2022 Annual Federal Tax Refresher (AFTR)
Course Instructions

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NASBA - Sponsor number: 103021

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Instructions to Participants

To assist the participant with navigating the learning process through to successful completion, this course has been produced with the following elements:

Overview of Topics / Table of Contents: In this electronic format you'll find a slide menu on the left side of the screen. This serves as your overview of topics for the program. You may navigate to any topic by clicking on the slide name.

Definition of Key Terms / Glossary: You'll find key terms defined for this program in the course information on the following page(s).

Index / Key Word Search: You can find information quickly in the PDF materials (slide handout plus any additional handouts) by using the search function built into your Adobe Reader.

Review Questions: Questions that test your understanding of the material are placed throughout the course. You'll see explanatory feedback for each incorrect answer, and reinforcement feedback for the correct answer for every review question.

Final Exam: The final exam measures if you have gained the knowledge, skills, or abilities outlined in the learning objectives. You may submit your final exam at the end of the course. Exams are graded instantly. A minimum score of 70% is required to receive the certificate of completion. **You have until December 31,2021 (midnight local time of student) to complete the course.**

Course Evaluation: Once you have successfully passed your online exam, please complete our online course evaluation. Your feedback helps Wolters Kluwer maintain its high quality standards!

About This Course

This section provides information that is important for understanding the course, such as course level and prerequisites. Please consider this information when filling out your evaluation after completing the course.

Publication Date: June 2021

Course Description
Each year, various limits affecting income tax return preparation and tax planning are affected by inflation-related changes. In addition, various laws passed to address the financial consequences of the coronavirus pandemic significantly affect tax planning and may also affect taxpayers' income tax liability. This course will examine many of those changes.

The Annual Federal Tax Refresher course is designed to meet the requirements of the IRS voluntary Annual Filing Season program. It discusses new tax law—including various tax extenders—and recent updates for the 2022 filing season, provides a general tax review, and examines important rules governing tax return preparer ethics, practices and procedures.

Enrolled Agents will not receive CPE credit for completing this course.

This course and final exam must be completed no later than midnight December 31, 2021 in order to receive credit from the IRS. The final exam includes 100 questions and you have 3 hours to complete the final exam. You have 3 attempts to complete the final exam with a passing score of 70% or better. No copy of the final exam can be provided.

In order to your completion reported to the IRS for CE Credit, you must enter your PTIN number MY Professional Profile under My Account in CCH CPELink.

Learning Objectives
Upon successful completion of this course, participants should be able to:

- Identify the principal individual income tax changes brought about by recent legislation
- Apply the inflation-adjusted and other limits to the proper preparation of taxpayers' income tax returns
- Recognize the federal income tax filing statuses and the criteria for their use
- Describe the current status of tax extenders
- Identify the types of income that must be recognized
- Apply the tax rules to the various credits and adjustments to income that are available to taxpayers;
- Recognize the penalties that may be imposed on a preparer for failing to meet ethical and practice standards in preparing tax returns
- Identify the duties and restrictions imposed on tax preparers under Circular 230

NASBA Field of Study
Taxes. Some state boards may count credits under different categories—check with your state board for more information.

Course Level
Basic. Program knowledge level most beneficial to CPAs new to a skill or an attribute. These individuals are often at the staff or entry level in organizations, although such programs may also benefit a seasoned professional with limited exposure to the area.

Prerequisites
None.

Advance Preparation
None.

Course Expiration
AICPA and NASBA Standards require all Self-Study courses to be completed and the final exam submitted within 1 year from the date of purchase as shown on your invoice. No extensions are allowed under AICPA/NASBA rules.

Contents

Introduction to the Course

Each year, various limits affecting income tax return preparation and tax planning are affected by inflation-related changes. In addition, various laws passed to address the financial consequences of the coronavirus pandemic significantly affect tax planning and may also affect taxpayers' income tax liability. This course will examine many of those changes.

The *Annual Federal Tax Refresher* course is designed to meet the requirements of the IRS voluntary Annual Filing Season program. It discusses new tax law—including various tax extenders—and recent updates for the 2022 filing season, provides a general tax review, and examines important rules governing tax return preparer ethics, practices and procedures.

In organizing this course, the term "domain" is used in place of the more common "chapter" to more closely follow the language of the IRS Annual Federal Tax Refresher course outline.

Course Learning Objectives

Upon completion of this course, you should be able to:

- Identify the principal individual income tax changes brought about by recent legislation;
- Apply the inflation-adjusted and other limits to the proper preparation of taxpayers' income tax returns;
- Recognize the federal income tax filing statuses and the criteria for their use;
- Describe the current status of tax extenders;
- Identify the types of income that must be recognized;
- Apply the tax rules to the various credits and adjustments to income that are available to taxpayers;
- Recognize the penalties that may be imposed on a preparer for failing to meet ethical and practice standards in preparing tax returns; and
- Identify the duties and restrictions imposed on tax preparers under Circular 230.

Domain 1 – New Tax Law/Recent Updates

Introduction

Federal tax law requires that various limits be adhered to in the preparation of tax returns, and such limits may change from year to year based on an inflation adjustment or on other factors. Included in those changes for 2021 are standard mileage rates, standard deductions and various other limits. These and additional changes brought about by recent legislation affect taxpayers' income tax liability. Domain 1 will examine these changes for 2021 and will offer some context within which they apply.

Domain 1 Learning Objectives

When you have completed the domain 1 text, you should be able to:

- Identify the inflation adjustments to various federal limits;
- Recognize the optional standard mileage rates;
- Apply the required minimum distribution rules applicable to traditional IRAs and retirement plans;
- Describe the rules for repayment of COVID-19 related distributions from qualified retirement plans and IRAs;
- Identify the rules governing nonitemizers' permitted adjustment for charitable contributions;
- Recognize the income tax rules applicable to the Recovery Rebate Credit;
- Describe the current status of tax extenders applicable to –
    - Medical expense deductions,
    - Tax credits for non-business energy property,
    - College tuition and fees deductions,
    - Deduction for payment of mortgage insurance premiums, and
    - Cancellation of primary residence indebtedness.

1.1 Annual Inflation Adjustments

Inflation adjustments are made annually to various limits that affect tax preparation, including adjustments to:

- The education savings bond program;
- Qualified long term care premiums and benefits;
- The Social Security taxable earnings limit;
- The retirement savings contribution credit;
- The Health Flexible Spending Arrangement (FSA) contribution limit;
- Various Affordable Care Act provisions including the –
    - refundable tax credits to assist taxpayers in purchasing qualified health plans,
    - small business health insurance premium tax credit,
    - large employer shared responsibility requirement;
- Health Savings Account (HSA) limits; and
- Standard mileage rates.

