

ANSWERS**SESSION 3 – INCOME****Problem 1 –**

Question 1 – First, the question tells you that you need to do the Simplified Method. In the real world, there is no one there to tell you that. But we know we need to by looking at the 1099-R because it has no entry for the taxable amount, the box stating that the taxable amount was not determined is checked, and there is an entry in Box 9b, Total employee contributions. We thus need to use the Simplified Method to determine the taxable amount to enter for line 2a.

You can do the Simplified Method calculation either in TaxSlayer or in a separate tool. To do this in TaxSlayer, you need to delete the taxable amount (Box 2a) that TaxSlayer automatically entered to match the gross distribution in Box 1, then underneath that entry click on the blue text “Click here for options”, and then select the Simplified Method Worksheet and complete the requested data (note that you do not have to complete the “Amounts previously recovered” entry unless you have this information).

I much prefer the other tool, the “Annuity/Pension Exclusion Calculator available at www.cotaxaide.org/tools. I am going to walk through using this tool to answer the question. In the tool, make the following entries:

1. Taxpayer’s last name (Washington)
2. Check to be sure the year shown is the correct tax year (2022)
3. No need to check either of the boxes at the top since this is not a public safety officer’s pension or a disability pension.
4. Enter the annuity start date – the facts stated the pension began on October 1, 2018
5. Enter the annuitant’s birth date – Tara is the annuitant (as it is her pension), so the date is 3/11/1956.
6. Enter the spouse’s birthdate of 5/5/1964. Here, the facts state this was a joint and survivor annuity, and, on the annuity starting date, both the annuitant (Tara) and the spouse (Gilbert) were alive so we must enter the birth dates of both spouses. If either spouse was not alive on the annuity starting date, we would only enter the birth date of the person receiving the annuity payments. Note that if the annuity starting date had been before 1998, the tool tells you that only Tara’s birth date would have been required even if it were a joint and survivor annuity.
7. Note that the tool now calculates the combined ages of the two spouses on the annuity starting date (which is more error-proof than what TaxSlayer asks for which is for you to determine their ages on that date).
8. Enter the gross distribution from Box 1 of the 1099-R – 18485.
9. Enter the total annuity contributions from Box 9b of the 1099-R – 13500.
10. Click on the blue box, “Click here to calculate”.

The tool then creates several things for you. First is a box that shows the entry to be made in TaxSlayer for the taxable amount (Box 2a), which under these facts is \$18,035 (so the correct answer to Question 1 is “c”). This is the only additional number you will need to enter into TaxSlayer (replacing the auto-filled entry in Box 2a that TaxSlayer entered), as the other numbers are shown on the 1099-R. Scroll down to the bottom table which shows the recovery

of the employee contributions over all the years, including showing when the cost recovery runs out and the annuity becomes fully taxable. This is a critical thing to watch out for when taxpayers begin reaching their late 80's so that you don't improperly continue to reduce the taxable amount of the annuity beyond the appropriate year. Be sure to hit the blue box "Print the table" which is near the "Click here to calculate button" to print out this information for the Quality Reviewer and the taxpayer.

Question 2 – The only income that will appear on Schedule 1 under these facts is the gambling income. The gambling income includes not only the \$3,000 reported on a Form W-2G but also the additional \$150 she won from the lottery. Just because she didn't receive a W-2G doesn't mean the winnings aren't taxable as a W-2G is only required for winnings above certain thresholds based on the type of game/wager. This is a great example of a question you should ask in the Intake interview to be sure you are capturing all income, not just that shown on a tax reporting document.

The facts in the prior discussion stated that gambling losses of \$1,500 are deductible as an itemized deduction up to the amount of any winnings. However, this is an itemized deduction on Schedule A and does not affect the gambling income reported on Schedule 1. Whether they can get any benefit from the itemized deduction depends on the amount of other itemized deductions they have (which the facts do not detail). Thus, the correct answer is "b", \$3,150.

Problem 2 –

Question 1 – The facts state that the taxpayers have never itemized deductions. A state tax refund can only be taxable if state income taxes were claimed as an itemized deduction in the previous year (and even then, may not always be taxable). Thus, the state tax refund is not taxable, so the correct answer is "a".

Question 2 – Both the annuitant and the spouse were alive at the annuity starting date, so we need their combined ages on that date to determine the taxable amount of the current year distribution using the Simplified Method. If you use TaxSlayer, you will need to determine their respective ages on the annuity starting date (May 1, 2020) and then add these ages together to get the answer. By using the Annuity/Pension Exclusion Calculator, you only need to enter their birth dates and the calculator determines their combined ages for you. Your answer should be "b", 115.

