Registered Tax Return Preparer Exam Study Guide

Accompaniment to the RTRP Exam Simulator Course
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Exam Overview

On Friday, Jan. 18, 2013, the United States District Court for the District of Columbia enjoined the Internal Revenue Service from enforcing the regulatory requirements for registered tax return preparers. In accordance with this order, tax return preparers covered by this program are not required to complete competency testing. As of the date of this publication, the administering of the RTRP exam has been suspended indefinitely pending the court case. Paid preparers may still take continuing education related to the RTRP exam for CE credit, but the actual test is not available. For more details, visit www.irs.gov/for-Tax-Pro.

The Registered Tax Return Preparer (RTRP) Exam is designed to identify individuals who meet minimum competency to preparer 1040-series tax returns. The IRS has undergone significant efforts to develop questions based on general tax rules covered in the IRS publications.

This study guide, along with the exam simulator course, will help you become proficient in passing the test should it become available.

To assist in test preparation, the following is a list of recommended by the IRS as study materials. This list is not all-encompassing, but a highlight of what the test candidates will need to know.

- Form 1040
- Form 1040 Instructions
- Publication 17: Your Federal Income Tax
- Circular 230 (Rev. 8-2011): Regulations Governing Practice Before the Internal Revenue Service
- Publication 334: Tax Guide for Small Business
- Publication 970: Tax Benefits for Education
- Form 6251: Alternative Minimum Tax – Individuals
- Form 6251 Instructions
- Form 8879: IRS e-File Signature Authorization
- Publication 596: Earned Income Credit
- Form 8867: Paid Preparers Earned Income Credit Checklist
- Form 2848 (Rev. October 2011): Power of Attorney and Declaration of Representative
- Form 2848 Instructions (Rev. October 2011)
- Form 8821 (Rev. October 2011): Tax Information Authorization
Actual Exam Day

On the exam day, you should arrive at least 30 minutes before your scheduled time. Bring an official government-issued photo ID containing your signature. Personal items are NOT allowed in the exam area and must be stored in a locker. You may want to bring a light jacket or sweater with you.

The following three reference materials will be the only items accessible electronically during the exam:

- Publication 17
- Form 1040
- Form 1040 instructions

Test Tips and Strategies

You will be successful in passing the exam if you adequately prepare and effectively execute your knowledge during the exam.

The exam covers seven major areas, which are also known as IRS domains. The exam coverage will be broken down as follows:

Domain 1: Preliminary Work and Collection of Taxpayer Data-15%
Domain 2: Treatment of Income and Assets-22%
Domain 3: Deductions and Credits-22%
Domain 4: Other Taxes-11%
Domain 5: Completion of the Filing Process-10%
Domain 6: Practices and Procedures-5%
Domain 7: Ethics-15%
Follow these tips:

1) **Become very familiar with Publication 17.** The exam **DOES** expect for you to know form numbers and threshold or qualifying amounts for certain deductions and credits. Use the Publication 17 index hyperlinks wisely. The test simulator you purchased is designed to help you become acclimated with looking up pertinent data on Publication 17. We highly suggest you utilize the test simulator’s hints to look up answers. Doing so will train you in become adept in navigating Publication 17 quickly.

2) Try to determine the correct answer and eliminate incorrect answers that are obviously wrong.

3) Manage the clock. Do not become ‘stuck’ on a question.

4) Guess if necessary. Do not leave any blank answers. Blank answers will be counted as wrong.

5) Practice exam questions. The best way to prepare for the actual test is to take practice tests that mimic exam conditions.

**Exam Details**

**Number of RTRP Test questions**

The Registered Tax Return Preparer competency test contains 120 questions, 100 scored questions, and 20 experimental questions in multiple-choice and true or false format. You will have 2.5 hours to complete the test.

**Exam Time Limit**

The actual test will be limited to 2 ½ hours. You may take an optional pre-test computer system tutorial.

**Experimental Questions**

The RTRP test will include 20 experimental questions. These questions are the source for future test questions. These questions do not count as part of your score, but you will not be told which questions they are. Since you will not know which questions are experimental, try your best on every question.

**RTRP Test scores**

You will receive a notice at the end of your test indicating that you have completed the test. Printed test results will be provided immediately following the test. Scaled scores are determined by calculating the number of questions answered correctly from the total number of questions in the test and converting to a scale that
ranges from 50 to 500. Some test questions may be weighted. The IRS has set the scaled passing score at 350, which corresponds to a minimum level of knowledge deemed acceptable for the tasks performed by a minimally competent Registered Tax Return Preparer.

**Privacy of Test Scores**

Individual test results are confidential and the IRS will not reveal your results to anyone but you. NO ONE knows your score except the IRS and the candidate.
Disclaimer

This publication is intended for educational purposes and to provide accurate and authoritative information in regard to the subject matter covered. This publication is not intended to render any legal, accounting, or professional advice. If legal advice or other expert advice or service is required, a competent professional should be sought.

The author and affiliated parties are not legally bound by this text, any accompanying electronic media, or lecture in the rendering of legal, tax, accounting, or similar professional services. While the legal, tax, and accounting issues discussed in this material have been reviewed with sources believed to be reliable, concepts discussed can be affected by changes in the law or in the interpretation of such laws since this text was printed. For that reason the accuracy and completeness of this information and the author's opinions based thereon cannot be guaranteed. In addition, state or local tax laws and procedural rules may have a material impact on the general discussion. As a result, the strategies suggested may not be suitable for every individual. Before taking any action, all references and citations should be checked and updated accordingly.

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Domain 1
1. **Review prior year’s return for accuracy, comparison, and carryovers for current year return.**

   Preparers should exercise care and review the client’s prior-year tax return for carryovers (i.e. depreciation, NOL, and capital loss carryforwards).

   If the client is new, the preparer should request at least one prior year tax return. Carryforwards, such as prior depreciation, capital loss, and NOLs need to be accurately accounted for on the current return.

   Every return must be complete and accurate. Check the prior return to ensure the following:

   - Use of correct forms. There are many forms that may be used. Be sure that each entry has the associated corresponding schedule (when applicable). If carryforwards are present, they should be presented on the current return.
   - Each entry contains accurate and correct information.
   - Each form used must be complete. Data contained on each form should be consistent across all forms.
2. Collect taxpayer’s biographical information (e.g., date of birth, age, marital status, citizenship, dependents)

The taxpayer's personal biographic information must be accurate and complete.

**Name**
If the taxpayer’s name has legally changed, the name change should be reported to the Social Security Administration before the tax return is filed. The name reported to the IRS should match the Social Security Administration's information.

**Date of Birth**
Although the taxpayer's date of birth is not directly input on the return, it is needed to determine certain calculations such as the additional standard deduction for those who are 65 and over. For tax purposes, the taxpayer’s age is calculated using the day before his birthday.

Example: Sonny was born on January 1, 1947. He is considered to be age 65 on December 31, 2011.

**Marital Status**
The taxpayer’s marital status is determined based on the last day of the year (e.g. if a client is becomes legally married on December 31, 2012, he is considered married for tax year 2012).

**Citizenship**
In most cases, U.S. citizens or resident aliens living abroad must file a tax return. The type of tax return to file is dependent upon whether the alien taxpayer is considered to be a resident alien, nonresident alien, or dual-status taxpayer. IRS

3. Determine filing status

Filing status is based on marital status and family situation. If a person qualifies for more than one filing status, he should generally choose the most advantageous tax status.

The five filing statuses are single, head of household, qualifying widow(er) with dependent child, married filing jointly, and married filing separately.

a. **Single** persons are those who are unmarried, legally separated, divorced, or who do not qualify for another filing status.

The **unmarried** status refers to any individual who is not legally married as of the last day of the tax year.

**Annulled** marriages that are court decreed will result in a status of unmarried. If joint returns were filed for previous years, amended returns must be filed for the tax years affecting the annulment unless they are closed by the statute of limitations, which usually is 3 years after the tax year closes.
**Divorced** persons are those who were divorced as of the last day of the tax year and are, therefore, considered unmarried (divorced) for the whole year.

- Individuals who divorce and then remarry for the purpose of gaining a better tax rate must file as married individuals.

**b. Head of Household**

The taxpayer must be unmarried and pay more than half the cost of maintaining a home for himself and another person who lives with the taxpayer for over half the year (unless the qualifying person is a parent who does not have to live with the taxpayer). The qualifying person for whom the taxpayer maintains a home must be qualified to be claimed as a dependent. A qualifying relative may be the taxpayer’s son, daughter, grandchild, or sibling who lived with the taxpayer for more than half the year.

*Note:* If the taxpayer’s son or daughter is married and the taxpayer cannot claim an exemption for the child, the daughter/son is not a qualifying person.

*Note:* If the taxpayer cannot claim an exemption for the taxpayer’s parent, the parent is not a qualifying person.

c  **Qualifying Widow(er) with Dependent Child** The taxpayer may be eligible to use qualifying widow(er) with dependent child as his filing status for two years following the year his spouse died. For example, if the spouse died in 2011 and the taxpayer has not remarried, he may be able to use the qualifying widow(er) filing status for 2012 and 2013. Note that in the year of the spouse’s death, if the taxpayer qualifies, he may file using the married filing jointly status.

The married filing jointly status entitles the taxpayer to use joint-return tax rates and the highest standard deduction amount (if he does not itemize deductions).

d. **Married Filing Jointly** (MFJ) Taxpayers can choose married filing jointly as their filing status if they are married and both spouses agree to file a joint return. They should report their combined income on the tax return and deduct their combined allowable expenses. They can file a joint return even if one of the spouses has no income or deductions.
If the taxpayers decide to file a joint return, their tax may be lower than their combined tax for the other filing statuses. Also, the standard deduction (if they do not itemize deductions) may be higher, and they may qualify for tax benefits that do not apply to other filing statuses.

e. **Married Filing Separately (MFS)** Taxpayers can choose the married filing separately even if they are married. The MFS filing status generally provides fewer tax benefits than filing joint returns because MFS taxpayers are ineligible to claim the following tax benefits:

- Tuition and fees deduction
- Hope, Lifetime Learning Credit, or American Opportunity Credit
- Student loan interest deduction
- Tax-free exclusion of US bond interest
- Tax-free exclusion of Social Security Benefits
- Credit for the Elderly and Disabled
- Child and Dependent Care Credit
- Earned Income Credit

If one MFS taxpayer claims the standard deduction, the other spouse may not itemize. Both must either claim the standard deduction or both must itemize their deductions.

The MFS status tax rate will generally be higher joint tax return rate. The exemption amount for figuring the AMT will be half the amount that is allowed for a joint tax return. The following child tax credit and retirement savings contribution credits are reduced at income levels that are half of those for a joint return. In addition, the capital loss deduction limit is $1,500 (instead of $3,000 if you filed a joint return).

MFS taxpayers often choose this status to separate tax liabilities. By filing a separate tax return, the taxpayer is solely responsible for the accuracy and payment of taxes related to the separate tax return.
4. **Determine all sources of taxable and non-taxable income (e.g., wages, interest, business, sale of property, dividends, rental income, income from flow-through entities, alimony, government payments, and pension distributions).**

Amounts included in income are taxable unless specifically exempted by law. Taxable income must be reported on the tax return. Income that is nontaxable may have to be shown on the tax return even though it is not subject to tax.

**Constructively-received income**

The taxpayer is generally taxed on income that is available to him. Even though the income may not be in the taxpayer’s possession, it may be taxable.

Example: A valid check that the taxpayer received or that was made available to him before the end of the tax year is considered income constructively received in that year even if the taxpayer does not cash the check or does not deposit it to his account until the next year.

**Employee Compensation**

Generally, a taxpayer must include in gross income everything received in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options.

The taxpayer should receive a Form W-2 from his employer showing the pay he received for services.
**Rents from personal property**

If taxpayer rents out personal property such as equipment or vehicles, how he reports his income and expenses is generally determined by the following:

- Whether or not the rental activity is a business, and
- Whether or not the rental activity is conducted for profit.

Generally, if taxpayer’s primary purpose is income or profit and he is involved in the rental activity with continuity and regularity, the rental activity is a business. Rental activity is reported on Schedule E of the Form 1040.

**Partnership Income**

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items.

**Partner's distributive share defined**

The distributive share of partnership income, gains, losses, deductions, or credits generally is based on the partnership agreement. The taxpayer must report his distributive share of these items on the return whether or not they actually are distributed to him. However, the distributive share of the partnership losses is limited to the adjusted basis of the partnership interest at the end of the partnership year in which the losses took place.

**S Corporation Income**

In general, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's pro rata share. The taxpayer must report his share of these items on his return. The items passed through to the taxpayer will increase or decrease the basis of his S corporation stock as appropriate.

**Bartering**

Bartering is an exchange of property or services. The taxpayer must include in his income, at the time received, the fair market value of property or services received in bartering.
**Alimony**

Alimony received under a separate maintenance decree or written separation agreement entered into between the taxpayer and the spouse or former spouse is taxable. Do not include child support in the calculation of alimony income. Payments not required by a divorce decree or separation instrument do not qualify as alimony.

**Government payments**

Government payments received are generally taxable unless specifically exempt by law.

A common type of government payment is unemployment compensation. Unemployment compensation generally includes any amounts received under the unemployment compensation laws of the United States or of a state. It includes state unemployment insurance benefits and benefits paid to the taxpayer by a state or the District of Columbia from the Federal Unemployment Trust Fund. It also includes railroad unemployment compensation benefits, disability benefits paid as a substitute for unemployment compensation, trade readjustment allowances under the Trade Act of 1974, and unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974. Unemployment compensation does not include worker's compensation. Unemployment compensation received during the year should be included in income.

The taxpayer should receive Form 1099-G if unemployment compensation is received during the year.

**Pension Distributions**

Pension or annuity payments received are fully taxable if the taxpayer has no cost in the contract because one or more of the following situations apply:

- He did not contribute anything or is not considered to have contributed anything to the pension or annuity
- The taxpayer’s employer did not withhold contributions from his salary, or
- The taxpayer received all of his contributions (his basis) tax free in prior years

If after-tax dollars were contributed to the pension or annuity, the pension payments are partially taxable. Tax is not paid on the part of the payment that represents a return of the after-tax amount that was paid. This amount is considered the cost in the plan or investment and includes the amounts the taxpayer’s employer contributed that were taxable to the taxpayer when contributed. Partly taxable pensions are taxed under either the General Rule or the Simplified Method. If the starting date of the pension or annuity
payments is after November 18, 1996, the Simplified Method generally must be used to determine how much of the annuity payments are taxable and how much is tax free.