We will examine those adjustments in the following material.

1.1.1 Education Savings Bond Program

Although the interest on U.S. savings bonds is normally taxable as ordinary income, a taxpayer may exclude some or all of the interest on certain cashed in savings bonds if he or she pays qualified education expenses and meets federal income tax filing status and income requirements. Under the federal education savings bond program, a taxpayer may exclude some or all interest income received on qualified U.S. savings bonds if the taxpayer:

- Paid qualified education expenses for the taxpayer, a spouse or a dependent;
- Has a modified adjusted gross income (MAGI) not exceeding specified maximum amounts that are adjusted for inflation each year; and
- Has a federal income tax filing status other than married filing separately.

The U.S. savings bonds that qualify for the education savings program are series EE bonds issued after 1989 and series I bonds. The bonds must be issued either in the taxpayer's name as sole owner or in the name of the taxpayer and spouse as co-owners. Furthermore, in order for the bond to qualify, the owning taxpayer must have been at least age 24 before the bond's date of issue.

1.1.1.1 Qualified Education Expenses

Education expenses considered qualified education expenses under the education savings bond program are education expenses incurred at an eligible educational institution by the taxpayer for the taxpayer, the taxpayer's spouse or a dependent claimed by the taxpayer. Such expenses include:

- Tuition and fees;
- Contributions to a qualified tuition program; and
- Contributions to a Coverdell education savings account (ESA)

Room and board expenses **are not** qualified education expenses for purposes of the education savings bond program.

1.1.1.2 Eligible Educational Institutions

An eligible educational institution for purposes of the education savings bond program is broadly defined as one eligible to participate in a student aid program administered by the U.S. Department of Education and includes:

- College;
- University;
- Vocational school; and
- Other post-secondary educational institution.

Thus, the definition of an eligible educational institution includes virtually all accredited U.S. public, nonprofit, and proprietary post-secondary institutions.

1.1.1.3 Qualified Education Expenses Reduced by Certain Tax-free Benefits Received

To determine the amount of tax-free interest, the qualified education expenses incurred must be reduced, for purposes of the education savings bond program, by certain tax-free education benefits received. The resulting education expenses, reduced as required, are referred to as "adjusted qualified education expenses."

Thus, *adjusted* qualified education expenses are equal to the qualified education expenses reduced by all of the following tax-free benefits:

- The tax-free part of scholarships and fellowships;
- Expenses used to figure the tax-free portion of Coverdell ESA distributions;
- Expenses used to figure the tax-free portion of qualified tuition program distributions;
- Any tax-free payments received as education assistance, including –
    - Veterans' educational assistance benefits,
    - Qualified tuition reductions, and
    - Employer-provided educational assistance; and
- Any expenses used in figuring the American opportunity and lifetime learning credits.

Neither gifts nor inheritances received, however, reduce qualified education expenses for purposes of the education savings bond program.

1.1.1.4 Figuring the Tax-Free Amount

If the total amount received by the taxpayer when eligible bonds are redeemed, including both the bond investment and accrued interest, does not exceed the adjusted qualified education expenses, all interest received may be tax free. (Note, the taxpayer must still be eligible based on income.) If the total amount received on liquidation of the bonds is greater than the adjusted qualified education expenses, only a portion of the interest may be tax free.

Determining the tax-free amount of the interest distributed when the bonds are redeemed **and the adjusted qualified education expenses are less than the distribution** requires that the interest received be multiplied by a fraction. The numerator of the fraction is the adjusted qualified education expenses, and the denominator of the fraction is the total proceeds received on liquidation of the bonds during the year the bonds were redeemed.

We can illustrate the part of the interest that may be tax free in this case by considering an example. Suppose a taxpayer received a $9,000 distribution of bond proceeds during the year, and the proceeds consisted of $6,000 of invested principal and $3,000 of interest. Further suppose that the adjusted qualified education expenses were $7,650—less than the bond proceeds, in other words. To determine the part of the $3,000 of interest that may be tax free, we need to use the following equation:

$$\text{Interest} \quad \times \quad \frac{\text{Adjusted qualified education expenses}}{\text{Total proceeds received}} \quad = \quad \text{Maximum tax-free interest}$$

By substituting the appropriate numbers into the equation, we can see that the amount of the tax-free interest in this example is $2,550, as shown below:

$$\$3{,}000 \quad \times \quad \frac{\$7{,}650}{\$9{,}000} \quad = \quad \$2{,}550$$

Since the taxpayer received $9,000 when cashing in the bonds, the $6,000 invested (or any portion of it) is tax free as a recovery of cost basis, but the portion of the interest other than the $2,550 tax-free amount—$450 in this case—is taxable interest. As noted earlier, however, a taxpayer's eligibility for the education savings bond program is determined by the taxpayer's income and filing status, discussed immediately below. Depending on the taxpayer's MAGI/filing status, some or all of the maximum tax-free interest may also be includible in income.

Let's continue with the earlier example but modify the facts slightly so that the taxpayer's MAGI exceeds the applicable dollar amount. In the earlier example we saw that $2,550 of the $3,000 interest is tax free, provided the taxpayer is eligible to take the full interest exemption. However, the excludible interest would be less than $2,550 if the taxpayer's MAGI exceeds the applicable dollar amount, i.e., it is in the phase-out range.

Suppose that the taxpayer has a $134,800 MAGI and is married filing a joint return in 2021. By substituting the actual values into the equation, we can see that the amount of the interest that must be included in gross income by the taxpayer because of his or her MAGI is $850, as shown below:

$$\frac{(\$134{,}800 - \$124{,}800)}{\$30{,}000} \quad \times \quad \$2{,}550 \quad = \quad \$850$$

Thus, the amount of interest excludible under the program is equal to the maximum tax-free interest *minus* the portion of it that must be included in income because of the taxpayer's MAGI. In this case, the taxpayer's excludible interest is $1,700. ($2,550 - $850 = $1,700)

If a taxpayer's filing status is single or head of household, the equation used to determine the taxpayer's exclusion is as follows:

$$\frac{(\text{MAGI} - \text{Applicable dollar amount})}{\$15{,}000} \quad \times \quad \text{Maximum tax-free interest} \quad = \quad \text{Includible interest}$$

$$\text{Maximum tax-free interest} \quad - \quad \text{Includible interest} \quad = \quad \text{Excludible interest}$$

When figuring the excludible interest amount, use IRS Form 8815.

