

> Ask how much of your gift will be used for the crisis and how much will go towards other programs and to administrative and fund-raising costs. And find out what the charity intends to do with any excess contributions remaining after the crisis has ended.

Check with organizations before donating goods for overseas disaster relief. Most groups involved in overseas relief will not accept donated goods since purchasing goods overseas is often less expensive and more efficient. If a charity accepts donated items, ask about their arrangements for shipping and distribution.

Some charities change their program focus during a crisis in order to respond to the changing needs of disaster victims. Do not assume the charity will carry out the same activities throughout a crisis situation.

Police And Firefighter Appeals

In reviewing such appeals, potential donors should be aware of the following points.

- Many different types of police and firefighter organizations exist. Some are charities that operate educational or youth programs. Others are labor organizations, fraternities, or benevolent associations that provide benefits to members.
- Your gift may not be deductible. Police and firefighter organizations can be tax exempt under different sections of the Internal Revenue Code. Only some of them are eligible to receive deductible charitable donations.
- Do not make assumptions based on the name alone. The words "police" and "firefighter" in the organization's name do not necessarily mean that representatives from your local and/or state police or fire departments are members. In fact, the organization may not have any police or firefighter members.
    - Ask about any affiliations the group might have with other organizations. Some groups operate as a lodge or chapter of a larger organization.

Others are independent associations of local, state, and/or federal law enforcement officers.
- Do not believe promises that your donation will "give you special treatment" from your police or firefighters. If such suggestions of threats are used, contact your state attorney general's office and your Better Business Bureau.
- Ask how your contribution will be used and what programs and activities it will support. Do not hesitate to ask for written materials on the police or firefighter group's programs and finances.
- Groups offering legitimate help to your police, firefighters, and community will welcome your questions and encourage your interest.

Child Sponsorship Groups

Not all sponsorship programs are alike. Sponsored donations usually benefit a project for an entire community (for example, medical care, education, food) and not the sponsored child exclusively. Some groups believe this is the most effective way to make significant and lasting changes in a child's living conditions. Other organizations do give a certain amount of the contribution directly to the sponsored child. Before deciding to participate in a sponsorship program, you may want to consider the following:

- Do you know how children are assisted (i.e., through a community development project operated by the charity or through an affiliated project that the group funds)?
- Can you commit at least several years to a program in the form of financial assistance and letter-writing?
- The child will not be your adopted child in any legal sense, and you will not be able to make any demands on him or her.
- Do you agree with the overall philosophy of the organization (e.g., any religious focus a program might have)?

Contact other child sponsors to get a sense of their overall satisfaction with the organization.

A Charity's National Office and Its Affiliates

While some organizations are a single entity under one name, others may be a network of local affiliates or chapters. If you give to a local chapter or affiliate, do not assume your donation will be spent locally. Nor should you assume that a chapter's operations are fully controlled by the national office.

Many different types of relationships can exist between a charity's national office and its chapters. Here are three possible relationships chapters:

1. The national office performs certain functions, such as developing educational or fund-raising materials but does not supervise affiliates. In this case, the local chapters are incorporated separately from the national office and each applies for its own tax-exempt status from the IRS. Each local chapter's programs and fund-raising is under the control of the chapter's local board of directors. To support the national office, the local affiliates purchase materials produced by it or send it a small percentage of their locally collected funds.
2. The organization's national office and affiliates function as one centralized unit under the control of a national board of directors. All income and expenses are channeled through the national office. In this case, the chapters are not separate legal entities and have only limited authority, as stated in their charter agreements with the national office.
3. Most national/chapter relationships fall somewhere between the two extremes in the preceding two paragraphs. In such a case, both the national office and the local affiliates share some level of authority. Local chapters may or may not be separately incorporated, but all have their own governing boards, some of which share control with the national office. The charity may have statewide affiliates that perform functions at the state level. With this structure, there is usually a fund sharing or dues formula between the local affiliates and the national office.

The bottom line for you is that, depending on the organization's structure, the local affiliate may carry out different activities from those of the national office. It is important to inquire about this difference. In addition, donors may want to identify how much of a local affiliate's contributions are spent on local programs.

When considering a donation to a local chapter, it is wise to check out the chapter separately.

Government and Non-Profit Agencies

- Most state governments regulate charitable organizations. To obtain information on these regulations, which vary from state to state, contact the appropriate government agency (usually a division of the Attorney General or the Secretary of State).

- Contact the appropriate state government agency to verify a charity's registration and to obtain financial information on a soliciting charity.
- Contact your local Better Business Bureau to find out whether a complaint has been lodged against a charity.