If the taxpayer receives pension or annuity payments before age 59 1/2, he may be subject to an additional 10% tax on early distributions. The additional tax does not apply to any part of a distribution that is tax free. There are also general exceptions to the additional tax, including the following:

- Distributions made as a part of a series of substantially equal periodic payments from a qualified plan that begins after separation from service
- Distributions made because of a total or permanent disability
- Distributions made on or after the death of the plan participant or contract holder and
- Distributions made from a qualified retirement plan after the participant’s separation from service and in or after the year he reached age 55

A summary of Taxable Income and Nontaxable Income can be found below:

**Taxable income**

- Compensation in return for service (fees, commissions)
- Gross income from business
- Gains from property dealings
- IRAs and pensions distributions
- Prizes and awards
- Interests, rents, royalties, and dividends from investments
- Alimony and separate maintenance payments
- Annuities and income from life insurance and endowment contracts
- Certain income from discharge of debt
- Distributed share of partnership gross income
- Cost of more than $50,000 of group-term life insurance purchased for employees
- Reimbursement of certain moving expenses
- Property transferred with service performance
- Certain Social Security and Tier 1 Railroad Retirement benefits

**Nontaxable income**

- Certain Social Security and Tier 1 Railroad Retirement benefits
- Certain death benefits
- Gifts and inheritances
- Interest on state and local bonds
- Compensation for injuries or sickness
- Amounts received under accident and health plans
- Contributions by employer to accident and health plans
- Rental value of parsonages
- Contributions to a corporation’s capital
- Certain combat zone compensation of members of the Armed Forces
- Most meals or lodging furnished by the employer (foreign housing may be taxable if it is above the annual exclusion amount).
- Certain fringe, foster care, and military benefits
- Income from US savings bonds used to pay higher education tuition and fees
- Adoption assistance programs
- Disaster relief programs
5. **Determine applicable adjustments to gross income (e.g., self-employed health insurance, self-employment tax, student loan interest deduction, alimony paid, tuition, and fees deduction).**

Some deductions are not itemized on a separate schedule; rather, these deductions appear directly on the tax return and “adjust” or reduce the taxpayer’s income to arrive at adjusted gross income.

The following are common “above-the-line” adjustments to income:

**Self-employed health insurance deduction**

Self-employed individuals paying for medical, dental or long-term care insurance may be eligible for special tax deduction insurance premiums paid for the taxpayer, his spouse, and eligible dependents. For self-employed individuals filing a Schedule C, C-EZ, or F, the policy can be either in the name of the business or in the name of the individual. This deduction is no longer allowed on Schedule SE (Form 1040), but you can still take it on Form 1040, line 29.

The taxpayer must be one of the following to qualify:

- A self-employed individual with a net profit reported on Schedule C (Form 1040), Profit or Loss From Business, Schedule C-EZ (Form 1040), Net Profit From Business, or Schedule F (Form 1040), Profit or Loss From Farming.
• A partner with net earnings from self-employment reported on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., box 14, code A.

• A shareholder owning more than 2 percent of the outstanding stock of an S corporation with wages from the corporation reported on Form W-2, Wage and Tax Statement.

Health savings account deduction

Health savings accounts (HSA) are tax-deductible savings plans that allow a taxpayer to save pre-tax dollars for future healthcare expenses. HSA are paired with high-deductible health insurance plans. Contributions to an HSA are tax-deductible.

• For 2012, the HSA Contribution limit is $3,100 for individual coverage, and $6,250 for family coverage. A $1,000 additional catch-up contribution is available for taxpayers age 55 or older.

• For 2011, the HSA Contribution limit was $3,050 for individual coverage and $6,150 for family coverage. A $1,000 catch-up contribution was available for taxpayers age 55 or older.

Self-employment tax

Self-employment tax (SE tax) consists of Social Security and Medicare taxes primarily for individuals who work for themselves. The tax is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners. This tax is calculated using Schedule SE of Form 1040. The employer-equivalent portion the SE tax is an above-the-line deduction.

Student loan interest deduction

Taxpayers may be able to deduct interest paid on a qualified student loan. Generally, the amount that may be deducted is the lesser of $2,500 or the amount of interest actually paid.

The deduction is claimed as an adjustment to income. The deduction may be claimed if all of the following apply:

• The taxpayer paid interest on a qualified student loan during the tax year
• The taxpayer has a legal obligation to pay interest on a qualified student loan
• The filing status of the taxpayer is NOT married filing separately
• The taxpayer’s modified adjusted gross income is less than a specified amount which is set annually, and
• The taxpayer and his spouse, if filing jointly, cannot be claimed as dependents on someone else's return

**Alimony paid**

The taxpayer may deduct from income the amount paid for alimony or separate maintenance.

Amounts paid under divorce or separate maintenance decrees or written separation agreements entered into between the taxpayer and his spouse or former spouse will be considered alimony for federal tax purposes if the following apply:

• The taxpayer and his spouse or former spouse do not file a joint return with each other;
• Payments are paid in cash (checks or money orders are considered cash);
• The payment is received by (or on behalf of) the spouse or former spouse;
• The divorce or separate maintenance decree or written separation agreement does not say that the payment is not alimony. If legally separated under a decree of divorce or separate maintenance, the taxpayer and his former spouse are not members of the same household when the alimony payment is made;
• The taxpayer has no liability to make the payment (in cash or property) after the death of his spouse or former spouse, and the alimony payment is not treated as child support or a property settlement.
6. Determine standard deduction and Schedule A itemized deductions (i.e., state and local tax, real estate tax, cash contributions, non-cash contributions, unreimbursed employee expense(s), medical expense(s), and mortgage interest).

The taxpayer may choose to reduce his taxable income by tax deductions. He can choose between taking a standard deduction, or he may itemize his deductions.

The standard deduction amount depends on the taxpayer’s filing status. As an example, if a taxpayer files with a single status in 2012, his standard deduction would be $5,950 (2011 standard deduction was $5,800). If the taxpayer is 65 or older and/or blind, he would be eligible for an additional standard deduction.

After interviewing the client, the paid preparer should determine if the standard deduction is higher than certain itemized deductions. The most common itemized deductions are as follows:

- state and local taxes
- real estate taxes
- cash and non-cash charitable contributions
- unreimbursed employee expenses
- medical expenses
- mortgage interest.

Details of the above-referenced itemized deductions can be found under Domain 3 of this study guide, Section A, Itemized Deductions.
7. Determine applicable credits (e.g., earned income tax credit, child tax credit, education, retirement savings, dependent and child care credit).

A. Earned Income Tax Credit

The preparer should determine whether the taxpayer is eligible for the earned income tax credit by knowing the main EIC rules. To qualify for the earned income tax credit, the following rules must be met:

To qualify for Earned Income Tax Credit or EITC, you and your spouse if married and filing a joint return, must meet all of the following rules:

1. Have a valid Social Security Number
2. Have earned income from employment, self-employment or another source
3. Cannot use the married, filing separate filing status
4. Must be a U.S. citizen or resident alien all year or a nonresident alien married to a U.S. citizen or resident alien and choose to file a joint return and be treated as a resident alien
5. Cannot be the qualifying child of another person
6. Cannot file Form 2555 or 2555-EZ (related to foreign earned income)
7. Adjusted Gross Income and earned income must be under certain limits
8. Your investment income must meet or be less than certain annual limits

Additional details on the earned income credit may be found in Domain 3 of this study guide.

B. Child Tax Credit

The Child Tax Credit is a nonrefundable (tax cannot go below zero) tax credit of up to $1,000 for taxpayers who have a qualifying child.

The qualifying child for this credit must meet all six of the following tests: age, relationship, support, dependent, citizenship, and residence.

- **Age Test** - To qualify, a child must have been under age 17 – age 16 or younger – at the end of the tax year.

- **Relationship Test** – the qualifying child must either be taxpayer’s son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, which includes the taxpayer’s grandchild, niece or nephew. An adopted child is always treated as the taxpayer’s child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption.

- **Support Test** - In order to claim a child for this credit, the child must not have provided more than half of his own support.

- **Dependent Test** – The taxpayer must claim the child as a dependent on your federal tax return.

- **Citizenship Test** - To meet the citizenship test, the child must be a U.S. citizen, U.S. national, or U.S. resident alien.

- **Residence Test** - Unless exceptions apply, the child must have lived with the taxpayer for more than half of the tax year.

The credit is limited if the taxpayer’s modified adjusted gross income is above a certain amount. The amount at which this phase-out begins varies depending on the filing status. For married taxpayers filing a joint return, the phase-out begins at $110,000. For married taxpayers filing a separate return, it begins at $55,000. For all other taxpayers, the phase-out begins at $75,000. In addition, the Child Tax Credit is generally limited by the amount of the income tax owed as well as any alternative minimum tax that may be owed.
C. Education Credits

Summary
The two education credits available to taxpayers are the American Opportunity Credit and the Lifetime Learning Credit. The American Opportunity credit provides a refundable tax credit of up to $2,500 for undergraduate education and is scheduled to expire at the end of 2012. The Lifetime Learning Credit provides a tax credit of up to $2,000 for any level of college education (even graduate school), and doesn’t require a minimum level of enrollment. Form 8863 should be used to claim either education credits.

American Opportunity Credit (AOC)

Per IRS guidelines, the following table summarizes the AOC:

<table>
<thead>
<tr>
<th>Maximum credit</th>
<th>Up to $2,500 credit per eligible student</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limit on modified adjusted gross income (MAGI)</td>
<td>$180,000 if married filling jointly; $90,000 if single, head of household, or qualifying widow(er)</td>
</tr>
<tr>
<td>Refundable or nonrefundable</td>
<td>40% of credit may be refundable; the rest is nonrefundable</td>
</tr>
<tr>
<td>Number of years of postsecondary education</td>
<td>Available ONLY for the first 4 years of postsecondary education</td>
</tr>
<tr>
<td>Number of tax years credit available</td>
<td>Available ONLY for 4 tax years per eligible student (including any year(s) Hope credit was claimed)</td>
</tr>
<tr>
<td>Type of degree required</td>
<td>Student must be pursuing a degree or other recognized education credential</td>
</tr>
<tr>
<td>Number of courses</td>
<td>Student must be enrolled at least half time for at least one academic period that begins during the tax year</td>
</tr>
<tr>
<td>Felony drug conviction</td>
<td>As of the end of 2011, the student had not been convicted of a felony for possessing or distributing a controlled substance</td>
</tr>
<tr>
<td>Qualified expenses</td>
<td>Tuition, required enrollment fees, and course materials that the student needs for a course of study whether or not the materials are bought at the educational institution as a condition of enrollment or attendance</td>
</tr>
<tr>
<td>Payments for academic periods</td>
<td>Payments made in 2011 for academic periods beginning in 2011 or beginning in the first 3 months of 2012</td>
</tr>
</tbody>
</table>

More details on this credit may be found in Domain 3.
Lifetime Learning Credit

Per IRS guidelines, the following table summarizes the Lifetime Learning Credit:

<table>
<thead>
<tr>
<th>Maximum credit</th>
<th>Up to $2,000 credit per return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limit on modified adjusted gross income (MAGI)</td>
<td>$122,000 if married filing jointly; $61,000 if single, head of household, or qualifying widow(er)</td>
</tr>
<tr>
<td>Refundable or nonrefundable</td>
<td>Nonrefundable—credit limited to the amount of tax you must pay on your taxable income</td>
</tr>
<tr>
<td>Number of years of postsecondary education</td>
<td>Available for all years of postsecondary education and for courses to acquire or improve job skills</td>
</tr>
<tr>
<td>Number of tax years credit available</td>
<td>Available for an unlimited number of years</td>
</tr>
<tr>
<td>Type of degree required</td>
<td>Student does not need to be pursuing a degree or other recognized education credential</td>
</tr>
<tr>
<td>Number of courses</td>
<td>Available for one or more courses</td>
</tr>
<tr>
<td>Felony drug conviction</td>
<td>Felony drug convictions are permitted</td>
</tr>
<tr>
<td>Qualified expenses</td>
<td>Tuition and fees required for enrollment or attendance (including amounts required to be paid to the institution for course-related books, supplies, and equipment)</td>
</tr>
<tr>
<td>Payments for academic periods</td>
<td>Payments made in 2011 for academic periods beginning in 2011 or beginning in the first 3 months of 2012</td>
</tr>
</tbody>
</table>

More details on this credit may be found in Domain 3.

D. Retirement Savings Credit (Saver’s Credit)

The Retirement Savings Credit gives a special tax break to low- and moderate-income taxpayers who are saving for retirement.
To claim a Savers Credit, the taxpayer must be age 18 or older and cannot be a full-time student or be claimed as a dependent on someone else’s tax return. The retirement contribution must have been made during the tax year for the return is filed.

The Savers Credit can be claimed for contributions to a 401k, 403(b), 457 plan, a Simple IRA or a SEP IRA. Contributions to a traditional IRA or a Roth IRA are also eligible for the Savers Credit.

Depending on the adjusted gross income and tax filing status, the credit may be 50%, 20% or 10% of the first $2,000 contributed during the year to a retirement account. Therefore, the maximum credit amounts that can be claimed are $1,000, $400 or $200. The biggest credit amount is $2,000 for a married couple filing jointly.

More details on this credit can be found in Domain 3.

E. Child and Dependent Care Credit To qualify for the child and dependent care credit, the taxpayer must have a dependent child age 12 or younger or a dependent of any age who cannot care for himself or herself. The credit is calculated on Form 2441.

In order to claim this tax credit, the following criteria must be met:

- The daycare provider must meet certain qualifications
- The taxpayer(s) must have earned income
- The care provided must enable the person(s) claiming the credit to work or to look for work, and
- The taxpayer(s) must reduce their eligible daycare expenses by any amounts provided by a dependent care benefits plan through their employer.

For more details on the Child and Dependent Care Credit, see Domain 3.
8. Understand tax payments (e.g., withholding, estimated payments)

The federal income tax system operates on a pay-as-you-go basis. There are two ways to accomplish this goal.

a. Withholding: Income taxes are taken out of each paycheck and deposited into an IRS account by the employer. The withholdings are credited to the taxpayer at tax filing time.
   - the taxpayer’s employer will withhold income tax from pay. Income tax can be withheld from pensions, bonuses, commissions, and gambling prizes.

b. Estimated tax In general, a taxpayer must pay estimated tax when
   - At least $1000 in taxes is owed for the current tax year-- after withholding and refundable credits-- and
   - The withholding and refundable credits are expected to be the lesser of 100% of the tax for the previous year or 90% of the tax for the current year (AGI limitations apply).

Note: Different amounts may apply for farmers, fishermen, or taxpayers with a higher AGI.

Estimated tax is not due for taxpayers who meet all of the following conditions:
   - Had no tax liability for the previous year
   - Were a U.S. citizen or resident alien for the entire year
   - Previous year includes a 12-month period

When to Pay Estimated Tax

Excluding the Saturday, Sunday, and holiday rule, estimated tax payments are due on April 15, June 15, September 15, and January 15 of the following year.
9. Recognize items that will affect future returns (e.g., carryovers, depreciation)

The paid preparer must exercise due diligence in determining whether the client has carryovers from prior tax years that may affect the client’s current tax return.

Common loss and expense carryovers are
   a. Short- and long-term capital loss carryovers
   b. Net operating loss carryovers
   c. Disallowed investment interest

Taxpayers may also have credits to carryover from prior year(s). Credits include the general business credit, the mortgage interest credit, and the foreign tax deduction and credits.

If the taxpayer has rental property and other depreciable property from prior year(s), the accumulated depreciation should be carefully carried forward to ensure that the current year’s depreciation is accurately calculated.
10. **Determine special filing requirements (e.g., presidentially declared disaster areas).**

Special filing requirements exist for taxpayers affected by certain situations such as presidentially declared disaster areas.

The affected taxpayer is an individual or business located within the designated disaster area or whose tax records are located within the designated area. Relief workers are also considered “affected taxpayers.”

Affected taxpayers are given extensions to file and/or pay taxes. The extension period applies to those whose original due date or extended due date falls within the period of the disaster. Interest is abated during this time.

Extensions are given only for filing or paying taxes but do not apply to returns for informational purposes or employment and excise taxes.