1.1.1.5 Education Savings Bond Program Eligibility Subject to Income Limits/Filing Status

The exclusion of interest under the education savings bond program reduces as the taxpayer's income increases and is eliminated at higher income levels. Under the bond program rules, the amount of a taxpayer's interest exclusion is gradually reduced if the taxpayer's modified adjusted gross income (MAGI) exceeds the applicable dollar amount for the taxpayer's filing status.

When the part of the bond interest that normally would be tax free under the education savings bond program is determined, the taxpayer's MAGI is then compared to the applicable dollar amount for the tax year to calculate the amount of the potentially tax-free interest that is excludible by the taxpayer. If a taxpayer whose filing status is married filing jointly has a MAGI that exceeds the applicable dollar amount by $30,000 or more, no interest may be excluded under the program. Similarly, if a taxpayer whose filing status is single, qualifying widow(er) or head of household has a MAGI that exceeds the applicable dollar amount by $15,000 or more, no interest is excludible under the program.

The applicable dollar amounts with which taxpayers' MAGI are compared are as follows:

Taxpayer's Filing Status	2021 Applicable Dollar Amount	Phase-Out Income Range	Completely Phased-Out
Single, qualifying widow(er) or Head of Household (HH)	$83,200	$83,200 - $98,200	$98,200
Married filing jointly	$124,800	$124,800 - $154,800	$154,800

The amount of excludible savings bond interest to which a taxpayer whose MAGI is in the phase-out income range is entitled, if any, can be determined using the following equation that calculates the part of the interest that is includible:

$$\frac{\text{(MAGI – Applicable dollar amount)}}{\text{\$30,000 (\$15,000 single or HH)}} \quad \text{X} \quad \text{Maximum tax-free interest} \quad = \quad \text{Includible interest}$$

The amount determined under the equation is then subtracted from the maximum tax-free interest amount to figure the amount of excludible savings bond interest.

1.1.2 Qualified Long-Term Care Insurance Premiums and Benefits

In 1996, Congress passed the Health Insurance Portability and Accountability Act (HIPAA). The law clarified the tax treatment of long-term care insurance policies by defining "qualified long-term care insurance." In addition, it provided for the tax-deductibility of qualified long-term care insurance premiums and, for individuals deemed to be chronically-ill, the tax-exemption of long-term care insurance benefits within certain limits.

Those limits generally change yearly.

1.1.2.1 Favorable Benefits Tax Treatment Reserved for Chronically-Ill

In order for long term care benefits to receive favorable tax treatment, the individual on whose behalf they are paid must meet the "chronically-ill" definition included in HIPAA. A *chronically-ill individual* is defined as an insured individual who has been certified by a licensed health care practitioner within the previous 12 months as an individual who:

- Is unable, for at least 90 days, to perform at least two activities of daily living (ADLs) without substantial assistance from another individual, due to loss of functional capacity; or
- Requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

1.1.2.2 Tax-Qualified Long Term Care Premiums Deductible within Limits

Premiums paid for tax-qualified long term care insurance may be deductible. Tax-qualified long term care insurance policy premiums are included in the definition of "medical care" and are, therefore, eligible for income tax deduction within certain limits.

For *individuals* who itemize deductions, the amounts paid for medical care—a category of expenses that includes tax-qualified long term care insurance premiums not exceeding the dollar limitations discussed below—are deductible. Medical expenses are normally tax-deductible only to the extent the taxpayer's medical expenses for the year exceed 7.5% of the taxpayer's adjusted gross income.

Self-employed persons[1] may also deduct such premiums not in excess of the dollar limitations (noted in the chart below) ***without*** the need for medical care expenses to exceed the applicable AGI threshold. In short, tax-qualified long term care insurance policy premiums are 100% tax-deductible for self-employed taxpayers to the extent they don't exceed the dollar limits or the self-employed individual's net earnings.

[1] A self-employed individual, for purposes of long term care insurance premium tax-deductibility, includes sole proprietors, partners, and owners of S corporations, limited liability partnerships and limited liability companies.

The amount of any long term care insurance premium that may be included in medical care expenses is limited by certain dollar maximums that are indexed for inflation and which change as the insured's attained age changes. The dollar limitations applicable to tax-qualified long term care premiums in 2020 and 2021 are as follows:

Attained Age Before Close of Tax Year	2020 Limitation on Premium*	2021 Limitation on Premium*
40 or younger	$430	$450
41 to 50	$810	$850
51 to 60	$1,630	$1,690
61 to 70	$4,350	$4,520
Older than 70	$5,430	$5,640
** Indexed for inflation*		

1.1.2.3 Tax-Qualified Long Term Care Insurance Benefits Tax-Free within Limits

Just as the treatment of a tax-qualified long term care insurance policy as an accident & health insurance contract results in the tax-deductibility of premiums within certain limits, having such status also affects the tax treatment of benefits paid under it. Benefits, other than dividends or premium refunds, received under a tax-qualified long term care insurance policy are treated as reimbursements for expenses incurred for medical care and are generally not included in the recipient's income. Also similar to the tax treatment of premiums, the benefits from a tax-qualified long term care insurance policy that may avoid inclusion in the recipient's income are limited by certain maximums.

Benefits received under tax-qualified long term care insurance policies that may be excluded from income are those benefits not exceeding the greater of:

- The applicable *per diem* limitation for the year; or
- The costs incurred for qualified long term care services provided for the insured.

So, if the benefit does not exceed the per diem limitation, all benefits are tax-free even though the benefits exceed the actual costs incurred. Similarly, if the benefit does not exceed the actual costs incurred all benefits are tax free even though the benefits exceed the per diem limit.

The applicable *per diem* limitation for 2021 is $400. The *per diem* limitation amount is adjusted each year, as needed, to reflect inflation. (Note: Periodic payments under a life insurance contract received on behalf of a chronically-ill insured are likewise tax-exempt, subject to the limits applicable to qualified long-term care insurance benefits.)

1.1.3 Social Security Taxable Earnings Limit

Social Security taxes are comprised of two components: OASDI (old age, survivors and disability income) and HI (health insurance) taxes. OASDI is a tax imposed on a worker's wages up to the applicable Social Security taxable earnings limit. That limit is $142,800 in 2021 and generally increases annually. The employee tax rate for the OASDI part of Social Security is 6.2%.