Question 3 – Again, you may use either the TaxSlayer Simplified Method Worksheet or the Pension/Annuity Exclusion Calculator. In addition, to the annuity starting date and the combined age determined in question 2, you also need the gross distribution amount (\$14,400) and the Total employee contributions (\$9,000). When all of this information is entered, you should get \$14,100 as the taxable amount.

One thing to know for the Certification tests. Whenever you have to enter a dollar amount as the answer for a question rather than answering a multiple choice question, like this question, do NOT enter a \$ sign and do NOT enter a comma. So, here, you would want to enter 14100 as the answer. Otherwise you will mis the question even though you got the right answer.

Problem 3 –

Question 1 – I encourage you to enter this information in the TaxSlayer Practice Lab to get the practice of completing a Schedule C even though you can answer the question without using TaxSlayer.

To determine her net profit, we must determine her gross profit (the income from the activity) and subtract the allowable expenses to determine her net profit. Her income is from the delivery service and is comprised of three pieces:

1. \$1,800 shown on her Form 1099-NEC;
2. \$15,245 shown on her Form 1099-K; and
3. \$300 in cash tips not reported on either of the forms (always be sure to ask about whether they received any other income not reported on a 1099-NEC or 1099-K when reporting self-employment income).

This gives her a gross income from the activity of \$17,345. If you entered this in TaxSlayer, you should start with the 1099-NEC and then create a Schedule C when requested by TaxSlayer. If you go to the 1099-K section, you will see that TaxSlayer tells you to add the amount shown on the 1099-K in the Income section of Schedule C. You would add the \$15,245 from Form 1099-K plus the \$300 in cash tips (for a total of \$15,545) to the line for Gross Receipts in the Income section of Schedule C. TaxSlayer will automatically carry the amount shown on the 1099-NEC so do NOT enter it again.

Expenses, her expenses for items other than the use of her car were as follows: \$300 for insulated box rental; \$50 for vehicle safety inspection; \$120 for a GPS device; \$100 for tolls; \$120 for car washes; \$48 for parking tickets; \$75 for PPE; and \$150 for snacks and lunches for herself while driving. The expenses for the box rental, safety inspection, GPS device, and PPE are all legitimate business expenses that may be deducted. The expenses for tolls, car washes, and parking tickets all relate to her use of her car. The toll expense is the only allowable deduction as the car wash expenses are viewed by the IRS as a maintenance expense that is covered by the cents-per-mile deduction and parking tickets are a nondeductible expense. Finally, the expenses for her snacks and lunches are viewed as personal expenses and are not deductible. See Pub. 4012, p. D-20 & 21 for a general discussion of the deductibility of expenses related to self-employment. Thus, her total expenses other than the cents-per-mile deduction for the use of her car are \$645 (the sum of 300, 50, 120, 100, and 75).

For the use of her car, we must determine the number of miles where the car was used in her business, not including any commuting miles. See Pub. 4012, p. D-22 for a discussion of commuting vs. business miles. For our clients, typically the only permissible miles are miles driven between job sites, but do not include driving from home to a job site or back again. In the case of delivery-type drivers (whether delivering food or people), this means that the miles driven from home to the first pickup of the day and from the last drop-off to home are not deductible as commuting. But everything in between is, including driving with a passenger or goods in the car or driving from one drop-off to the next pickup. In the case of self-employed workers such as painters, generally, none of their miles are viewed as business miles when they are traveling from home to a job site and back home again. However, if they travel from one job site to another job site, these would be legitimate miles, as well as miles driven if they

are doing work outside of their “metropolitan area” (50 miles one way is a good rule of thumb). In this case, Keisha drove 7,200 miles while delivering food (reported by the delivery service to her, which is typical) and 4,120 miles between deliveries, for a total of 11,320 miles. The 4,200 miles driven from and to her home are nondeductible commuting miles. For 2022, the cents-per-mile deduction is 58.5 cents per mile for the first 6 months of the year and 62.5 cents per mile for the second half. The facts stated her miles were evenly split between the two halves of the year. Her deduction for the first half of the year will equal $5,660 \times 58.5$, or \$3,311. For the second half, her deduction will equal $\$5,660 \times 62.5$, or \$3,538.