An affected taxpayer must write “Disaster Designation” in red ink at the top of his return. As an alternative, taxpayer may file Form 5500 and check Box D of Part 1, follow the instructions, and attach necessary statements. This process will serve the same purpose as writing “Disaster Designation” at the top of the return.
11. Determine filing requirements (including extensions and amended returns)

The tax preparer should determine the proper filing requirements for the client. He should also determine the deadline(s) of the tax return. If it is determined that more time is need to obtain accurate information or because of other extenuating circumstances, extensions still need to be filed on time.

If an error is discovered after taxpayer’s return has been filed, the return may have to be amended. Amended returns may have to be filed if the filing status, income, deductions or credits are incorrect.

If an amendment is necessary, use Form 1040X, *Amended US Individual Income Tax Return.*

The Internal Revenue Service Center may correct errors in math on a return and may accept returns with certain forms or schedules left out. In these instances, an amended return may not be necessary.
12. Understand due dates including extensions.

File form 1040, 1040 A or 1040 EZ by April 15, 2013. In the years when April 15 falls on a Sunday, the tax due date will be Monday, April 16. In addition, when a holiday falls on Monday, April 16, the tax due date will be April 17.

Extensions

Taxpayers may also apply for an automatic six-month extension by filing Form 4686 by the due date of the tax return.

Extensions of time to file can be requested in three ways:

a. **File Form 4868, Application For Automatic Extension of Time to File US Individual Tax Return** electronically. An acknowledgment of the request will be sent. Additional tax payments can be made using e-file or another provider.

b. Make partial payment or payment in full of the estimated income tax due using a credit or debit card. This can be done by phone or via the Internet. A convenience fee may be charged. A copy of all records must be kept.

c. File Form 4868 by mail.

Note: A request for extension of time to file is not a request to extend time to pay.
13. **Determine personal exemptions including dependents.**

Exemptions reduce the total amount of taxable income. Each exemption reduces taxable income ($3,800 in 2012).

The two types of exemptions taxpayers may take are personal exemptions and exemptions for dependents.

a. **Personal** exemptions are exemptions the taxpayer can take for himself and spouse (if applicable). The spouse is never considered the taxpayer’s dependent.

b. **Dependent exemptions** are exemptions the taxpayer can take for dependents known as dependency exemptions. The dependent can either be a qualifying child or relative.

A qualifying child or relative may be claimed only if the following three tests are met:

1. **Dependent taxpayer test** - if an individual can be claimed as a dependent by another person, he may not claim a dependent on his tax return. Example: Ross is claimed by Julie as Julie’s dependent. Ross may not claim a dependent on his own tax return.

2. **Joint return test** - Taxpayer generally cannot claim a married person as a dependent if that person files a joint return.

3. **Citizen or resident test** - A person may not be claimed as a dependent unless he is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico. However, if a child is considered to be legally adopted by a U.S. citizen or U.S. national, he is exempt from this rule and may be claimed. If the taxpayer is U.S. citizen when his child is born, the child may be a U.S. citizen and meet this test even if the other parent was a nonresident alien and the child was born in a foreign country.
Domain 2
A. Income

1. Taxability of wages, salaries, tips, and other earnings (e.g., W-2 Wage and Tax Statement, cash)

W-2 wages, cash, or any other income earned as payment for goods or services is taxable.

Employers who are engaged in a trade or business and pay remuneration for services performed by an employee including noncash payments must file a Form W-2 for each employee (even if the employee is related to the employer) when

- Income, social security, or Medicare tax was withheld.
- Income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4, Employee’s Withholding Allowance Certificate.

The employee is able to file an income tax return without a W-2 as long as the IRS has been notified the employee did not receive the W-2. Form 4852, the substitute form for Form W-2, would need to be filed.

2. Interest Income (taxable and non-taxable) (e.g., Schedule B and 1099-INT).

Income earned from deposits in financial institutions including savings accounts, money market funds, loans, bonds, or mortgages is considered ordinary income and is taxed at the ordinary tax rate.

Taxable interest includes
- Bank accounts
- Money market accounts
Certificates of deposit
Deposited insurance dividends

Form 1099-INT should be received from each business/institution that pays interest of $10 or more. The 1099-INT shows the taxable or tax exempt interest to be reported.

Interest is taxable when it is received (or when it is paid to the individual). In some situations, interest income can be deferred to a future tax year.

If interest is refunded in the same year paid, the interest expense must be reduced by the amount received in refund. If refunded interest is received in a year after it was paid, the interest refund generally must be claimed as income.

3. Dividend Income (e.g., Schedule B and 1099-DIV).

Dividend income from stocks, including mutual funds containing stocks, is considered investment income. Tax is paid when the dividend is paid. Dividends may be taxed at the ordinary income tax rate or at the long-term capital gains tax rate.

Dividend income is reported on Form 1099-DIV. Dividend income is reported on tax returns as ordinary dividend income on Form 1040 and 1040 A, Line 9a; or as qualified dividend income on Line 9b.

Dividends are distributions of property (can include money, stock of another corporation, or other property) a corporation pays taxpayer because he owns stock in that corporation. A taxpayer may also receive dividends through a partnership, an estate, a trust, a subchapter S corporation, or from an association that is taxable as a corporation. Most dividends are paid in cash. A shareholder of a corporation may be deemed to receive a dividend if the corporation pays the debt of its shareholder, provides services to the shareholder, or allows the shareholder to use the property of the corporation. A shareholder may also receive distributions such as additional stock or stock rights in the distributing corporation. Such distributions may or may not qualify as dividends.

A Form 1099-DIV (PDF), Dividends and Distributions, from each payer for distributions of $10 or more should be provided. Also, if taxpayer receives dividends through a partnership, an estate, a trust, or a subchapter S corporation, he should receive a Schedule K-1 from that entity indicating the amount of dividends taxable to taxpayer. Taxpayer must report all taxable dividends even if he does not receive a Form 1099–DIV or Schedule K-1.
Ordinary dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of the corporation. Ordinary dividends are taxable as ordinary income unless they are qualified dividends. Qualified dividends are ordinary dividends that meet the requirements to be taxed at a lower long-term capital gains rate.

4. **Self-employment income and expenses (e.g., Schedule C Profit or Loss From Business and Form 1099-MISC Miscellaneous Income, cash)**

Self-employment income must be reported as income. Form 1099-MISC should be issued to self-employed individuals if annual payments are $600 or greater. Business-related expenses can be deducted from the gross profit to reduce the net profit and subsequent taxes paid.

Generally, a taxpayer is self-employed if any of the following apply:

- He carries on a trade or business as a sole proprietor or an independent contractor.
- He is a member of a partnership that carries on a trade or business.
- He is otherwise in business for himself (including a part-time business)

5. **Rental income and expenses (e.g., Schedule E Supplemental Income and Loss)**

Rental income is any payment received for use or occupation of property. Any rental income received must be included in gross income.

Rental property expenses can be deducted from the gross rental income. Rental income and rental property expenses are generally paid in the year actually paid/received.

Schedule E of the Form 1040 is used to report rental income and expenses.

The taxpayer needs to keep records of the following:

- Purchase price of the house, condo, or apartment building that is being rented out
- Accumulated depreciation and current annual depreciation on the rental property
• Rental income
• Security deposits from renter(s)

The taxpayer should also maintain records of expenses which may include the following:

• Commissions or property management fees
• Advertising costs
• Cleaning, maintenance, and repair costs
• Homeowners insurance and HOA dues
• Real estate taxes and mortgage interest expenses
• Security deposits reimbursed to the tenant(s)
• Various other expenses such as utilities, landscaping, garbage, and other similar expenses.

Renting out real estate property is generally considered a passive activity even if owner devotes a substantial amount of time to selecting the right tenants, repairing the rental unit, and inspecting the property for routine maintenance. What this means is that the IRS limits the losses from the rental business to a maximum of $25,000 per year in total losses from all of taxpayer’s properties.

Landlords are allowed to depreciate the purchase price of the rental property, which is usually sufficient to turn a small economic profit into a small tax loss. That means expenses exceed income after depreciation is taken into consideration.

Landlords may face major expenses such as replacing a roof, or gutting an apartment after a long-term tenant vacates. In these circumstances, it is possible that the landlord has a loss greater than $25,000, but the Passive Activity Loss rules will limit the loss to exactly $25,000. The remainder may be carried over to next year’s taxes.

6. Identification of forgiveness of debts as income (including Form 1099-C Cancellation of Debt).

Debt that is forgiven or canceled may be taxable. For example, money borrowed from a lender that is later canceled or forgiven may have to be reported as income.

In general, if taxpayer is liable for a debt that is canceled, forgiven, or discharged, he will receive a Form 1099-C, Cancellation of Debt, and must include the canceled amount in gross income unless he meets an exclusion or exception. If taxpayer receives a Form 1099-C but the creditor is continuing to try to collect the debt, then the debt has not been canceled and taxpayer does not have taxable cancellation of debt income.
A debt includes any indebtedness whether a taxpayer is personally liable or liable only to the extent of the property securing the debt. Cancellation of all or part of a debt that is secured by property may occur because of a foreclosure, a repossession, a voluntary return of the property to the lender, abandonment of the property, or a principal residence loan modification. The taxpayer must report any taxable amount of a canceled debt for which he is personally liable as ordinary income from the cancellation of debt. The taxpayer must report the taxable amount of a taxable debt whether or not he received a Form 1099-C.

Canceled debts that meet the requirements for any of the following exceptions or exclusions are not taxable:

**Canceled Debt that Qualifies for EXCEPTION to Inclusion in Gross Income**

1. Amounts specifically excluded from income by law such as gifts or bequests
2. Cancellation of certain qualified student loans
3. Canceled debt that if paid by a cash basis taxpayer is otherwise deductible
4. A qualified purchase price reduction given by a seller

**Canceled Debt that Qualifies for EXCLUSION from Gross Income**

1. Cancellation of qualified principal residence indebtedness
2. Debt canceled in a Title 11 bankruptcy case
3. Debt canceled during insolvency
4. Cancellation of qualified farm indebtedness
5. Cancellation of qualified real property business indebtedness

The exclusion for "qualified principal residence indebtedness," provides canceled debt tax relief for many American home owners involved in the mortgage foreclosure crisis currently affecting much of the country. The exclusion allows taxpayers to exclude up to $2,000,000 ($1,000,000 if married filing separately) of "qualified principal residence indebtedness."

Generally, if the taxpayer excludes canceled debt from income under one of the exclusions listed above, he must also reduce his tax attributes (certain credits, losses, and basis of assets) by the amount excluded
7. Other Income (e.g., alimony, barter income, hobby income, non-taxable combat pay, state income tax refund from prior years, prizes)

**Compensation includes:**

Wages

Tips

Commissions

Self-employment income

Alimony

Nontaxable combat pay

Bartering income must be included as income reported at the fair market value of the goods or services exchanged.

Income earned from hobbies should be reported as income. Whether it is reported as earned income or other income depends on the motive for profit. Expenses associated with the hobby can be claimed but may not exceed the amount of profit.

State income tax refunds are sometimes taxable income.

Bartering occurs when you exchange goods or services without exchanging money. An example of bartering is a plumber doing repair work for a dentist in exchange for dental services. You must include in gross income in the year of receipt the fair market value of goods and services received in exchange for goods or services you provide.

**ADDITIONAL OTHER INCOME**

Some income-generating activities are deemed infrequent enough to constitute other income. Some examples of income-producing activities that were infrequent enough to escape being classified as a trade or business include the following:

All of the following kinds of income are taxable and may be reported on Form 1040, Line 21:

- Alaska Permanent Fund dividends (generally reported on a 1099-MISC)
• Alternative Trade Adjustment Assistance (ATAA) or Reemployment Trade Adjustment Assistance (RTAA) payments (generally reported on a 1099-G)
• Barter income (The fair market value of goods or services exchanged by two parties is taxable. Both parties should report the full value received from the transaction as other income.)
• Canceled debts (usually reported on a 1099-C)
• Dividends on insurance policies if the amount is more than the total of all premiums paid
• Gambling winnings including awards, prizes, jackpots, and contest winnings (Winnings and any tax withheld may be reported on W-2G, depending on the amount won and the type of gambling, but the full amount is taxable regardless of whether taxpayer receives a W-2G. Gambling losses may be deducted up to the amount of gambling winnings if the taxpayer itemizes.)
• Hobby income (This is income from an activity not performed for profit. Hobby expenses can be deducted up to the amount of hobby income.)
• Jury duty pay (Jury duty pay is reported on a 1099-MISC if it totals $600 or more, but any amount is taxable. Jury duty pay can be deducted if it is paid to taxpayer’s employer.)
• Losses on certain corrective retirement plan distributions of excess deferrals
• Nonbusiness rental income (Income earned from renting personal property if taxpayer is engaged in the rental for profit but is not in the business of renting, is reported as other income. Expenses related to this rental may be deducted.)
• Recapture of a charitable contribution deduction (if the charitable organization disposes of the donated property within three years or due to the contribution of a fractional interest in tangible personal property)
• Recoveries (reimbursements received for previously deducted expenses such as medical expenses, employee expenses, and other deductions)
• Taxable distributions from a health savings account (HSA) or an Archer MSA (These are generally reported on a 1099-SA. Taxpayer can deduct qualified contributions to an Archer MSA.)
• Taxable HSA distributions deemed to be income because taxpayer did not remain an eligible individual during the testing period (generally reported on a 1099-SA)
• Taxable portion of disaster relief payments
8. Retirement Income

a. Reporting requirements of Social Security benefits (e.g., Form SSA-1099 Social Security Benefit Statement).

Generally, Social Security benefits are not taxable unless the taxpayer receives other types of income. Up to 85% of benefits may be taxable depending on how much ‘additional’ income is received by the taxpayer.

Social security benefits include monthly retirement, survivor, and disability benefits. They do not include supplemental security income (SSI) payments which are not taxable. The amount of social security benefits that must be included on taxpayer’s income tax return and used to calculate his income tax liability depends on the total amount of income and benefits for the taxable year.

To find out whether any of the benefits may be taxable, compare the base amount for taxpayer’s filing status with the total of

- One-half of his benefits
- All of his other income including tax-exempt interest

The base amount for his filing status is shown next
• $25,000 if he is single, head of household, qualifying widow(er) or married filing separately living apart from his spouse at any time during the tax year
• $32,000 if he is married filing jointly
• $0- if he is married filing separately and lived with his spouse at any time during the tax year

b. Taxable distribution from an IRA including basis in an IRA (e.g., Form 8606 Non-deductible IRAs).

Taxable distributions from an IRA are calculated by multiplying the amount of the distribution by the federal income tax rate. Additional taxes, such as penalties for early withdrawals, may apply.

Form 8606 is used to report the following:
• Nondeductible contributions made to traditional IRAs;
• Distributions from traditional, SEP, or SIMPLE IRAs, if you have ever made nondeductible contributions to traditional IRAs;
• Distributions from Roth IRAs;
• Conversions from traditional, SEP, or SIMPLE IRAs to Roth IRAs; and
• Certain distributions from designated Roth accounts allocable to in-plan Roth rollovers.

c. Distribution from qualified plans (e.g., 401k, IRA, Roth IRA).

Distributions from 401ks, IRAs, or Roth IRAs may be subject to penalty taxes if early withdrawals occur. Distributions that are rolled over to a qualified retirement plan from a qualified retirement plan are not taxable except when distributed

- to a beneficiary or estate after the taxpayer’s death
- for the purposes of total and permanent disability
- equally in periodic payments over a life or life expectancy
- in equal or less than equal amounts as those of deductible medical expenses
- for the purpose of an IRS levy
- to qualified reservists

The tax treatment of a distribution depends upon the participant’s basis in the plan. The basis is the after-tax contributions in a plan, which are nondeductible. If all contributions
to the plan are pre-tax contributions, the plan will have no basis; therefore all distributions will be taxable.