HI, the second component of Social Security taxes, is a tax of 1.45% imposed on all taxpayer wages—no earnings limit applies, in other words—to fund Medicare Part A.

1.1.4 Retirement Savings Contribution Credit

The retirement savings contribution tax credit—typically referred to as the saver's credit—is a *nonrefundable* credit that is limited to the applicable percentage of the taxpayer's eligible retirement savings contributions; the credit is equal to the product of up to $2,000 of eligible contributions multiplied by the percentage determined by the taxpayer's adjusted gross income and tax filing status. Accordingly, the saver's credit cannot exceed $1,000 per taxpayer. A nonrefundable tax credit is a tax credit that is limited by the individual's tax liability and acts to reduce the amount of federal income tax payable. However, if a taxpayer has no income tax liability, or has an income tax liability that is less than the tax credit, a nonrefundable tax credit will not result in a payment of any amount in excess of the taxpayer's tax liability from the federal government.

The retirement savings contribution tax credit, if any, for which a taxpayer is eligible does not affect the tax treatment to which the contribution would normally be subject. For example, if a taxpayer's contribution to a traditional individual retirement account made him or her eligible for the credit, the taxpayer would still normally be able to take a tax deduction for the IRA contribution. In other words, retirement savings contributions made by individuals who are otherwise eligible for the tax credit receive the credit *in addition to* enjoying any other tax advantages for which they are eligible.

1.1.4.1 Saver's Credit Applicable to Range of Retirement Contributions

The retirement savings contribution credit is available to taxpayers who make a wide range of retirement plan contributions. The retirement plan contributions eligible for the credit are contributions to traditional and Roth individual retirement arrangements (IRAs) and elective deferrals to:

- 401(k) plans;
- 403(b) tax sheltered annuity plans;
- Section 457 governmental plans;
- SIMPLE IRAs;
- Salary reduction SEPs (SARSEPs); and
- ABLE accounts.

Despite the number of plans to which the taxpayer makes contributions and the amount of those contributions, the total saver's credit will not exceed $1,000 per taxpayer for the year.

1.1.4.2 Saver's Credit Eligibility Based on Income and Filing Status

The percentage of the retirement savings contribution (not exceeding contributions of $2,000) available to the taxpayer as a tax credit, up to the $1,000 maximum tax credit, depends upon the individual's adjusted gross income and income tax filing status. The applicable percentages for 2021 retirement contributions are as shown below:

Saver's Credit Adjusted Gross Income Limits (2021)[2]						
Joint Return		**Head of Household Return**		**All Other Statuses**		**Applicable Credit**
Over	Not over	Over	Not over	Over	Not over	Percentage
$0	$39,500	$0	$29,625	$0	$19,750	50%
$39,500	$43,000	$29,625	$32,250	$19,750	$21,500	20%
$43,000	$66,000	$32,250	$49,500	$21,500	$33,000	10%
$66,000		$49,500		$33,000		0%

1.1.5 Health Flexible Spending Arrangement Contributions

Health FSAs enable workers to contribute before-tax amounts to an account that may then be accessed tax-free to pay various out-of-pocket health-related expenses. Although annual caps on the amount that can be contributed to a health FSA are generally imposed by employers—usually as a way to limit their risk of pre-funding—no limit was previously imposed by the federal government. That changed for years 2013 and later. The limit for 2021 is $2,750.

1.1.6 Refundable Premium Tax Credit to Assist in Purchase of Qualified Health Plan

Although the tax penalty for a taxpayer's failure to maintain health coverage has been reduced to zero, individuals who meet specified income, coverage and other criteria are eligible to receive a refundable tax credit to enable them to purchase a qualified health plan. Since the tax credit is a *refundable* tax credit, the taxpayer may receive the credit even though he or she has no income tax liability.

[2] Note that the adjusted gross income limits may change from year to year.

1.1.6.1 Eligibility for Credit

Under the Affordable Care Act, taxpayers who obtain qualifying health insurance from a marketplace and who meet certain household income levels relative to the federal poverty line are eligible to receive premium subsidies. For 2021, prior to passage of the American Rescue Plan Act (ARPA), premium subsidies were to be as shown in the following table:

In the case of household income (expressed as a percent of poverty line) within the following income tier:	The initial premium percentage is—	The final premium percentage is—
Up to 133%	2.0%	2.0%
133% up to 150%	3.0%	4.0%
150% up to 200%	4.0%	6.3%
200% up to 250%	6.3%	8.05%
250% up to 300%	8.05%	9.5%
300% up to 400%	9.5%	9.5%.

ARPA, § 9661, significantly expands the subsidies provided under the ACA in two ways:

1. By increasing the level of subsidy to those taxpayers who currently qualify for a subsidy; and
2. By including taxpayers who, solely because their income, would not qualify for a subsidy under the law prior to passage of ARPA.

Under ARPA, the above chart is revised for years 2021 and 2022 to be as follows:

In the case of household income (expressed as a percent of poverty line) within the following income tier:	The initial premium percentage is—	The final premium percentage is—
Up to 150%	0.0%	0.0%
150% up to 200%	0.0%	2.0%
200% up to 250%	2.0%	4.0%
250% up to 300%	4.0%	6.0%
300% up to 400%	6.0%	8.5%
400% and higher	8.5%	8.5%

As can be seen from the above chart, applicable taxpayers whose household income is 150% of the federal poverty level or less will not normally be required to pay any premium when purchasing a health plan whose premium does not exceed the premium for a benchmark plan through an ACA marketplace. Those applicable taxpayers with household income exceeding 150% of the federal poverty level but less than 400% will have an expected contribution of gradually increasing percentages up to 8.5% for such a plan, and those taxpayers with household incomes of 400% or more of the federal poverty level will have expected contributions of 8.5% of household income.

1.1.6.2 Federal Poverty Level

The federal government's poverty level is based on the amount of income received in a year relative to annually-published poverty guidelines that generally increase annually to account for the higher prices for goods and services that result from inflation.