Her total expenses will equal \$7,494, \$645 for the expenses other than the use of her car plus \$3,311 for the first half of the year for the use of her car, plus \$3,538 for the second half. Thus, her net profit will equal \$9,851 (\$17,345 gross income less \$7,494 of expenses). The \$3,600 in health insurance premiums are not considered a business expense. See Question 3 below.

Question 2 – Her gambling income was \$10,000 from her lottery winnings. She also had \$3,000 of losing tickets. But remember that the deduction for gambling losses up to the amount of gambling winnings is an itemized deduction that most of our taxpayers will not be able to take advantage of. The term “Adjusted Gross Income” refers to the taxpayer’s gross income after the adjustments to income shown on Schedule 1 with the total shown on Line 10 of Form 1040. AGI is shown on the return on Line 11. Itemized deductions and the standard deduction are deductions that occur after AGI (they are shown on Line 12) to determine Taxable Income, which is shown on Line 15. Thus, the answer is \$10,000, since any benefit she would get from the itemized deductions is after the computation of AGI on Line 11.

Question 3 – This question specifically addresses whether they qualify for the Self-Employed Health Insurance adjustment to income. Health insurance premiums paid by a self-employed taxpayer for the taxpayer, spouse, or certain dependents may create an adjustment to income. We typically enter the amount of this adjustment on the General Expense page of TaxSlayer, which is put there just for convenience but not to suggest it is a deduction in computing Schedule C net income. This adjustment reduces the taxable self-employment income but does not reduce the Self-Employment taxes.

However, the one primary limitation on this adjustment is that the premiums do not qualify if the person for whom the premiums were paid is eligible for employer health coverage. Here, the facts state that Keisha and her husband had health insurance that was subsidized by Jay’s employer. Thus, none of their health insurance costs are eligible for the Self-Employed Health Insurance deduction and the correct answer is “e”. Had they not been eligible for health insurance through an employer, the correct answer would have been “b” as they would have been entitled to an adjustment to income on Schedule 1 for the health insurance premium costs of both Keisha and Jay.

Question 4 - Question 4 – If you used the Practice Lab to do question 1, go back and change the gross receipts on the Schedule C Income page from \$15,545 to \$5,545. Using the given information, Keisha would have a net loss of \$149 on her Schedule C. This loss makes the return out-of-scope for VITA.

Problem 4 –

Question 1 – The second page of the broker’s statement provides the detail of the short-term and long-term sales made during the year. The first section provides the short-term sales, which shows a sale of stock for \$2,650. The statement provides that the basis of these shares was \$2,000 and shows a net short-term gain of \$650. As this is the only short-term capital transaction for the year, her net short-term gain was \$650, answer “c”.

Question 2 – As in Question 1, the broker’s statement reports a long-term sale of stock for \$3,500 and shows a basis of \$2,100, resulting in a long-term capital gain of \$1,400. However, this is not all her long-term gains. On her Form 1099-DIV on the first page of the broker’s statement, Line 2a shows a Capital Gain Distribution of \$300. When entered into TaxSlayer, this adds \$300 of long-term gain on Line 13 of Schedule D. This results in a total net long-term capital gain of \$1,700 on Line 15 of her Schedule D.

Question 3 – As we saw in Example 3, Question 1, meals for the self-employed person while at work are not allowable business expenses. Thus, the correct answer is “c”.

Question 4 – She provided two pieces of information about her miles. First, she drove 750 miles to and from home while providing her cleaning services. These are considered commuting expenses and are thus not includible in the cents-per-mile calculation. She also provided that she drove 450 miles between job locations. These are permissible miles for the calculation. Thus, the answer is 450.

Question 5 – Cynthia received a Form 1099-NEC showing income from her cleaning services of \$4,000. She also told you during the interview that she received an additional \$400 in cash, for a total gross income of \$4,400.

As shown in Question 3, her lunch expenses do not qualify as a deduction. In addition, she stated that she spent \$175 on work clothes that were suitable for everyday use. These are not deductible expenses since they can be used for everyday purposes. Her deductible out-of-pocket expenses are: \$350 for cleaning supplies; \$225 for business cards; \$450 for a mop, broom, and vacuum cleaner; and \$150 for work gloves, for a total of \$1,175. In addition, she has 450 miles of driving that qualify as discussed in Question 4. Her cents-per-mile deduction will be \$275 (150 miles times .585 plus 300 miles times .625), for total expenses of \$1,450.

Thus, her net income on Schedule C will equal \$2,950.