**401(k)**

Distributions from a 401(k) plan are usually fully taxable unless the employee contributed after-tax money to the plan.

**IRA**

Distributions from traditional IRAs are fully taxable if the taxpayer has no basis in the plan. If basis exists, a portion of each distribution is considered a tax-free return on basis.

**Roth IRA**

Roth IRA distributions from a Roth are accomplished in the following order:

1. Contributions-Distributions are tax AND penalty free until total distributions EXCEED total contributions.

2. Conversions-Distributions are tax-free to the extent the converted amount was taxed upon conversion. Distributions of converted amounts are penalty free if held in the Roth IRA for a minimum of five years or one of the early withdrawal penalty exceptions apply.

3. Qualified distributions are tax free if the taxpayer held a Roth IRA for five years and if
   - The taxpayer is a first-time homebuyer
   - The IRA participant died or is disabled
   - The participant has reached age 59 ½

4. Nonqualified distributions are taxable. However, the 10% early withdrawal penalty is not applicable if any of the early withdrawal penalty exceptions apply.

d. **Required minimum distributions from retirement plans**

Required Minimum Distributions are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he reaches 70 ½ years of age or later in the year in which he retires. The first distribution can be delayed until April 1 of the year following the year in which he or she turns 70 ½. For all subsequent years
including the year in which the first required minimum distribution was paid by April 1, the account owner must take the required minimum distribution by December 31 of the year.

Types of retirement plans requiring minimum distributions are as follows:

- 401k
- 403(b)
- 457(b)
- Profit-sharing

Note: If the account is an IRA or the individual is 5% owner of the business sponsoring the retirement plan, the withdrawal must begin at age 70 ½ years whether or not the individual is retired.

If the taxpayer fails to take the required minimum distribution, he will incur stiff penalties. The amount not withdrawn is taxed at 50%. The account owner would be required to file Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, with his tax return for the year in which the full amount of the required minimum distribution was not taken.

If an owner of an account dies before the required minimum distributions have begun, beneficiary rules will apply to the withdrawals for the beneficiaries.
9. **Property, Real and Personal**

a. **Short-term and long-term capital gains and losses (e.g., Schedule D Capital Gains and Losses, Form 1099-B Proceeds From Broker and Barter Exchange Transactions).**

   **Capital gains and losses** – Gain or loss realized when personal-use or investment property is sold

   **Investment Property** – i.e., stocks, bonds. Investment property is property held for the production of income or anticipated appreciation in value. A gain or loss from the sale or exchange of investment property is a capital gain or loss.

   **Holding Periods**

   Short-term - If property is held for one year or less, the holding period is considered short-term.

   Long-term - If property is held for more than one year, the holding period is considered long-term.

b. **Determination of basis of assets (e.g., purchased, gifted, or inherited).**

   An asset’s basis is how much it cost or how much was invested to obtain the asset or the fair market value at the time of acquisition. The asset’s basis is used to calculate the

   - Depreciation
   - Depletion
• Casualty loss
• Amortization
• Gain or loss from its disposition

**Basis**

An asset’s basis is how much investment the taxpayer put into the property for tax purposes.

The three main types of basis are as follows:

1. **Adjusted basis** - Increases and decreases to basis result in a taxpayer’s adjusted basis amount. The adjusted basis amount is used to determine gain or loss if applicable. The basis of property purchased is usually its cost, which is also its original value.

   • Increases to basis add to a capital account. Examples of increases include capital improvements, legal and professional fees, local improvements.
   
   • Decreases to basis reduce a capital account. Examples of decreases include casualty or theft loss deductions, insurance reimbursements, depreciation, Section 179 deductions, and tax credits.
     
     a. Gifted basis - Basis of property received as a gift is the donor’s adjusted basis at the time of the gift. However, if the donor’s adjusted basis was higher than the FMV at the time of the gift, the recipient’s basis for calculating loss is the FMV at the time of the gift.

Example: Aggie purchased stock for $100 and gave it to Longhorn when the stock’s FMV was $50. Longhorn’s basis depends on the price received when the stock is sold.

   • If the stock is sold for $200, Longhorn’s basis for the gain is $100.
   • If the stock is sold for $20, Longhorn’s basis for the loss is $50.
   • If the stock is sold for $75, no gain or loss exists. Basis for the gain is $100 so the sale for $75 produces no gain. Basis for the loss is $50 so the sale for $75 produces no loss.

1. Inherited basis - Generally, the basis of property inherited from a decedent is its FMV on the date of death. A common term for the rule is “stepped-up basis,” but it also applies whether the FMV at death is higher than the decedent’s basis (stepped-up basis) or lower than the decedent’s basis (stepped-down basis).
When determining holding period, the beginning of the holding period for inherited property begins on the date of the decedent’s death. Inherited property is considered long-term.

c. **Sale of non-business assets (gains or losses).**

**Personal Use Property** – Examples - household furnishings, personal property, and personal-use vehicles. Gain from the sale or exchange of personal-use property is considered to be a capital gain. Losses are not deductible unless the losses resulted from a casualty or theft.

d. **Sale of a principal residence (e.g., IRC 121 exclusions, 1099S Proceeds From Real Estate Transactions).**

Under IRC section 121, a taxpayer may exclude the gain on the disposition of a principal home. He must own and occupy the property as a principal residence for two of the five years immediately before the sale. However, the ownership and occupancy need not be concurrent. The law permits a maximum gain exclusion of $250,000 ($500,000 for certain married taxpayers). The IRS has issued proposed regulations to clarify how these rules work in certain situations.

The taxpayer is considered to have **owned** and used a home as a principal residence during the time his or her deceased spouse used the home as a principal residence. This rule applies as long as on the day the home is sold the taxpayer’s spouse is deceased and the taxpayer has not remarried. Divorced spouses can also benefit from the ownership and use periods of former spouses to satisfy the exclusion requirements.

A principal residence is considered any of the following:

Conventional single-family dwelling or structure

House trailer

Mobile home

Condominium

Houseboat

Cooperative apartment

Row house

RV with cooking, sleeping, and sanitation facilities
10. **Adjustments to Income**

a. **Self-employment tax (e.g., Schedule SE Self-Employment Tax).**

Self-employment income must be reported as income and is subject to Social Security and Medicare taxes. Calculating self-employment tax is done using Schedule SE (Form 1040).

Limits on each type of tax exist and are dependent on total amount of income earned.

The employer-equivalent portion of the self-employment tax is deductible from the taxpayer’s income tax.

b. **Tuition and fees (e.g., Form 8917 Tuition and Fees Deduction, Form 1098T Tuition Statement).**

You may be able to deduct qualified tuition and related expenses that you pay for yourself, your spouse, or a dependent, as a tuition and fees deduction. You do not have to itemize to take this deduction. You do not have to itemize to claim qualified tuition and fees unless you claim them as a business expense. If you claim qualified tuition and fees as a tuition and fees deduction, the deduction is taken as an adjustment to income on Form 1040 or Form 1040A with Form 8917 attached.

You cannot take the tuition and fees deduction on your income tax return if your filing status is married filing separately, or if you may be claimed as a dependent on someone else’s return. The deduction is reduced or eliminated if your modified adjusted gross
income exceeds certain limits that depend on your filing status. You cannot claim the tuition and fees deduction and a Hope or Lifetime Learning credit for the same student. If the educational expenses are also allowable as a business expense, the tuition and fees deduction may be claimed in conjunction with a business expense deduction, but the same expenses cannot be deducted twice.

An eligible educational institution that is a governmental unit, or an agency or instrumentality of a governmental unit, is subject to the reporting requirements of Form 1098-T to report payments received, or amounts billed, for qualified tuition and related expenses.

c. Eligible Moving Expenses (e.g., Form 3903 Moving Expenses)

If a taxpayer meets the requirements for deducting moving expenses, the reasonable cost of the following may be deducted:

- Traveling to the new home
- Lodging expenses incurred while moving to the new home
- Moving of household goods and personal effects

The taxpayer may deduct moving expenses if all three of the following requirements are met:

- The move is closely related to the start of work In most cases, taxpayer can consider moving expenses incurred within one year from the date he first reported to work at the new location. It is not necessary that he arranges to work before moving to a new location as long as he actually goes to work in that location.

- The distance test is met - The move will meet the distance test if the new main job location is at least 50 miles farther from taxpayer’s former home in addition to the miles to work from his former home. For example, if taxpayer’s old main job location was 10 miles from his former home, his new main job location must be at least 60 miles from that former home.

- The time test is met

  1. Time test for employees - Taxpayer as an employee must work full time for at least 39 weeks during the first 12 months after he arrives in the general area of his new job location (39-week test). Full-time employment depends on what is usual for taxpayer’s type of work in the new area.
For purposes of this test, the following four rules apply:

- Taxpayer must be employed full time. Self-employment does not count.
- Taxpayer does not have to work for the same employer for all 39 weeks.
- Taxpayer does not have to work 39 weeks in a row.
- Taxpayer must work full time within the same general commuting area for all 39 weeks

2. Time test for the self-employed – If taxpayer is self-employed, he must work full time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months after he arrives in the general area of his new job location (78-week test).

For purposes of the time test for self-employed persons, the following three rules apply.

- Taxpayer can count any full-time work he does either as an employee or as a self-employed person.
- Taxpayer does not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.
- Taxpayer must work within the same general commuting area for all 78 weeks.

d. Other adjustments to income (e.g., IRA contribution deduction).

Taxable income can be reduced by contributions to an individual retirement account (IRA). Qualifying contributions made as of the first due date of a tax return are allowed and can be retroactive to the previous tax year. Contributions cannot exceed total income earned, and the individual must have earned income within the tax year.

Self-employed SEP, SIMPLE and qualified plans

If the taxpayer has self-employment income, he can take a tax deduction for contributions made to a SEP, SIMPLE, or solo 401(k) retirement plan. Each plan has different deadlines and funding limits.

SEP:

SEP-IRAs can be established and funded as late as October 15 for the previous year provided that the taxpayer files an extension. The maximum contribution is 20% of the
person’s net self-employed income, with a maximum dollar limit of $50,000 for 2012. "Net self-employment income" means self-employed income minus one-half of the self-employment tax. If the salary from the business comes in the form of a W-2, the maximum a taxpayer could contribute to an eligible SEP IRA is set at either fifty $50,000, or twenty-five percent of the employee’s salary, whichever is smaller.

SIMPLE IRAs:

The SIMPLE IRA plan is an IRA-based plan that gives small employers with no more than 100 employees, who earned $5,000 or more in compensation during the preceding calendar year, a simplified method to make contributions toward their employees’ retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or non-elective contributions. All contributions are made directly to an Individual Retirement Account or Individual Retirement Annuity (IRA) set up for each employee (a SIMPLE IRA).

A SIMPLE IRA plan can be set up effective on any date between January 1 and October 1, provided the plan sponsor did not previously maintain a SIMPLE IRA plan. If a SIMPLE IRA plan was previously established, a SIMPLE IRA plan may be set up effective only on January 1.
Domain
A. Itemized Deductions

Taxpayers are allowed a standard deduction amount based on filing status.

*Exception: If a taxpayer uses the Married Filing Separately filing status and his or her spouse itemizes deductions, the taxpayer must also itemize deductions.*

Taxpayers may choose to use the standard deduction or itemized deductions to reduce taxable income.

Common itemized deductions are listed below.

1. **Medical and dental expenses**

Medical and dental care expenses paid for the main taxpayer, spouse, or dependents may be deductible if deductions are itemized using Form 1040, Schedule A. Medical and dental expenses may be deducted only by the amount that exceeds 7.5% of the adjusted gross income.

**Medical expenses include any of the following:**

- Doctors, dentists, psychologists, and nontraditional medical practitioners
- In-patient hospital care
- Health insurance premiums
• Acupuncture
• Inpatient treatment for drug addiction
• Participation in smoking-cessation programs
• Payments for insulin
• Payments for drugs that require a prescription
• Payments for false teeth, prescription eyeglasses or contact lenses, hearing aids, crutches, wheelchairs, and guide dogs

Medical expenses are deductible in the year actually paid.

**Nursing home**- If the principal reason for being in a nursing home is to receive medical care, the cost of living in the nursing home, including meals and lodging is deductible.

**Transportation**- Amounts paid for transportation for medical care are deductible. The taxpayer may use the standard mileage rate to deduct expenses. Parking and tolls can be deducted in addition to the standard mileage rate.

**Decedent’s medical expenses**- Medical expenses paid by a decedent before death are included in figuring the deduction for medical and dental expenses on the decedent’s final income tax return. This includes expenses for the decedent’s spouse and dependents, as well as for the decedent.

Medical expenses paid by a taxpayer for a deceased spouse or dependent are deducted on the taxpayer’s return in the year paid regardless of whether they’re paid before or after the decedent’s death.

2. **State, local, and real estate taxes**

**State and Local**

When itemizing deductions, state and local income taxes can be deducted. The following are a listing of state and local income taxes:
• Taxes paid in the current year for a prior year such as a balance due paid when filing for a prior-year tax return or a balance due when amending a prior-year state income tax return.

• Withholding amounts reported on Forms W-2, W-2G, 1099-G, 1099-R, and 1099-MISC.

• State and local estimated tax payments made during the year including the prior-year refund credited to the current year and prior-year estimated payments made during the current tax year.

• Mandatory contributions made to the states of California, New Jersey, or New York Nonoccupational Disability Funds; the Rhode Island Temporary Disability Benefit Fund; the New Jersey, Pennsylvania, or Alaska Unemployment Compensation Funds; or the Washington State Supplemental Workmen’s Compensation Fund.

Note: If a taxpayer elects to deduct state and local general sales taxes, he may NOT deduct state and local income taxes. If the taxpayer chooses to deduct state and general sales taxes, he may choose one of the two following methods 1) Actual sales taxes paid or 2) Amounts from the Optional Sales Tax Tables plus amounts from the Optional Local Sales Tax Tables plus general sales taxes paid on specified items.

Real estate taxes

Real estate taxes can be an itemized deduction if the taxpayer owns the real estate and the taxes are based on the assessed value of the property. Unlike mortgage interest (discussed below), the real estate tax deduction is not limited to the first two homes owned by the taxpayer.

3. Mortgage interest expense (e.g., Form 1098 Mortgage Interest Statement).

Most mortgage interest payments are reported by the lender on Form 1098 – Mortgage Interest Statement
Form 1098, Mortgage Interest Statement

If taxpayer paid $600 or more of mortgage interest (including certain points and mortgage insurance premiums) during the year on any one mortgage, he generally will receive a Form 1098 or a similar statement from the mortgage lender. The taxpayer will receive the statement if he pays interest to a person (including a financial institution or cooperative housing corporation). The statement for each year should be sent to the taxpayer by January 31 of the following year. A copy of this form will also be sent to the IRS. The statement will show the total interest the taxpayer paid during the year, any mortgage insurance premiums paid, and whether the taxpayer purchased a main home during the year. The statement will also show the deductible points paid during the year including seller-paid points. However, it should not show any interest that was paid for the taxpayer by a government agency.