The 2021 federal poverty guidelines are as shown in the chart below:

HHS Poverty Guidelines			
Persons in family/household	**48 Contiguous States and D.C.**	**Alaska**	**Hawaii**
1	$12,880	$16,090	$14,820
2	$17,420	$21,770	$20,040
3	$21,960	$27,450	$25,260
4	$26,500	$33,130	$30,480
5	$31,040	$38,810	$35,700
6	$35,580	$44,490	$40,920
7	$40,120	$50,170	$46,140
8	$44,660	$55,850	$51,360
For each additional person add	$4,540	$5,650	$5,220

1.1.6.3 Amount of the Credit

The amount of the tax credit for an eligible taxpayer is generally equal to the difference between the premium for the benchmark plan and the taxpayer's expected contribution, a contribution that increases as the taxpayer's income increases. The amount of the credit is capped at the premium for the plan chosen. Thus, the tax credit will never be larger than the premium for the plan.

Tax Credit = Benchmark Plan Premium - Taxpayer's Expected Contribution

1.1.6.4 Benchmark Plan

The "benchmark plan," as the term is used in connection with the insurance premium tax credit, is the second-lowest-cost plan that would cover the family at the silver level of coverage. The PPACA defines[3] such a silver level plan as one "designed to provide benefits that are actuarially equivalent to 70 percent of the full actuarial value of the benefits provided under the plan." In other words, the plan pays at least 70 percent of covered charges after any applicable deductible amount.

1.1.6.5 Taxpayer's Expected Contribution

The taxpayer's expected contribution, as the term is used with respect to the premium tax credit, is a specified percentage of the taxpayer's household income. The applicable percentage of the taxpayer's household income in 2021 was scheduled to increase as the taxpayer's income increases, from 2.07% of income for families at less than 133% of the federal poverty level to 9.83% of income for families at 300% to 400% of the federal poverty level, as shown in the chart below. The amount a family actually pays for coverage will be less than the expected contribution if the family chooses a plan that is less expensive than the benchmark plan.

[3] Affordable Care Act §1302(d)(1)(B).

Household Income Percentage of Federal Poverty Line – 2021 Before ARPA Passage	**Initial Percentage**	**Final Percentage**
Less than 133%	2.07%	2.07%
At least 133% but less than 150%	3.10%	4.14%
At least 150% but less than 200%	4.14%	6.52%
At least 200% but less than 250%	6.52%	8.33%
At least 250% but less than 300%	8.33%	9.83%
At least 300% but less than 400%	9.83%	9.83%

However, the American Rescue Plan Act (ARPA) which became law on March 11, 2021 expanded the premium tax credit substantially. Thus, the above table is revised for years 2021 and 2022 as shown in the following chart:

Household Income Percentage of Federal Poverty Line – 2021 & 2022 after ARPA Passage	**Initial Percentage**	**Final Percentage**
Up to 150%	0.0%	0.0%
At least 150% but less than 200%	0.0%	2.0%
At least 200% but less than 250%	2.0%	4.0%
At least 250% but less than 300%	4.0%	6.0%
At least 300% but less than 400%	6.0%	8.5%
400% and higher	8.5%	8.5%

1.1.7 Small Business Tax Credit

Small employers may be eligible to receive a nonrefundable tax credit for premiums paid for employee health insurance coverage. The credit may be carried back one year and forward 20 years.

The credit is available to eligible employers for two consecutive taxable years and is subject to limitations based on:

- The number of employees; and
- The average annual wages paid to employees.

The maximum small employer health insurance premium credit available to eligible small employers is 50% of workers' healthcare premiums paid by small employers and 35% of such premiums paid by small tax-exempt employers, such as charities. If an employer receives a tax credit for premiums paid, its tax deduction for the cost of providing health insurance coverage is reduced by the amount of the credit.

1.1.7.1 Eligibility Requirements

Not all small employers are likely to be eligible to receive the small employer health insurance premium credit. The credit is available only if the employer meets the following three requirements:

1. The employer paid premiums for employee health insurance coverage under a qualifying arrangement—one under which the employer is required to pay at least 50% of the premium for the employee—obtained through a Small Business Health Options Program (SHOP);
2. The employer had fewer than 25 full-time equivalent employees (FTEs), not counting employees with ownership interest, for the tax year; and
3. The employer paid average annual wages for 2021 of less than $55,600 (indexed for inflation) per full-time equivalent employee.

Small employer health insurance premium tax credits are available for no more than two consecutive years.

1.1.7.2 Average Annual Wage Limitation

A small employer's health insurance premium credit is also reduced if the employer paid average annual wages in 2021 of more than $27,800 and is eliminated if the employer paid average annual wages of $55,600. For purposes of the health insurance premium credit, the term "wages" means wages subject to Social Security and Medicare tax withholding determined without considering any wage base limit. For purposes of this limitation, wages paid to a seasonal employee who worked 120 or fewer days during the tax year should not be included.

In order to figure the average annual wages an employer paid for the tax year, follow the steps below:

1. Figure the total wages paid for the tax year to all individuals considered employees; and
2. Divide the total wages paid by the employer by the number of FTEs the employer had for the tax year.

If the result of the following the steps above is not a multiple of $1,000—$1,000, $10,000 or $20,000, for example—the result should be rounded down to the next lowest multiple of $1,000. Thus, if the result is $25,750, it should be rounded down to $25,000.

1.1.8 Large Employer Shared Responsibility: The Employer Mandate

The Affordable Care Act requires that large employers—employers with 50 or more full-time employees—offer their full-time employees and dependents health plan coverage at least equal to minimum essential coverage or face a possible tax penalty. The possible penalties imposed on a large employer for failing to comply with the employer mandate vary, depending upon the nature of its noncompliance. Thus, liability for a penalty may arise as a result of:

- The employer's failure to offer coverage; or
- An employer's offering coverage but whose employee received a premium tax credit.

1.1.8.1 Employers Not Offering Coverage

A large employer that does not offer full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan may be liable for a penalty[4] if one or more of its full-time employees enrolls in health insurance coverage through an exchange and receives a premium tax credit or cost-sharing reduction because the taxpayer's premium for healthcare coverage providing minimum essential coverage exceeds 9.83% of household income.

The penalty for each month in such a case is an amount equal to the number of the employer's full-time employees in excess of 30 multiplied by 1/12th of $2,000 adjusted for years after 2014. That penalty applies regardless of the number of employees who are enrolled in health insurance coverage obtained through a state exchange and who receive a tax credit or cost-sharing reduction. For calendar year 2021, the penalty is adjusted to $2,700, i.e., $225 per month.

An employer who has no full-time employee for whom healthcare coverage providing minimum essential coverage would exceed 9.83% of household income and who received a subsidy when purchasing health insurance coverage through an exchange will not be liable for the penalty ***even though it offers no health insurance coverage to its full-time employees***.