The following types of interest are deductible:

- Acquisition debt and home-equity debt interest are deductible
- Points and loan origination fees paid to obtain a mortgage or to refinance a mortgage

Mortgage insurance premiums

Mortgage insurance premiums paid for acquisition indebtedness are considered deductible mortgage insurance through 2011 unless Congress extends the deduction. The deduction is phased out by 10% for each $1,000 (or fraction thereof) by which the taxpayer’s AGI exceeds $100,000 ($500 and $50,000 for MFS). The deduction is disallowed when AGI exceeds $109,000 ($54,500 MFS).

Note: Prepaid mortgage insurance premiums cannot be deducted in the year paid. The amount is required to be amortized over the shorter of:

- The stated term of the mortgage, or
- 84 months beginning with the month in which the mortgage insurance was obtained.

These allocation rules do not apply if the mortgage insurance was provided by the Department of Veterans Affairs or Rural Housing Authority.
Home Mortgage Interest Paid

Secured Debt- A home mortgage is any loan that is secured by the taxpayer’s primary or second home as collateral for the loan.

First and second mortgages, home equity loans, and refinanced mortgages are included in the list of home mortgages approved by the IRS. Debt not secured by the property would be considered personal debt which is not deductible.

Definition of a “home”- A qualified home is any home owned by the taxpayer and used as a residence. It can be a condominium, cooperative, house, mobile home, boat, or similar property.

4. Charitable contributions (e.g., cash, non-cash, Form 8283 Non-Cash Charitable Contributions).

Charitable contributions are deductible only if taxpayer itemizes deductions on Schedule A of Form 1040.

To be deductible, charitable contributions must be made to qualified organizations. Payments to individuals are never deductible.

If the contribution entitles taxpayer to merchandise, goods, or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, he can deduct only the amount that exceeds the fair market value of the benefit received.

For a contribution of cash, check, or other monetary gift (regardless of amount), taxpayer must maintain a record of the contribution which can include a bank record or a written communication from the qualified organization containing the name of the organization, the date of the contribution, and the amount of the contribution. In addition to deducting cash contributions, taxpayer can generally deduct the fair market value of any other property he donates to qualified organizations.
For any contribution of $250 or more (including contributions of cash or property), the taxpayer must obtain and keep in his records a contemporaneous written acknowledgment from the qualified organization indicating the amount of the cash donation and a description of any property contributed. The acknowledgment must say whether the organization provided any goods or services in exchange for the gift and, if so, must provide a description and a good faith estimate of the value of those goods or services. One document from the qualified organization may satisfy both the written communication requirement for monetary gifts and the contemporaneous written acknowledgment requirement for all contributions of $250 or more.

Federal tax law allows taxpayer to claim a deduction for the value of all property donated to a qualified charity during the year provided taxpayer is eligible to itemize deductions. Generally, any nonprofit organization that promotes religious, literary, educational, scientific, humanitarian or other charitable causes will qualify. However, if the combined value of all property donated is more than $500, taxpayer must prepare Form 8283 and attach it to his tax return.

The IRS requires taxpayer to obtain a qualified appraisal for donations that have a value of more than $5,000. The appraisal must be done by someone who holds some expertise in the type of property and must be signed and dated no more than 60 days prior to making the donation. The appraisal must also include a description of the property and its condition. The appraiser must also sign Part III of Form 8283. Note: The appraisal fees to determine the fair market value of property donated to a tax-exempt organization are deductible as miscellaneous itemized deductions.

General rules apply as follows:

- All contributions can be deducted in full up to 50% of taxpayer’s contribution base (AGI); however, limits on donations of qualified conservation contributions may be higher.

Note: The contribution base is the taxpayer’s adjusted gross income (AGI) without any net operating loss carry-back. The contribution base is often referred to as simply AGI.
- Donations to 50% limit organizations (listed below) have no other limitations.
• A 30% limit applies for capital gain property contributions at FMV with no reduction for appreciation.  
*Note:* Contributions made in excess of these limits can be carried over to the following year up to a maximum carry-over of five.

The following are some of the organizations that qualify as 50% limit organizations:
• Churches including conventions or associations of churches
• Educational organizations
• Hospitals, including medical research organizations associated with them
• Certain government entities
• Corporations, trusts, community chests, or foundation for charitable, religious, educational, scientific, or literary purposes or for the prevention of cruelty to children or animals.

Donations to all qualified organizations other than 50% limit organizations are subject to a 30% limit.

Gifts of capital gain property are subject to the 30% (Code Sect 170 (b) (3)). Qualified organizations other than 50% limit organizations include but are not limited to
• Non-operating foundations
• War veterans
• Fraternal organizations and public cemeteries

Property contributions can be deducted in full up to 30% of your contribution base:
• Ordinary income property contributions to qualified tax-exempt organizations are limited to 50% of the contribution base, with some exceptions.
• Ordinary income property contributions to the following organizations can be deducted but with limitations:
• Ordinary income property contributions made *for the use* of tax-exempt organizations, rather than *to* the organizations, have limitations.

Capital gains asset contributions to qualified tax-exempt organizations can be deducted in full up to 30% of contribution base.

The 30% limit for capital gain contributions is separate from the limit to 30% limit organizations. Therefore, one 30% deduction does not reduce the amount of a different 30% deduction.

A 20% limit of all gifts of capital gain property applies to donations made to or for the use of qualified charitable organizations except those made to 50% limit organizations.
Qualified conservation contributions made for tax years before 2012 can be deducted at 50% of the contribution base and the excess above the 50% can be carried over for 15 years.

Qualified conservation contributions made in 2012 are limited to deductions of up to 20% or 30% of the contribution base for capital gain appreciated property and the excess above the 20% or 30% can be carried over for 5 years.

A deduction limit of 100% is set for individuals with more than 50% of their gross income from farming or ranching.

Note: For donations made before 2012, the donation must be used for agriculture or production of livestock to qualify for the 100% limit.

A contribution made to a college or university that allowed the individual the right to purchase tickets to an athletic event is 80% deductible.

Example: Taxpayer purchases a membership to My Great University for $200 that allows him to attend special sports events at a reduced cost. He can deduct $160 which is 80% of the membership. If the purchase of the $200 membership included the cost of one ticket to a special event, the deduction would be $200 minus the cost of the ticket ($50) totaling $120 (80% of $150).

A donation made to a donor-advised fund is deductible if
  - The sponsoring organization is not a cemetery, war veterans' organization, or other limited type of organization.
  - A written acknowledgment of exclusive legal control over the asset is obtained from the sponsoring organization

5. Miscellaneous itemized deductions (including deductions subject to 2% AGI Limit).

Miscellaneous itemized deductions can be claimed using Form 1040, Schedule A. Some of the expenses are subject to a limitation based on the taxpayer’s adjusted gross income.

Deductions Not Subject to the 2% Limit

The taxpayer can deduct the items listed below as miscellaneous itemized deductions not subject to the 2% limit. Report these items on Schedule A (Form 1040), line 28, or Schedule A (Form 1040NR), line 14.
- Amortizable premium on taxable bonds
- Casualty and theft losses from income-producing property
- Federal estate tax on income in respect of a decedent
- Gambling losses up to the amount of gambling winnings
- Impairment-related work expenses of persons with disabilities
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2
- Losses from Ponzi-type investment schemes
- Repayments of more than $3,000 under a claim of right
- Unrecovered investment in an annuity

Expenses subject to the 2% limit include

- Unreimbursed employee expenses
- Tax preparation fees
- Other expenses such as
  1. Expenses to produce or collect income that is included in gross income
  2. Expenses to manage, conserve, or maintain property held for producing income
  3. Costs or fees to determine, contest, pay, or claim a refund of any tax

6. Employee travel, transportation, education, and entertainment expenses (e.g., Form 2106-EZ and Form 2106 Unreimbursed Employee Business Expenses)

In order to be able to deduct employee travel, transportation, and entertainment expenses, they must be common, helpful, and appropriate for the taxpayer’s field of work. An expense does not necessarily have to be “required.” Reimbursed expenses may not be deductible.

Deductible expenses generally fall into one of two categories: job-specific expenses and travel-related expenses.

Examples of deductible job-specific expenses

- Safety equipment, small tools, and supplies needed for job
- Uniforms required by employer that are not suitable for ordinary wear
- Protective clothing required for the job such as hard hats, safety shoes, and glasses
- Physical examinations required by employer
- Passport for a business trip
- Job search expenses in present occupation
- Depreciation on a computer that employer requires for work.
- Dues to professional organizations and chamber of commerce
- Licenses and regulatory fees
- Subscriptions to professional journals
• Occupational taxes
• Union dues and expenses
• Fees to employment agencies and other costs to look for a new job in present occupation even if taxpayer does not get a new job
• Certain work-related educational expenses

Examples of deductible travel-related expenses

• Cost of getting to and from business destination (air, rail, bus, car, etc.).
• Meals and lodging while away from home
• Cleaning and laundry expenses
• Meals and entertainment only if they are directly related to taxpayer’s trade or business. However, the expense only needs to be associated with the active conduct of trade or business if it directly precedes or follows a substantial and bona fide business-related meeting or convention
B. Credits

1. Child and dependent care credit (e.g., Form 2441 Child and Dependent Care Expenses).

   a. To qualify for the child and dependent care credit, the taxpayer must have a dependent child age 12 or younger or a dependent of any age who cannot care for himself or herself. The credit is calculated on Form 2441.

   In order to claim this tax credit, the following criteria must be met. The qualifying child or dependent must meet certain qualifications:

   - The daycare provider must meet certain qualifications
   - The taxpayer(s) must have earned income
   - The care provided must enable the person(s) claiming the credit to work or to look for work, and
   - The taxpayer(s) must reduce their eligible daycare expenses by any amounts provided by a dependent care benefits plan through their employer.

   The qualifying child must be a dependent aged 12 or younger. If the child is aged 13 or older, the child must be physically or mentally unable to care for himself. Adult daycare expenses may be claimed for a dependent age 13 or older or for a spouse if that person is physically or mentally unable to care for himself.

   The taxpayer(s) must provide a home for the dependent and pay over half the costs of maintaining a home for the dependent. Childcare or adult daycare expenses may not be claimed for someone who does not live with the taxpayer.
Normally, the child must also be the taxpayer’s dependent. If the child is not a dependent solely because the non-custodial parent is allowed to claim the child as a dependent, then the taxpayer may be able to claim the child care credit even though he isn’t claiming the child as the dependent. Only the custodial parent can take the child care credit, however. (See Publication 503 for more details about this exception.)

The person who provides childcare or adult daycare services cannot be one of the taxpayer’s dependents. Also, the daycare provider must provide his name, business name (if applicable), address, and either Social Security or Employer Identification Number. This information must be reported on Form 2441 in order to claim the Child and Dependent Care Tax Credit.

The child and dependent care tax credit is worth 20% to 35% of day care expenses paid. The percentage of the credit depends on the taxpayer’s adjusted gross income.

Child and dependent care may be claimed as a deduction if it allowed the taxpayer or spouse to work or seek work. In order to claim the deduction, the taxpayer must have earned income, although there are some exceptions.

2. Child tax credit and additional child tax credit (e.g., Form 8812, Additional Child Tax Credit).

The child tax credit can be claimed for qualifying children. Federal income tax is reduced by the amount for each qualifying child up to age 17. The child must be the son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or descendant of any of the above, including grandchildren, nieces or nephews. Adopted children are treated just as a biological child. The child must be a US citizen, US national, or US resident alien, and must have lived with you for more than half of the tax year.

The Child Tax Credit is a nonrefundable (tax cannot go below zero) $1,000 tax credit for taxpayers who have a qualifying child.

The qualifying child for this credit must meet all six of the following tests: age, relationship, support, dependent, citizenship, and residence.
- **Age Test** - To qualify, a child must have been under age 17 – age 16 or younger at the end of the tax year.

- **Relationship Test** – the qualifying child must either be taxpayer’s son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, which includes the taxpayer’s grandchild, niece or nephew. An adopted child is always treated as the taxpayer’s child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption.

- **Support Test** - In order to claim a child for this credit, the child must not have provided more than half of his own support.

- **Dependent Test** – The taxpayer must claim the child as a dependent on your federal tax return.

- **Citizenship Test** - To meet the citizenship test, the child must be a U.S. citizen, U.S. national, or U.S. resident alien.

- **Residence Test** - Unless exceptions apply, the child must have lived with the taxpayer for more than half of the tax year.

The credit is limited if the taxpayer’s modified adjusted gross income is above a certain amount. The amount at which this phase-out begins varies depending on the filing status. For married taxpayers filing a joint return, the phase-out begins at $110,000. For married taxpayers filing a separate return, it begins at $55,000. For all other taxpayers, the phase-out begins at $75,000. In addition, the Child Tax Credit is generally limited by the amount of the income tax owed as well as any alternative minimum tax that may be owed.

**Additional Child Tax Credit: Form 8817**

If the total credit amount for all qualifying children exceeds the amount of tax owed for the year, Form 8812 may be used to calculate an alternative refundable credit called the “additional child tax credit.”

The additional child tax credit is a refundable credit that can be claimed by taxpayers who are ineligible to claim the full non-refundable child tax credit, because it exceeds their total tax liability. This credit was created to reimburse taxpayers for the non-refundable portion of their child tax credit.
3. Education credits (e.g., Form 8863 Education Credits (American Opportunity and Lifetime Learning Credits), Form 1098T Tuition Statement)

Summary

The two education credits available to taxpayers are the American Opportunity Credit and the Lifetime Learning Credit. The American Opportunity credit provides a refundable tax credit of up to $2,500 for undergraduate education and is scheduled to expire at the end of 2012. The Lifetime Learning Credit provides a tax credit of up to $2,000 for any level of college education (even graduate school), and doesn't require a minimum level of enrollment. Form 8863 should be used to claim either education credits.

American Opportunity Credit

The American Opportunity Credit is worth up to $2,500 on the first $4,000 of qualifying educational expenses, which include course materials as well as tuition. The American Opportunity credit applies to all four years of undergraduate college education. The credit is gradually reduced (or "phased out") for income from $80,000 to $90,000 (or $160,000 to $180,000 for joint filers). The tax credit is not available for people with incomes above the phase-out range.

Up to 40% of the credit is refundable, meaning that it can generate a refund larger than the amount of payments you made.

The amount of the American Opportunity tax credit is:

- 100% of the first $2,000 in qualifying education expenses, plus
- 25% of the next $2,000 in qualifying expenses

To claim the maximum credit of $2,500, $4,000 in qualifying expenses must be expended.

Taxpayers may claim the American Opportunity Credit for themselves or their dependents if the student is enrolled at least half-time in a college, university, or other accredited post-secondary educational institution.

The American Opportunity Credit is available for the first four years of a student's post-secondary education (for the first four years of education after high school). The
American Opportunity credit is not allowed if a student has already completed four years of college education in a previous year or if the student has already claimed the American Opportunity Credit on four previously filed tax returns.

Qualifying educational expenses for the American Opportunity Credit are tuition and related course materials. Course materials such as books, lab supplies, software, equipment, and other class materials can qualify for the tax credit.

**Lifetime Learning Credit**

The Lifetime Learning Credit is a tax credit for taxpayers who take college classes in approved higher-learning institutions. It provides a tax credit of 20% of tuition expenses, with a maximum of $2,000 in tax credits on the first $10,000 of college tuition expenses. Unlike the American Opportunity credit described above, the student does not need to be in the first four years of undergraduate classes.

Accredited colleges and universities are eligible educational institutions. Additionally, vocational schools and other post-secondary institutions are also eligible.

Qualifying expenses include amounts paid for tuition and any required fees (such as registration and student body fees). Qualifying expenses *may include* any of the following provided the expense is required to be paid to the school: books, supplies, equipment, student fees. The following are not deductible: Room and board, insurance, student health fees, transportation, and living expenses.

The taxpayer must be responsible for paying the college tuition and fees. Qualifying expenses must be reduced by any amount of financial assistance received from grants, scholarships, or reimbursements from an employer.

The amount of the Lifetime Learning Credit is limited over a phase-out range. If the taxpayer's income exceeds the phase-out range, he would not eligible to claim the Lifetime Learning tax credit. Below is the income phase-out range for the year 2011:

- $51,000 to $61,000 : Single, Head of Household, or Qualifying Widow
- $102,000 to $122,000 : Married Filing Jointly

For the year 2012, the income phase-out ranges will be

- $52,000 to $62,000 : Single, Head of Household, or Qualifying Widow
4. **Earned Income Credit (EIC)** (e.g., Schedule EIC Earned Income Credit, Form 8867 Paid Preparer’s Earned Income Credit Checklist).

The EIC is a tax credit designed for taxpayers who meet low-income guidelines. It reduces tax liability and in some cases will allow a taxpayer to receive a refund even if no tax liability exists.

The due diligence form, Form 8867 Paid Preparer’s Earned Income Credit Checklist, is required to be filed in conjunction with the claim of earned income credit if prepared by a paid preparer.

**In order to qualify for an Earned Income Tax Credit, the taxpayer must meet the following criteria:** Earned Income, Valid Social Security Number, US citizenship, and filing jointly.

**Income Guidelines** - Adjusted gross incomes of taxpayers must be less than the following:

<table>
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<tr>
<th></th>
<th>Single AGI Limit</th>
<th>Married, Filing Jointly AGI Limits</th>
<th>Maximum Credit Amounts</th>
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</table>
Must Have Earned Income

1. In order to qualify for an Earned Income Credit, the taxpayer must have earned income. As is implied in the name of the credit itself, in order to gain the credit, the taxpayer must have worked and earned income. If the taxpayer is an employee, earned income refers to all of the taxable income that has been received from the employer though there can be an exception for nontaxable combat pay which will be explained further. If the taxpayer is self-employed, earned income is calculated by utilizing a worksheet found in the form 1040 instructions.

2. If the taxpayer is married and filing jointly, this rule can be met as long as one spouse has earned income.

3. Earned Income includes
   - wages, salaries, and tips (and other taxable employee pay)
   - net earnings from self-employment
   - gross income, if received as a statutory employee
   - strike benefits paid by a union

4. In terms of wages, salaries and tips, employee pay is only considered earned income if it is taxable. For example, certain benefits are not taxable and are not considered earned income. For instance, the taxpayer can elect to include nontaxable combat pay in his earned income when calculating for the EIC. (Nontaxable combat pay is located in box 12 of the W-2 form, and accompanied by code Q.) Inclusion of this pay may increase the amount of Earned Income Credit owed to the taxpayer.

5. Taxpayers may have net earnings from self-employment if they own their own business or if they are a member of or minister to a religious order.

6. If the taxpayer is a minister, the amount that he receives in the form of a housing allowance as part of income is generally not subject to income tax. However, it is included in net earnings for self-employment and is included in earned income for the Earned Income Credit.
7. **Investment income** must be $3,150 (2011 figure) or less in order to claim the Earned Income Credit.

Investment income is money earned through any of the following:

- Interest and Dividends
- Capital Gains Net Income
- Royalties and Rental Income from Personal Property
- Passive Activities

8. **Disability Benefits**

   - Taxable disability benefits paid to retired taxpayers that retired on disability are earned income until the taxpayer reaches minimum retirement age. Starting the day the taxpayer reaches minimum retirement age, payments become taxable pension and are not considered earned income.
   - Minimum retirement age is typically the earliest age that an employee could have received a pension were they not disabled.

9. **Unqualified Income § 32(i)(2)**

   a. The following would **NOT** be considered as earned income:

   - pensions
   - annuities
   - interest and dividends
   - social security
   - alimony and child support
   - workers’ compensation benefits
   - welfare
   - unemployment benefits
   - veterans' benefits
   - money earned while an inmate

10. **Nontaxable Military Pay and Combat Pay** Taxpayers can elect to include nontaxable combat pay as earned income. However, nontaxable pay for members of the armed forces like basic allowances for housing and subsistence are not considered earned income for the EIC calculation purposes.

11. **Community Property** Taxpayers that live in a state that has community property laws and are qualified to file as head of household under the special rules for married taxpayers living apart should not include any amount earned by their spouse in their earned income. Though this money is included as gross income on the tax return, it is not used to calculate the EIC under these
conditions. However, the entire income earned by the taxpayer is treated as earned income whether or not part of it is attributed to their partner under the state's community property laws.

12. **Welfare Payments** Taxpayers who receive nontaxable workfare payments may not include these payments as earned income. Workfare payments are cash payments paid to individuals from public assistance programs funded by the federal Temporary Assistance for Needy Families program.

13. **File a 2555 or 2555-EZ form** If the taxpayer is filing Form 2555 or Form 2555EZ, the income cannot be included as earned income. These forms are used to report foreign-earned income, and that income must be excluded from gross income.

14. **Other** Taxpayers who received social security retirement benefits or social security disability benefits at the time they received Conservation Reserve Program payments cannot count those CRP payments as earned income. Taxpayers who are members of a qualified joint venture that reports solely rental real estate income that is exempt from self-employment tax cannot include income or loss from the venture as earned income.

**Must have valid Social Security Number**

In order to claim EIC, the taxpayer (and spouse, if filing jointly) must have a valid Social Security Number (SSN) that has been issued by the Social Security Administration. In addition, any qualifying child that is claimed must also be in possession of a valid SSN unless that child was born or died during the calendar year. In this case, a copy of a birth or death certificate or a hospital record that shows a live birth must be attached to the return.

1. Taxpayers cannot claim Earned Income Credits with a qualifying child or children when
   - The social security number for a child is missing or incorrect on the tax return;
   - A child has a social security card that is marked as “not valid for employment” and was issued in order to obtain a federally funded benefit;
   - The qualifying child has an individual taxpayer identification number (ITIN) or an adoption taxpayer identification number (ATIN) instead of a social security card.
2. If the taxpayer is in the possession of a social security card that reads either “valid for work only with DHS authorization” or “valid for work only with INS authorization,” this is a valid SSN and can be used to claim an EIC.

3. If the taxpayer (or jointly-filing spouse) has a social security card that states it is “not valid for employment,” and it was issued in order to obtain a federally-funded benefit such as Medicaid, the taxpayer is ineligible for the EIC.

4. Missing or incorrect social security numbers either for taxpayers or their spouses when filing jointly may translate to EIC ineligibility.

5. If the taxpayer does not have a valid SSN and instead he (or his spouse, if filing jointly) has an Individual Taxpayer Identification Number, he cannot claim the EIC. (These numbers are issued to non-citizens who are ineligible for a SSN and as such cannot be substituted for one in this instance.)

**Must be a United States citizen OR resident alien for the entire filing year**

In the case that the taxpayer or his spouse was a nonresident alien for any part of the year, he cannot claim EIC unless a joint return is filed. This status is only eligible if one spouse is a U.S. citizen or resident alien and the nonresident spouse is treated as a U.S. resident. In this scenario, both spouses are taxed on their worldwide income and may want to investigate the consequences of this filing status further.

**The following EIC rules apply either to having children or to not having children**

1. Rules for the taxpayer are based upon whether taxpayer has or does not have a qualifying child.
   
   a. If the taxpayer has a qualifying child,
      
      • the child must meet set requirements in terms of age, relationship, residency, and joint-return tests.
      • the child must not be used to claim more than one EIC.
      • the taxpayer cannot be a qualifying child for EIC for another person.
   
   b. If the taxpayer does NOT have a qualifying child, he/she must
      
      • be between the ages of 25 and 65.
      • have lived in the United States for more than half of the year.
• NOT be the dependent or qualifying child of another person.

2. Rules for EIC Qualifying Children

In order for a child to be claimed as a qualifying child for an Earned Income Credit, he/she must meet requirements in four areas.

• Relationship
• Age
• Residency
• Joint Returns

a. Relationship A qualifying child must be related to the taxpayer in one of the following ways:

• Son, Daughter, Stepson, Stepdaughter, or Foster Child
• Brother, Sister, Stepbrother, Stepsister, Half-Brother or Half-Sister
• Descendants of any of the above (for example, grandchildren, nieces or nephews.)

 Adopted and Foster Children Adopted children are not legally distinct from other children and are consequently treated the same. Foster children can be qualifying children when placed in the taxpayer's care by a legal authority such as a court order, judicial decree, tribal authority, or authorized placement agency.

b. Age Qualifying children must meet certain age requirements. These requirements vary slightly depending upon student status and disability and fall into three categories. Children must meet one of the following guidelines:

• Child must be under the age of 19 at the end of the tax year and must be younger than the taxpayer (or spouse, if filing jointly);
• Disabled - Regardless of age, a child who has become permanently and totally disabled sometime during the tax year is considered a qualifying child. Even though there is no age limit for a child who is permanently and totally disabled, certain requirements must be met in order to meet the disability test:
  1. A child is considered permanently and totally disabled if he/she cannot participate in gainful activity due to mental or physical condition.
  2. A doctor must determine that his/her condition has or will last continuously for at least one year or has the potential to be fatal. It is important to note that both of these criteria must be met.
● **Student** - Must be enrolled as a student and must be under 24 years of age at the end of the tax year and must be younger than the taxpayer (or spouse, if filing jointly). Must be enrolled full time (as defined by the school) during some portion of any five months during the calendar year at either
1. A school that has a regular teaching staff, course of study, and student body OR
2. An on-farm training course administered by a school, a state, or county or local government
3. In addition to the above definition, examples of schools are elementary school, middle school, junior high school, high school, college, university, technical school, trade school, or mechanical school.
4. Students who work in a vocational capacity as part of coursework or training are also considered full-time students.
5. It is important to note for EIC purposes, on-the-job employee training courses, correspondence schools, and schools that are entirely online are **not** considered schools.

### c. Residency § 7701
Children of the taxpayer must have lived with the taxpayer in the United States for more than half of the calendar year. For income tax purposes, the United States refers to the 50 states and Washington D.C. An exception to this rule concerns military personnel stationed outside the United States. Military personnel who are on extended active military duty and are stationed in places other than the U.S. are considered to live in the United States for purposes of obtaining the EIC.

It is not necessary to reside in a “traditional” home in order to establish residency with your child. A home is considered any location that the taxpayer regularly lives and can include places such as homeless shelters.

### d. Joint Return
A child cannot file a joint return for the same tax year he is claimed as a qualifying child. This is true UNLESS a child and his/her spouse files a claim solely as a claim for a refund.

- **The taxpayer must NOT** have a filing status of “Married filing separately”
  - **Exception:** Married taxpayers whose spouse did not live with him/her during any time in the last six months of the calendar year may be able to file as head of household, not “married, filing separately.” Under these circumstances, they may also qualify for an Earned Income Credit.

### 3. Additional rules regarding EIC

#### a. Married Children
Married children cannot be qualifying children for the EIC even if they do not file a joint return unless
• the taxpayer can claim an exemption for the (married) child, **OR**
• the taxpayer cannot claim an exemption because he allowed the child's other parent to claim the exemption in accordance with the special rules for divorced or separated parents or parents who live apart.

**Example**

Steven's 18 year-old daughter Christy is married but lived with Steven the entire year while her husband worked on an oil rig in the Gulf of Mexico. Despite Christy and her husband’s physical separation during the year, they filed jointly at the end of the year. As a result, Steven is unable to claim his daughter as a qualifying child despite his support.

**b. Qualifying Children Cannot be Claimed By More Than One Person**

Although it is possible for a child to meet the tests of being a qualifying child for more than one person, only one person may actually claim the child to qualify for an Earned Income Credit.

In addition to the EIC, a child can only be claimed by a taxpayer for a number of tax benefits, such as

There are a number of “tiebreaker rules” which help to determine who should claim a child in the case when that child meets the test of being a qualifying child for more than one parent.

**c. Tiebreaker Rules**

In order to determine which taxpayer can claim a child as a qualifying child for the above tax benefits, there are four established rules:

• If only one of the people vying to claim the child is his/her parent, the child is treated as the qualifying child of the parent
• In the case when the parents are not filing jointly and each can claim the child, the parent with whom the child lived with longer during the year can claim the child OR if the amount of time with each parent is equal, the parent that had the higher Adjusted Gross Income that year can claim the child

• If no parent can claim the child as qualifying, the taxpayer with the highest AGI may claim him/her.

• If a parent can but chooses not to claim his/her child, the person who has the higher AGI may (provided that their AGI is higher than the parent or parents who chose not to) claim their child.

The tiebreaker rules can help determine who between two people can claim a child as qualifying. If the taxpayer who is determined to be able to claim the child does not qualify for the EIC for other reasons, the next taxpayer in line might be able to claim the child; however, this is not the case if the first taxpayer chooses to claim any of the six available benefits listed above using that particular child as a qualifier.

d. Rules for Taxpayers without Qualifying Children

If the taxpayer is childless or does not meet the requirements for a qualifying child that are outlined previously, he has a set of parallel requirements that must be met.

• Age In order to qualify for the EIC, taxpayers must be at least 25 years of age but under the age of 65 at the end of the calendar year. Under circumstances where the taxpayer is married and filing jointly, either one of the spouses must meet the age requirement.

If the taxpayer is filing a joint return with a spouse who died in the filing year and that spouse was at least 25 but under 65 at the time of his death, the age requirement has been met.

e. Taxpayer as Qualifying Child
1. If the taxpayer (or spouse, if filing jointly) is a qualifying child of another person, he/she cannot receive the EIC. This is true even if the person who is able to claim the credit chooses to opt out of claiming it.

5. **Retirement savings contribution credit (e.g., Form 8880 Credit for Qualified Retirement Savings Contributions).**

Individuals who make eligible contributions to an employer-sponsored retirement plan or IRA may qualify for a retirement savings contribution credit. Requirements include the individuals filing status and income limits based on the filing status. Age and the contribution amount are also factors. The individual must not have been a full-time student during the calendar year.

**D. Retirement Savings Credit (Saver’s Credit)**

The taxpayer may be eligible for a nonrefundable tax credit if he makes eligible contributions to an employer-sponsored retirement plan or to an individual retirement arrangement. This credit was designed to give a special tax break to low- and moderate-income taxpayers who are saving for retirement.

To claim a Savers Credit, the taxpayer must be age 18 or older and cannot be a full-time student or be claimed as a dependent on someone else's tax return. The retirement contribution must have been made during the tax year for the return is filed.

The Savers Credit can be claimed for contributions to a 401k, 403(b), 457 plan, a Simple IRA or a SEP IRA. Contributions to a traditional IRA or a Roth IRA are also eligible for the Savers Credit.

Depending on the adjusted gross income and tax filing status, the credit may be 50%, 20% or 10% of the first $2,000 contributed during the year to a retirement account. Therefore, the maximum credit amounts that can be claimed are $1,000, $400 or $200. The biggest credit amount is $2,000 for a married couple filing jointly.

**2011 Income Limits**
The credit is limited to individuals with a filing status and income of:
- Single, married filing separately, or qualifying widow(er), with income up to $27,750
- Head of Household with income up to $41,625
- Married Filing Jointly, with incomes up to $55,500

To claim the credit, use Form 8880, "Credit for Qualified Retirement Savings Contributions."