1.1.8.2 Employers Offering Coverage

It is not only large employers who fail to offer coverage that may be liable for a penalty. In some cases, employers who offer health insurance coverage to their full-time employees may, nonetheless, be subject to a penalty. If a large employer offers coverage to its full-time employees but at least one full-time employee receives a premium tax credit or cost-sharing reduction, the employer is subject to a penalty. Thus, even if an applicable large employer offers coverage to at least 95% of its full-time employees and their dependents, it may be subject to a penalty if one or more of the full-time employees obtains a premium tax credit because the coverage fails to provide minimum value, its premium exceeds 9.83% (2021) of the individual's income[5] or the employee is not one of the 95% of employees offered coverage.

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[4] IRC §4980H(a).
[5] IRC §4980H(b).

Unlike the penalty to which an employer who fails to offer health insurance coverage to its full-time employees may be subject—whose penalty is based on the total number of full-time employees in excess of 30—the penalty applicable to an employer who offers coverage but whose employee purchases coverage through an exchange and receives a premium tax credit or subsidy is based solely on the number of full-time employees for whom healthcare coverage providing minimum essential coverage would exceed 9.83% of household income and who purchase health insurance through a state exchange and receive a premium tax credit or cost-sharing reduction.

For each full-time employee for whom healthcare coverage providing minimum essential coverage would exceed 9.83% of household income and who received a credit or subsidy through a state exchange, the penalty for any month in 2021 is equal to 1/12th of $4,060 ($338.33 per month). Thus, if 25 employees of such large employer were offered healthcare coverage whose employee-required premium contribution exceeded 9.83% of household income and, instead, purchased coverage from an Exchange and received a credit or subsidy in 2021, the applicable employer penalty for that month would be $8,458.25. ($338.33 x 25 = $8,458.25)

The penalty for the month to which a large employer offering unaffordable coverage (or coverage failing to provide minimum value) to its full-time employees in 2021 would be subject is limited to no more than the penalty for which it would have been liable if it didn't offer coverage at all, i.e., an amount equal to the number of full-time employees in excess of 30 during the month multiplied by 1/12th of $2,700.

Review #1

1. Karl received qualified long term care insurance benefits in 2021 of $420 per day. How much of such daily benefits must he include in income, if any, assuming his actual long term care costs were $330 per day and the applicable per diem limitation is $400?

   A. $0

   B. $20

   C. $70

   D. $90

2. Hank is single and has a $29,250 adjusted gross income in 2021. What would his saver's credit be if he deferred $1,000 in his employer's 401(k) plan and received a $500 employer match?

   A. $100

   B. $150

   C. $200

   D. $500

3. Sally made a $4,000 traditional IRA contribution in 2021 and received a $1,000 saver's credit. If she would be eligible to deduct the contribution in the absence of a saver's credit, how much of her contribution may she deduct?

   A. $0

   B. $2,000

   C. $3,000

   D. $4,000

1.1.9 Health Savings Accounts

Based, in part, on the experience of the Archer MSA pilot program, legislation was signed into law in December 2003 establishing health savings accounts (HSAs).

HSAs are trusts created solely to pay the qualified medical expenses of an account beneficiary and call for an individual to:

- Buy a high-deductible health insurance policy, and
- Make tax-deductible contributions to the HSA trust.

Contributions made to the trust and any earnings are tax-deferred for as long as they remain in the trust. HSA account holders may withdraw funds from the trust to pay any qualified healthcare expenses. Distributions from an HSA may be taken by an account holder at any time. If taken to pay or be reimbursed for qualified healthcare expenses, such distributions are tax free. If taken for any purpose other than to pay qualified healthcare expenses, the distribution is taxable as ordinary income and may be subject to a tax penalty.

1.1.9.1 HSA Benefits

HSAs offer account holders several benefits. Principal among those benefits are the following:

- A taxpayer can claim a tax deduction for contributions made to the HSA even if he or she does not itemize deductions;
- Contributions made to the HSA by the taxpayer's employer, including contributions made through a cafeteria plan, may be excluded from the taxpayer's gross income;
- The earnings on amounts contributed to the HSA are tax-deferred;
- Distributions from an HSA to pay qualified medical expenses are entirely tax free;
- A taxpayer's contributions and earnings, if any, remain in the HSA from year to year until the taxpayer uses them;
- An HSA is non-forfeitable and portable, so that it remains with the account holder if he or she changes employers or leaves the work force; and
- Distributions from an HSA for other than qualified medical expenses—if taken after the account holder reaches age 65, becomes disabled or dies—are taxable but not subject to tax penalties.

1.1.9.2 HSA Eligibility

An individual eligible to establish an HSA is one who meets the following requirements. The individual:

- Is covered under a high deductible health plan (HDHP) on the first day of the month;
- Has no other health coverage except for certain specified coverages;
- Is not enrolled in Medicare; and
- Cannot be claimed as a dependent on another person's tax return for the year.

If a taxpayer meets these eligibility requirements, he or she is an HSA-eligible individual even if the taxpayer's spouse has non-HDHP coverage, provided the spouse's coverage does not cover the taxpayer.

1.1.9.3 HSA High Deductible Health Plan Requirement

To be eligible for an HSA, an otherwise eligible individual must be covered under a high-deductible health plan.

High Deductible Health Plan – 2021

Contribution, deductible and out-of-pocket limits in an HSA high deductible health plan for a specific year depend on whether the plan provides self-only coverage or family coverage. The limits applicable to an HSA in 2021 are the following:

Coverage Type	Minimum Deductible	Maximum Annual Out-of-Pocket*	Maximum Individual Annual Contribution	Individual Annual Catch-up Contribution
Self-only coverage	$1,400	$7,000	$3,600	$1,000
Family coverage	$2,800	$14,000	$7,200	$1,000

*The maximum out-of-pocket limit does not apply to deductibles and expenses for out-of-network services if the plan uses a network of providers. Instead, only deductibles and out-of-pocket expenses for services within the network should be used to figure whether the limit applies.

1.1.9.4 HSA Contributions

The maximum deductible contribution that may be made to an HSA depends on whether the high deductible health plan provides self-only coverage or family coverage. However, the *amount* of the applicable deductible does not affect the maximum HSA contribution.

An eligible individual who has not attained age 55 by the end of the taxable year may deduct the contributions he or she makes to an HSA during 2021 in an amount not to exceed:

- $3,600 for account holders with self-only coverage; or
- $7,200 for account holders with family coverage.

1.1.9.4.1 Additional Contributions for Age 55 and Older Account Holders

HSA account holders who attain age 55 before the close of a taxable year are eligible to make an additional contribution. The maximum additional contribution amount is $1,000. Thus, an HSA account holder who is age 55 or older and has self-only coverage may make a maximum contribution in 2021 of $4,600; such an individual with family coverage may make a maximum contribution of $8,200. (If both spouses are age 55 or older, each may make a catch-up contribution of up to $1,000.)

1.1.9.5 HSA Distributions

Although distributions from HSAs are designed to pay qualified medical expenses, they may be taken by the individual to meet any kind of need. The tax treatment of the distribution, however, is different—and less favorable—when distributions are taken to meet other than qualified medical expenses. The responsibility of determining that a distribution is used to pay qualified medical expenses is one borne by the individual account holder rather than the HSA trustee.

1.1.9.5.1 Account Transfer Incident to Divorce

The account holder's divorce or death may cause the HSA account to be transferred. If the account holder divorces, the HSA interest may be transferred from one spouse (or former spouse) to another ***without income taxation***. To avoid taxation on the transfer it must be made under a divorce or separation agreement. Upon such a transfer, the HSA is treated as the HSA of the spouse to whom it was transferred.

1.1.9.5.2 Account Transfer at Death

The disposition of an HSA upon the death of the account holder depends on who the beneficiary is. The HSA designated beneficiary may be:

- A spouse;
- A designated beneficiary other than a spouse; or
- The individual account holder's estate.

If the designated beneficiary of the HSA is the account holder's surviving spouse, he or she becomes the new account holder. If the spouse becomes the HSA owner, no income needs to be recognized as a result of the original account holder's death.

Alternatively, an HSA designated beneficiary may be someone other than a spouse—a friend or the individual's estate, for example. In such a case, the account stops being an HSA when the account holder dies. Furthermore, if the beneficiary is a natural person the value of the HSA must be recognized by the beneficiary, i.e., it must be included in his or her gross income to the extent its value exceeds the amount of the decedent's qualified medical expenses paid by the beneficiary within one year following the account holder's death.

When the HSA account holder's estate is designated as the beneficiary, the account's fair market value is taxable in the account holder's final taxable year and included in the final income tax form prepared by the executor or administrator. In such a case, the assets in the HSA are distributed income tax-free according to the terms of the account holder's will or the intestacy laws if the account holder dies without a will.

1.1.9.6 HSA Tax Treatment

A taxpayer who is an HSA account holder must file Form 8889, Health Savings Accounts (HSAs), and attach it to Form 1040 or Form 1040NR if:

- The taxpayer or employer made contributions to the taxpayer's HSA during the year;
- The taxpayer files a joint return and his or her spouse or spouse's employer made contributions to the spouse's HSA during the year; or
- The taxpayer (or spouse, if filing jointly) acquired an interest in an HSA because of the death of the account holder.

1.1.9.6.1 HSA Contribution Tax Treatment

When HSA contributions not exceeding the maximum permitted are made by an individual account holder they are deducted by the individual from his or her income for purposes of determining the account holder's adjusted gross income. When an individual's employer makes HSA contributions to an account for the individual, the contributions are considered employer-provided coverage for medical expenses up to the allowable amount of HSA contributions. Accordingly, employer-provided HSA contributions are generally deductible to the employer as a business expense but are not included in the employee's gross income for income tax purposes. Contributions made to an HSA earn tax-deferred interest, and tax-deferral continues as long as the funds remain in the account.

Deductible contributions may be made through the due-date of the federal income tax return (without extensions). Such contributions should be reported on Form 8889, Health Savings Accounts (HSAs) and on Form 1040 or Form 1040NR.

1.1.9.6.2 HSA Distribution Tax Treatment

Distributions from an HSA may be tax-free or taxable as ordinary income. The difference between the tax treatments lies in the use to which the distribution is put. A distribution, including a rollover distribution, from an HSA must be reported on Form 8889, Health Savings Accounts (HSAs). The amount by which a distribution (other than a distribution that is rolled over) exceeds the account holder's unreimbursed qualified medical expenses must be reported as "Other income" on Form 1040 or Form 1040NR. On the adjacent dotted line, enter "HSA" and the amount. In addition, 20% of the taxable HSA distribution during the year that does not meet any of the exceptions to the tax penalty must be reported as "Other taxes" on Form 1040 or Form 1040NR. The amount of the additional tax and "HSA" should be entered on the adjacent dotted line.

1.1.9.6.2.1 Tax-Free HSA Distributions

HSA distributions are tax-free when the funds distributed are used to pay qualified medical expenses. Distributions from HSAs are typically used to pay the deductible amount, any coinsurance and other amounts that the account holder must pay for needed healthcare.

1.1.9.6.2.2 Taxable HSA Distributions

HSA distributions are taxable and must be included in the account holder's gross income for tax purposes to the extent used for any purpose other than the payment of qualified medical expenses. An HSA owner who is at the age at which he or she is eligible for Medicare may withdraw funds from the account for other than to pay qualified medical expenses without incurring a tax penalty. Although the funds thus withdrawn are subject to income taxation as ordinary income—just as a distribution from a traditional IRA would be—no tax penalty applies.

1.1.9.6.2.3 HSA Distribution Tax Penalty

A taxable HSA distribution may also subject the account holder to a substantial tax penalty. HSA distributions are includible in income ***and subject to income tax penalties*** when they:

- Are used for other than qualified medical expenses; and
- Fail to meet specified exceptions.

An HSA distribution includible in an account holder's income is also subject to a 20% penalty tax levied on the amount of the distribution includible in income, unless one of the following exceptions applies:

- The distribution is received while the account holder is disabled;
- The distribution is received following the account holder's death; or
- The distribution is received by the account holder after reaching the eligibility age for Medicare, i.e., age 65.

Even if these exceptions apply, however, a distribution *not used to pay qualified medical expenses* is includible in the distributee's income for tax purposes.

1.2 Standard Mileage Rates

The standard mileage rates enable a taxpayer using a vehicle for specified purposes to deduct vehicle expenses on a per-mile basis rather than deducting actual car expenses that are incurred during the year. The rates vary, depending on the purpose of the transportation.

Accordingly, the standard mileage rates differ from one another depending on whether the vehicle is used for:

- Business purposes;
- Charitable purposes; or
- Obtaining medical care or moving.