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2012 Income Limits

• Single, married filing separately, or qualifying widow(er), with income up to $28,750
• Head of Household with income up to $43,125
• Married Filing Jointly, with incomes up to $57,500

Filing Form

To claim the credit, use Form 8880, "Credit for Qualified Retirement Savings Contributions."
Domain
1. Alternative Minimum Tax (e.g., Form 6251 Alternative Minimum Tax)

The alternative minimum tax (AMT) limits the tax benefit of certain types of income and deductions that otherwise would be available under the regular tax system. The AMT has its own defined set of rules for accounting and timing, definition of income and expenses, tax rates. If the AMT calculation yields a higher tax than the regular income tax, the difference is paid and reported on Form 1040.

Taxpayers compute AMT on Form 6251, Alternative Minimum Tax-Individuals. The starting point for computing alternative minimum tax income is adjusted gross income, which is then adjusted up or down with adjustments or preference items (exclusions and deferrals).

The following chart summarizes common AMT exclusions and deferrals.
<table>
<thead>
<tr>
<th>Expense</th>
<th>Exclusion or deferral</th>
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</thead>
<tbody>
<tr>
<td>Medical and dental</td>
<td>Exclusion</td>
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<tr>
<td>Mortgage interest</td>
<td>Exclusion</td>
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<tr>
<td>Miscellaneous itemized deduction</td>
<td>Exclusion</td>
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<tr>
<td>Itemized taxes</td>
<td>Exclusion</td>
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<td>Investment Interest Expense</td>
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<td>Depletion</td>
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<tr>
<td>Private activity bond interest</td>
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<tr>
<td>Depreciation on assets placed in service after 1986</td>
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<tr>
<td>Gain/loss on sale of property</td>
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<tr>
<td>Exercise of incentive stock options</td>
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<tr>
<td>Research and experimental costs</td>
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<tr>
<td>Long-term contracts</td>
<td>Deferral</td>
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<tr>
<td>Passive activities</td>
<td>Deferral</td>
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<tr>
<td>Loss limitations</td>
<td>Deferral</td>
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</table>

AMT is most commonly triggered by the following items:
• High gross income compared to taxable income
• High number of dependents
• Exercise of incentive stock options
• Long-term capital gains
• High tax or miscellaneous deductions on Schedule A
• Tax-exempt interest
2. Early distributions from retirement plans (e.g., Form 5329 Additional Tax on Qualified Plans).

Distributions from 401ks, IRAs, or Roth IRAs may be subject to penalty taxes if early withdrawals are initiated. If distributions from traditional IRAs and qualified plans are initiated before the taxpayer turns 59 ½, a 10% penalty will be assessed unless certain exceptions apply. Taxable distributions are also taxed at the taxpayer’s regular federal income tax rate.

Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts, must be completed and attached to the tax return.

3. Self-employment tax (e.g., Schedule SE Self-Employment Tax).

Self-employment income is subject to Social Security and Medicare taxes to ensure self-employed individuals earn credits for Social Security and Medicare. This tax encompasses both the employee and employer’s share of the Federal Insurance Contributions Act (FICA). The basis for the self-employment tax calculation is the near earnings from self-employment, which are profits reported on Schedule C or F.

The calculation of the self-employment tax is accomplished using Schedule SE (Form 1040).

Note: The employer’s portion of the self-employment tax is deductible from the taxpayer’s income tax.
Example: Sal earned $100,000 in net income from self-employment activities. The base for his self-employment tax calculation would be $92,350 ($100,000 minus $7,650, which is 7.65% of $100,000, the employer’s share of FICA).
4. **Unreported Social Security and Medicare tax (e.g., Form 4137 Social security and Medicare Tax on Unreported Tip Income).**

All tips are taxable. Employees receiving any tips totaling at least $20 per month must be reported to the employer.

**Allocated Tips**

Tips that an employer assigns to a worker in addition to any tips reported by the worker is subject to special rules. Allocated tips occur when:

- The tips reported by the employee to the employer were less than the worker’s share of 8% of food and drinks sales
- The employee works in a business type (restaurant, bar, etc), that is required to allocate tips to employees
- The employee did not participate in the employer’s Attributed Tip Income Program.

Allocated tips are reported in Box 8 of Form W-2. The tips are reported as income UNLESS any of the following are applicable:

- The employee’s daily tip record is reliable and credible. If this is the case, only the amount in the employee’s record is reported.
Even though the employee’s tip record is incomplete, the employee has a means of providing credible evidence that actual tips were more than the tips reported to the employer plus allocated tips. If such is the case, only the amount in the employee’s record is reported.

**Form 4137**

Since no Security and Medicare taxes are withheld on allocated tips income, the employee must pay these taxes directly to the IRS. Form 4137, Social security and Medicare Tax on Unreported Tip Income, should be used to calculate the Social Security and Medicare taxes owed on the income.
5. Repayment of first-time home buyer credit (Including Form 5405 First-Time Homebuyer Credit and Repayment of the Credit).

Taxpayers who claimed the first-time homebuyer credit may be subject to repayment rules. The additional-tax reporting is also referred to as recapturing. The recapture rules depend on when the home was bought:

Home was purchased in 2008

1. Continued ownership as principal residence

If the home was purchased in 2008 and the home continues to be owned and used as a principal residence, the credit is recaptured over 15 years. Part IV of Form 5405, First-Time Homebuyer Credit and Repayment of the Credit, should be used to report the recapture.

In a typical example, if a taxpayer received the maximum $7,500 credit in 2008 for the purchase of a home, $500 must be recaptured each year beginning in 2010.
2. **Discontinuation of home as principal residence**

If the home was purchased in 2008 and the taxpayer sells the home or ceases using it as his principal residence before the end of the 15-year recapture period, the remaining credit must be recaptured. The recapture is limited to the amount of gain (if applicable) on the sale of the property. The gain is calculated by reducing the adjusted basis of the home by the amount of the first-time homebuyer credit claimed but not yet recaptured. For instance, if $500 of the $7,500 credit has been recaptured, the adjusted basis of the home would be reduced by $7,000.

In the case the home is sold or disposed of because of an involuntary conversion (property is destroyed, condemned, or disposed of under a threat of condemnation), no recapture is required if the new principal residence is acquired within a two-year period beginning on the date the first home ceases to be the taxpayer’s principal residence. There is no recapture upon the death of the homeowner.

**Home was purchased in 2009 or 2010 (2011 is rarer, special cases)**

For homebuyers in 2009 and 2010, full recapture, i.e., the entire credit must be repaid, is required if the home is sold or ceases being used as the taxpayer’s principal residence within 36 months from the date of purchase. However, if the home is sold for a valid reason, recapture is not applicable. No recapture is required if the following situations exist:

- Death
- Involuntary conversion
- Divorce
- The home is sold at a loss

Note: After 36 months of ownership, recapture no longer applies.
Domain

5
1. **Check return for completeness and accuracy**

Every return must be complete and accurate. Check the return to ensure:

- Use of correct forms. There are many forms that may be used. Be sure that each entry has the associated corresponding form (when applicable).
- Each entry contains accurate and correct information. The taxpayer must present true and accurate information on the tax return.
- Each form used must be complete and accurate. Data contained on each form should be consistent across all forms.

*Example:* You have been a paid tax return preparer for Russ for over a decade. For the past 5 years, Russ has reported W-2 income from her full-time job and business income from her side job as a writer. Like clockwork, Ruby sends in her information to you this year but fails to include any data for her writer job. Before the return is finalized, you should exercise due diligence and inquire about the potential missing data.

- Signatures. Be sure all signatures and e-signature requirements have been met.
- Calculations must be accurate.
2. Explain and review tax return

In order to explain a tax return, a tax preparer must be familiar with the following terms:

- **AGI (adjusted gross income).** AGI is all the income received over the course of a year, including wages, dividends, and interest. AGI also includes contributions to a qualified IRA, business expenses, and alimony payments, which are known as capital gains.
- **Tax Credits.** Credits reduce the amount of tax owed, not the income amount.

*Example:* Farrah calculates her tax bill to be $1200. She has a credit of $400. She reduces her tax bill to $800.

*Example:* Sierra calculates her tax bill to be $400. She has a tax credit of $500. She will receive a refund of $100.

- **Deductions.** Deductions reduce the AGI, resulting in a sum known as taxable income.

*Example:* Suzette earned $75,000 in wages from her job. She had $5,000 in deductions. Her taxable income is $70,000.
• Itemized deductions. Deductions that are listed individually. Student loan interest, alimony payments, and IRA contributions may be listed on Form 1040 or 1040A.
• Standard deduction. A fixed amount that can be deducted from AGI, based on inflation.
• Withholding. A method of paying taxes as income is earned. Taxes are held out of a paycheck and deposited into an IRS account. The withholdings are credited to the taxpayer at tax time.
• Exemptions. Exemptions can be claimed for persons who rely on the taxpayer’s income. These include the taxpayer, his or her spouse, and his or her dependents. Exemption amounts are fixed and adjusted for inflation. The exemption amount is deducted from the AGI to calculate taxable income.
3. **Explain record-keeping requirements to the taxpayer.**

Keeping records, including proof of income, expenses, deductions, and any other items listed on a tax return is the responsibility of the taxpayer. Records must be kept for the following:

Deductions for travel away from home, entertainment, gifts, and transportation expenses while traveling away from home must be substantiated.

Expenses can be proven by:
- Receipts
- Canceled checks
- Bills

Receipts should have the following:
- Amount
- Time
- Place or description
- Business purpose or business relationship

Records should be kept in something similar to one of the following:
- An account book
- Diary
- Log
- Statement of expense
- Trip sheet

Evidence/records of this sort are not needed when:
- Meals or lodging expenses while traveling away from home that are accounted for under a plan with an employer
- Meals or lodging expenses while traveling for which a per diem allowance is used
Proof of business purposes must be provided. A written statement of the purpose will usually suffice, and is not necessary when the purpose is clear based on the circumstances/documentary evidence. Keeping incomplete records will require a written or oral statement be used instead and any other supporting evidence that can substantiate the expense. Records that have been destroyed can be reconstructed to prove expenses. Separate events require separate expense records.

**Example:** A dinner event with a client and a theater event following the dinner with the same client are two separate events that must each be substantiated separate from each other.

Car expenses incurred as part of a round trip event or uninterrupted business use can be substantiated with one record. Records should be kept as long as necessary to meet the provisions of the Internal Revenue Code, which is generally 3 years from the date of the return.
4. Discuss significance of signatures (e.g., joint and several liabilities, penalty of perjury. Form 8879 IRS e-file Signature Authorization

When two or more individuals are liable for the same tax, they may be:

- Jointly liable, wherein each individual is liable up to the full amount.

*Example:* Samantha and Giovanni are married. They have a tax for which they are jointly liable. Giovanni files bankruptcy. The bank can sue Samantha for the full amount owed.

- Several liability, also known as proportionate liability, where each individual is responsible solely for his or her obligation.
- Jointly and severally liable, also known as all sums, allows a loaner or claimant to sue either of the parties for the total sum, and the parties are responsible for determining their respective liabilities.
Signatures

If MFJ status is filed, both spouses must sign the tax return, even if only one person had income. If the spouse is away from home for traveling purposes, arrangements should be made so that the spouse who is away can sign for the return. If a refund is due, no refund will be issued unless the return has been properly signed.

Someone can sign for the taxpayer if the following are true:

1) Disease or injury exists
2) The taxpayer(s) is absent from the United States for a continuous period of at least 60 days before the due date for filing the return
3) Permission from the taxpayer’s local-area IRS office has been given

Form 8879

Form 8879, IRS e-signature Authorization, is the declaration and signature form used when a tax return is filed by an electronic return originator (ERO). The form is also used when the taxpayer is using the Practitioner PIN method or is authorizing an ERO to generate or enter the taxpayer’s PIN. The form is not filed with the IRS; rather, tax return preparers should keep the completed Form 8879 for three years from the later of the return due date or the date the IRS received the return.
5. Understand the tax preparer's responsibilities related to rejected electronic returns

Rejections may occur for a variety of reasons:

- Erroneous bank account information
- Conditions that require unusual or excessive demands on processing
- Incorrect use of or failure to use Personal Identification Numbers (PIN)
- Untimely filing
- Errors with use of TINs such as an incorrect TIN, mismatch of TIN and name, or multiple use of same TIN

If a return is rejected, the ERO must make a reasonable effort to provide the taxpayer with the rejection codes and an explanation of the rejection codes within 24 hours.

In order to resubmit a rejected a return, a taxpayer must either resubmit the electronic portion of the return when possible, or if it is not possible, must file a paper return. Resubmission must be timely, which is the later of either:

- The due date of the return, or
- Ten calendar days after the notification date of the rejection

Note: A written explanation of why the return is filed late should be included in the return.
6. Understand timeframe for submitting electronic returns (e.g., Form 8879 taxpayer signature and date prior to submission)

Electronic returns must be filed by the due date, just as paper returns.

The date for filing the 2012 tax return, if using the calendar year, is April 15th, 2013.

If using a fiscal year, the return is due on the 15th day of the fourth month after the last day of the fiscal year. A fiscal year is any 12-month or 52-week period that doesn’t end on December 31.

*Example:* The fiscal year for a taxpayer is July 1 through June 30. The return is due on October 15.

When a due date falls on a Saturday, Sunday, or legal holiday, the due date is postponed to the next business day.
Automatic extensions are possible whether filing a paper or electronic return. An automatic extension will extend the due date 6 months from the due date. Payments not made by the due date will accrue interest.

Individuals living outside of the United States at the time of the due date are eligible for a two-month extension. Individuals who are serving out of the country in the military may be eligible for a longer extension.

To apply for an automatic extension using e-file, use Form 4868.
7. Understand payment options (e.g., check, direct debit, EFTPS, credit card, installment agreement Form 9465).

Tax payments can be made by:

- Check
- Money order
- Cashier’s check
- Cash

Payments should:

- Be made payable to the US Treasury (or United States Treasury)
- Include the taxpayer’s social security number or EIN
- Include the tax period and related tax form number

Cash payments can only be made in person at a local IRS office that is equipped to accept cash payments. (Not all IRS offices are equipped to accept cash.)

Taxpayers can make electronic payments via:

- A credit or debit card
- The Electronic Federal Tax Payment System (EFTPS)
Monthly payment options can be made via an installment agreement. In order to apply for an installment agreement all tax forms must be filed first.

Use form 9465-FS to apply for an installment agreement. Apply online if $50,000 or less in tax, interest and penalties is owed. If more than $50,000 is owed, Form 433-F must be completed.

All potential refunds will be applied to the tax debt until paid in full.

It is important to know that a loan or credit card may be a less expensive way to pay off a tax debt.

Fees for establishing an installment agreement are as follows:

- Direct debt = $52
- Standard or payroll deduction = $105
- Low-income reduction = $43
8. Understand the estimated tax payment requirements (e.g., potential for penalties, Form 1040-ES Estimated Tax).

Estimated tax is a method of figuring tax on income that is not subject to withholding.

Estimated tax is due for taxpayers who owe additional tax, over and above what they have withdrawn or paid as installments. In general, a tax payer must pay estimated tax when:

- At least $1000 in taxes is owed, after withholding and refundable credits, and
- The withholding and refundable credits are expected to be less of the smaller of 100% of the tax for the previous year, or 90% of the tax for the current year.

Note: Different amounts may apply for farmers, fisher people, or taxpayers with higher incomes.

Estimated tax is not due for taxpayers who:

- Had no tax liability
- Were US citizens or resident aliens for the entire year, and
- Have a tax year that includes a 12-month period

Penalties may be owed if the total amount of the withholding and estimated tax payments does not equal 90% of the current year’s tax or 100% of the previous year’s tax.
Penalties are generally not owed when any of the following apply:

- Total tax for the current year after withholding is less than $1000 or there was no withholding and the taxes were less than $1000
- There is no tax liability for the year
- The taxes are not greater than 10% of the tax bill and the estimated tax payments were made on time

The taxpayer does not have to figure out the penalty owed, except when:

- A waiver is requested for part of the penalty
- The annualized income installment method is used for figuring the penalty
- The federally withheld income tax is treated as paid on the dates withheld (rather than as a deposit)

Other than these situations, the IRS will figure the penalty owed and send a bill to the taxpayer.

Form 2210 or Form 2210-F can be used in situations where the penalty may be lowered or eliminated.
9. Understand refund options (e.g., Form 8888 Allocation of Refund).

Refunds can be paid via direct deposit into an account with a financial institution. Refunds can also be used to purchase up to $5000 in paper series 1 savings bonds.

Form 8888 can be used to allocate the refund to a financial institution, bank, broker, or credit union.

Note: The first account listed on Form 8888 is the account in which the full refund will be deposited—even if a split was requested—if the return is delayed.
Domain

6
1. Penalties to be assessed by the IRS against a preparer for negligent or intentional disregard of rules and regulations, and for a willful understatement of liability (e.g., IRC 6694(a), IRC 6694(b)).

The IRS may assess penalties to taxpayers for aiding and abetting the understatement of a tax liability or estimated tax, for failure to file or pay, for fraud including promoting abusive tax shelters and including frivolous returns, or for negligence, and to tax return preparers for negligence or non-compliance.

Common issues of non-compliance, negligence, and fraud include:

- Disregard of rules or regulations
- Failure to make a reasonable attempt to comply
- Careless, reckless, or intentional disregard for rules and regulations
- Untimely filing
- History of non-compliance
- Inadequate record-keeping
- Failure to keep control of processes and business transactions
- Inability or failure to explain questionable items
- Intentional overstatements of deductions or credits

*Example:* Sue is a tax return preparer for Molly. Molly has a small business, selling plastic containers to her friends and family. Molly also works a full-time job that is 50 miles from her home. Sue uses Molly’s mileage to and from her full-time job as a
deduction for her plastic-container business, even though they are completely unrelated. Sue’s behavior is non-compliant and fraudulent, and subject to penalty.

2. Appropriate use of Form 8867 Paid Preparer’s Earned Income Credit Checklist and related penalty for failure to exercise due diligence (e.g., IRC 6695(g)).

Form 8867 must be attached to the tax return when filed, if the return is prepared by a paid preparer.

A tax return preparer who fails to practice diligence when determining earned income credit eligibility may be subject to a $500 penalty for each occurrence of failure to comply.

The earned income tax credit (EITC) is a benefit for low-to-moderate income/wages, which reduces the amount of tax owed.
To qualify for EITC, the taxpayer must:

- Not be married filing separately
- Have a valid social security number
- Be a US citizen or resident alien for the whole tax year
- Not be the qualifying child or dependent of another person
- Have a qualifying child, or
- Be at least age 25 but under age 65
- Live in the United States for more than 6 months of the year

To qualify for the EITC, a tax return must be filed, even if no tax is owed.

*Example:* Matilda is a tax return preparer for Tom and Sally, and for June. Matilda knows that Tom is not a US citizen, and he and Sally are engaged to be married. She sees that they will qualify for a tax refund which would help pay for the wedding if she applies the earned income tax credit for them. June is a single mother, whose child lives full-time with the child’s father (not with June). Matilda does not verify whether the child’s father claims the child as a dependent, and applies the EITC to June’s return, using her child as the qualifying child. In both cases, Matilda does not practice due diligence for determining whether Tom and Sally and June are eligible to receive the EITC. Matilda is potentially subject to $1000 in penalties.
3. Furnishing a copy of a return to a taxpayer (e.g., IRC 6695(a)).

A tax return preparer is required to furnish the taxpayer with a copy of the tax return, claim, or refund. The copy of the return or refund must be furnished at the time the return is presented for the taxpayer’s signature.

Failure to do so may result in a penalty of $50 for each failure to furnish a copy, but will not exceed $25,000 per year.
4. Signing returns and furnishing identifying (PTIN) numbers (e.g., IRC 6695(b), IRC 6695(c)).

A tax return preparer is required to sign a return or claim and to furnish an identifying number. Electronic signatures, alternative methods, or a declaration of written permission may be acceptable.

A penalty of $50 per failure to sign a return may be imposed, up to $25,000 per year.

A penalty of $50 per failure to furnish an identifying number may be imposed, up to $25,000 per year.
5. Rules for the return preparer for keeping copies and/or lists of returns prepared (e.g., IRC 6695(d)).

A tax return preparer is required to keep a copy of a completed return or a list of the taxpayer’s name and ID number, for a period of 3 years.

A tax return preparer is required to furnish such a list to the IRS upon request.

A tax return preparer who fails to retain copies of completed returns or lists of taxpayers for whom returns have been completed may be penalized $50 for each, up to $25,000 per year.

Example: Mr. Mortimer has been a tax return preparer for 15 years. He has kept every record of his clients for the past 14 years. Mr. Mortimer decides to retire and sloppily decides not to keep the records of the 21 clients he prepared returns for in the last year that he worked as a paid tax return preparer. Mr. Mortimer is subject to a penalty of $1,050 for the year that he failed to retain copies.
6. Compliance with e-file procedures (e.g., timing of taxpayer signature, timing of filing, recordkeeping, prohibited filing with pay stub).

A tax return preparer must not submit a return electronically without first being in receipt of all and earning statements, such as Forms W-2, W-2G, and 1099-R for the taxpayer. He should also not file using a pay stub.

In the event that the tax return preparer is not able to secure the pertinent w-2 forms, then the electronic submission of the return is permitted after Form 4852 is completed. The taxpayer should always attempt to obtain Form W-2, W-2C, or Form 1099R from the employer or payer before filling Form 4852.

A tax return preparer may be warned, sanctioned, reprimanded, suspended, or expelled from participation in the IRS e-file if found to be in violation of these requirements. The IRS monitors the adherence to these requirements. Infractions are issued at one of three levels: Level One, Level Two, or Level Three. While tax return preparers can appeal, any suspensions result in ineligibility until which time the sanction is reversed, or for a period of one or two years from the effective date.
7. Completion and use of Form 2848 Power of Attorney and Declaration of Representative and Form 8821 Tax Information Authorization.

Form 2848 is used to authorize a tax return preparer representative to act for a taxpayer. Persons who can be authorized to represent a taxpayer include students working in low-income taxpayer clinics or student tax clinic programs, but these are granted under special order by the Office of Professional Responsibility.

A corporation or entity cannot be named a power of attorney. Only an individual can be appointed.

Form 2848 must be signed by the taxpayer and the power of attorney, and must include a beginning and ending period for the authorization. The ending period can extend up to three years beyond the date of December 31 of the current year, but no longer than three years after the date it was received.

8. Safeguarding taxpayer information (e.g., Publication 4600 Safeguarding Taxpayer Information, Quick Reference Guide for Business, IRC 7216).
All entities and individuals who participate in the exchange of taxpayer information are responsible for the safeguarding of such information, in order to prevent unauthorized disclosure, use, or destruction of such information.

Tax return preparers who are authorized e-file providers must use a secure system and have security systems and processes in place to prevent unauthorized access to taxpayer information. The type of security system is related to the dimensions of the business and transactions, and can be identified via IRS Publication 4600 and IRS Publication 4557. Additional safeguards may be deemed necessary by the IRS, in the event that the IRS determines they are necessary.

Authorized tax return preparers must provide an EFIN, a name of a principal or responsible official, and the URL of the website prior to any collection of tax payer information. Any change to the EFIN, name of the principal, or URLs must be provided within three days of the change.
Domain 1
1. Preparer’s due diligence for accuracy of representations made to clients and the IRS; reliance on third-party work products.

A tax return preparer must practice due diligence to be reasonably sure that representations made to and by clients, and to the IRS, are accurate.

Authorized tax return preparers are required to register websites that collect taxpayer information with the IRS.
2. What constitutes practice before the IRS and categories of individuals who may practice.

Practice before the IRS includes any communication with the IRS on behalf of a taxpayer, representation of a taxpayer at a hearing or meeting with the IRS, preparation and filing of documents for a taxpayer, or advising on tax returns.

Individuals who can practice before the IRS include: attorneys, certified public accountants, enrolled agents, retirement plan agents, and actuaries. Some students may also practice before the IRS under special circumstances. Registered tax return preparers, which include those who have passed the IRS competency test may also have limited practice before the IRS.

Note: Providing information to the IRS when requested by the IRS or acting as a witness for a taxpayer is not considered to be practice before the IRS.

Any individual who engages in disreputable conduct while practicing before the IRS is subject to disciplinary action.
3. Limits on practice by a registered tax return preparer.

Registered tax return preparers must:

- Meet requirements for renewing their enrollment
- Request, when appropriate, to be placed as inactive in retirement status
- Not violate regulations or become suspended or disbarred

A registered tax return preparer who has lost ineligibility cannot practice before the IRS until reinstatement occurs.

Note: Ineligibility voids a power of attorney.
4. Requirements to furnish information to IRS upon request.

A tax return preparer must furnish records, information, copies of returns, or other items at the request of the IRS, and must do so promptly.

Information regarding tax advice is confidential. In the event that a tax return preparer is asked to provide information he or she believes is privileged, he or she may be excused from furnishing such information if it is not related to criminal matters or proceedings, and if it is not related to a corporate tax shelter.

A tax return preparer must provide information about errors or omissions to advise the taxpayer of the issue and the consequences of such noncompliance.
5. Prompt disposition of matters before the IRS.

A tax return preparer is responsible for providing information requested by the IRS promptly. Any purposeful delaying of information sharing is not allowed.

A tax return preparer must also promptly notify the IRS when information is not available.

It is important that a tax return preparer not unreasonably delay the distribution of information or any other such method of delaying a matter before the IRS.
6. Prohibition on receiving assistance from or providing assistance to disciplined practitioners.

Registered tax return preparers who have been disbarred or suspended from practice due to disciplinary reasons are not allowed to provide assistance to other registered tax return preparers.

Tax return preparers are not allowed to accept assistance or advice from preparers who are under disbarment or suspension for reason related to practice before the IRS.

*Example:* Franklin earns his living preparing tax returns. Franklin is found by the IRS to be acting unlawfully and is suspended from practicing before the IRS. His good friend and colleague, Joelle, also a tax return preparer, feels terribly for Franklin and offers to a position for Franklin, which entails helping Joelle with clients’ returns. Circular 230 rules prohibit Joelle from hiring Franklin or accepting his advice/assistance, and Franklin is prohibited from offering help to Joelle. Both Franklin and Joelle would be in violation of Circular 230 rules.
7. Rules regarding fees, including contingent fees.

A tax return preparer must charge only reasonable fees. Unconscionable fees may not be charged.

A contingent fee is one that is based on a position taken on a tax return or one it is one that is based on the result of the filing, a percentage of the taxes saved, or other specific result.

Example: Sally hangs her shingle for tax return preparation, offering a guaranteed refund from the IRS or “your money back.” Because Sally’s fee is contingent on the result of the filing, the contingent fee is prohibited.

Contingent fees are not allowed for any matter related to the IRS, except those that are charged for services related to the review or challenge of an original or amended tax return, or related to the assessment of interest or penalties by the IRS, or judicial issues related to the internal revenue code.
8. Rules in dealing with clients, including return of client records, conflicts of interest, advising on omissions and errors, solicitation (including advertising), and negotiation of taxpayer refund checks.

A tax return preparer is required to act as a trusted professional for the industry and uphold the laws and requirements related to filing accurate and truthful returns.

A tax return preparer who stands to gain monetarily or otherwise from the preparation of a particular client’s returns should consider the conflict of interest rules and act ethically with regard to the taxpayer. The tax return preparer is required to advise clients on any information that is omitted for the sake of increasing a refund or credit or decreasing a tax liability or amount owed, and to advise about any errors in reporting that may result in untruthful or inaccurate returns. The tax return preparer is expected to act ethically with regard to solicitation of business and clients and is not allowed to make statements of contingent-based fees for service.

The tax return preparer is also prohibited from negotiating a refund check in exchange for services rendered. A practitioner is prohibited from endorsing a refund check or otherwise cashing, depositing, or accepting payment in the form of the taxpayer’s refund.
9. Due diligence with standards with respect to tax returns and other documents; standards for signing, advising positions on returns and advising submissions of other documents; advising on penalties; good faith reliance on client information; reasonable inquiries regarding incomplete, inconsistent, incorrect information.

A tax return preparer is expected to act with diligence when preparing or assisting with the preparation of filing returns or other IRS-related matters. Returns, documents, affidavits, and other matters must be diligently prepared with regard to accuracy and correctness, both oral and written.

A tax return preparer must not delay any matter before the IRS, and must act promptly with regard to any disposition of IRS-related matters.

A practitioner or tax return preparer is prohibited from accepting advice from practitioners who are suspended or who have been disbarred.

A practitioner must make reasonable inquiries into the information provided by the taxpayer. As the practitioner collects information, he or she may come to gain more knowledge about the taxpayer. The tax practitioner is required to make further
reasonable inquiry into any information that may appear incorrect or inaccurate with the useful information he obtains based on past experience with the client.

10. Responsibility of individual(s) who have principal authority over a firm’s tax practice.

A tax return preparer or practitioner who has principal authority over a firm’s tax practice is required to reasonably verify that all adequate preparations and processes are in place to ensure accurate returns. This is necessary to protect members, associates, and employees, and is required for compliance with IRS circular 230.

Behavior by a practitioner who does not take steps to reasonably verify adequate processes, through willfulness, recklessness, or gross incompetence, will be considered criminal activity.

If a practitioner is aware that a member of the firm has engaged in unlawful or dishonest practice and who does not report it is considered to be noncompliant with the IRS Circular 230.
11. Incompetence and disreputable conduct that can result in disciplinary proceedings.

A practitioner is required to act with due diligence to ensure accurate filing of returns. Any intentional delay of material or response to any IRS-related matter is considered to be unlawful and may result in disciplinary actions.

A practitioner who accepts advice or service from a suspended or disbarred preparer is subject to disciplinary action.

Any practitioner who acts as a notary must not notarize or otherwise act as a notary to any matter before the IRS in which the practitioner has personal or material interest.

A practitioner is prohibited from endorsing, accepting, or otherwise cashing or collecting as payment a taxpayers’ refund check.
12. Sanctions that may be imposed under Circular 230.

A practitioner found to be involved in criminal or prohibited behavior may have sanctions imposed by the IRS. There are three levels of sanctions.

Level One: A letter of reprimand may be sent for violations constituting a Level One infraction. These infractions have little to no impact on the quality of the return.

Level Two: A restriction of participation in the IRS e-file program or suspension of the participation for one year may be imposed for Level Two infractions. These infractions have an adverse affect on the quality of the return.

Level Three: Suspension of two years or expulsion from participation may result from a Level Three infraction, in which case fraud, criminal activity, or other such unlawful conduct has occurred.