Rather than using the optional standard mileage rates, however, a taxpayer may choose to take a deduction based on the actual costs of using the vehicle.

1.2.1 Business Use of a Taxpayer's Personal Vehicle

Although taxpayers may no longer deduct unreimbursed employee expenses as "miscellaneous itemized deductions" to the extent the total of such expenses exceeds 2% of AGI, the 2021 alternative standard mileage rate applicable to ***eligible*** business use of a vehicle is 56¢ per mile, down from 57.5¢ in 2020. In order for such expenses to be deductible, they must have been:

- Paid or incurred during the tax year;
- For the purpose of carrying on the taxpayer's trade or business; and
- Ordinary and necessary.

Provided the vehicle expenses meeting these three criteria are not reimbursed, the deductible personal vehicle expenses include those incurred while traveling:

- Between workplaces;
- To meet with a business customer;
- To attend a business meeting located away from the taxpayer's regular workplace; or
- From the taxpayer's home to a *temporary* place of work.

In addition to using the standard mileage rate, a taxpayer may also deduct any business-related parking fees and tolls paid while engaging in deductible business travel. However, parking fees paid by a taxpayer to park his or her vehicle at the usual place of business are considered commuting expenses and are not deductible.

1.2.2 Personal Vehicle Use for Charitable Purposes

A taxpayer may deduct as a charitable contribution any unreimbursed out-of-pocket expenses, such as the cost of gas and oil, directly related to the use of a personal vehicle in providing services to a charitable organization. Alternatively, a taxpayer may use the standard mileage rate applicable to the use of a personal vehicle for charitable purposes. The standard mileage rate applicable to a taxpayer's use of a personal vehicle for charitable purposes is based on statute and is 14¢ per mile. The taxpayer may also deduct parking fees and tolls regardless of whether the actual expenses or standard mileage rate is used.

1.2.3 Use of a Taxpayer's Personal Vehicle to Obtain Medical Care

A taxpayer may also deduct medical and dental expenses to the extent they exceed the applicable percentage of his or her adjusted gross income (AGI). The vehicle expenses a taxpayer may include as medical and dental expenses are the amounts paid for transportation to obtain medical care for the taxpayer, a spouse or a dependent. A taxpayer may also include as medical and dental expenses those transportation costs incurred:

- By a parent who must accompany a child needing medical care;
- By a nurse or other person who can administer injections, medications or other treatment required by a patient traveling to obtain medical care and unable to travel alone; or
- For regular visits to see a mentally-ill dependent, if such visits are recommended as a part of the mentally-ill dependent's treatment.

A taxpayer who uses a personal vehicle for such medical reasons is permitted to include the out-of-pocket vehicle expenses incurred—the expenses for gas and oil, for example—or deduct medical travel expenses at the standard medical mileage rate. For 2021, the standard medical mileage rate is 16¢ per mile, down 1¢ from 2020. The taxpayer may also deduct any parking fees or tolls, regardless of whether actual expense or the standard mileage rate is used.

1.2.4 Basis Reduction Amount

A taxpayer must reduce the basis of an automobile used in business by the greater of a) the amount of depreciation claimed by the taxpayer, or b) the amount of the depreciation allowable. However, if the business standard mileage rate is used, then a per-mile amount (published annually by the IRS) is used to reduce the automobile's basis. That per-mile amount is:

- 25¢ for 2017
- 25¢ for 2018
- 26¢ for 2019
- 27¢ for 2020
- 26¢ for 2021

1.3 Resumption of Required Minimum Distributions

IRC Section 401(a)(9) requires a traditional IRA owner and certain retirement plan participants to take distributions (RMDs) at least equal to a required minimum amount annually once that person reaches age 72 (formerly age 70 ½ prior to passage of the SECURE Act in the closing days of 2019). The CARES Act suspended this requirement for 2020. The requirement to take distributions at age 72 resumes for years after 2020.

For employer-sponsored retirement plan participants, the required beginning date for RMDs is the later of:

1. The calendar year in which the participant attains age 72; or
2. The calendar year in which the participant retires from the service of the employer sponsoring the qualified plan. (This option is unavailable to a 5% owner of the employer.)

The initial required minimum distribution (RMD) must be made by April 1st of the year following the year in which the required beginning date falls. If the traditional IRA owner or plan participant fails to take a distribution at least equal to the required minimum distribution, a tax penalty equal to 50% of the insufficiency is payable.

1.4 Three-Year Repayment of COVID-19 Related Distributions

Contributions to IRAs and qualified retirement plans are afforded special tax benefits under the Internal Revenue Code—benefits including possible deductibility of contributions, tax-deferred accumulations, possible tax-free distributions—principally to encourage individuals to participate in such plans that will provide them with retirement income. In an attempt to limit their use to accumulating funds that will produce retirement income, early distributions, i.e., distributions before age 59 ½, are subject to a 10% penalty tax unless an exception to the penalty applies.

In addition to the customary exceptions to imposition of the penalty, the CARES Act adds an exception for coronavirus-related distributions. The 10% tax penalty is waived for any coronavirus-related early distributions up to $100,000 from an individual's IRA or qualified plan. This $100,000 limit applies to the aggregate of distributions to a single person – not per account.

Although the early distribution tax penalty is waived in the case of a coronavirus-related distribution, the distribution is, nonetheless, taxable and is includible in income ratably over the three-taxable-year period beginning with the taxable year in which the withdrawal was made unless the taxpayer elects to have the entire amount included in income in the year of withdrawal.

Except for certain types of distributions (see **Exceptions to Coronavirus-Related Distribution Repayment** below), an IRA account holder or qualified plan participant who receives such a distribution is permitted, but not required, to redeposit the distribution and may make a single contribution or multiple contributions in an aggregate amount not to exceed the amount of the coronavirus-related distribution to an eligible retirement plan. Repayment, if any, must occur before the end of the three-year period beginning on the day after the date on which it was received. Upon repayment, a form will need to be completed and the tax return(s) for the year(s) that the distribution was included in income amended and refiled. The redeposited withdrawals, for tax purposes, will be treated as if the redeposited distribution had been transferred to an eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution; in short, it will avoid taxation. Additional guidance is provided in Notice 2020-50.

1.4.1 Exceptions to Coronavirus-Related Distribution Repayment

Although coronavirus-related distributions from a qualified retirement plan or IRA may generally be repaid, a taxpayer cannot repay the following types of distributions:

- Qualified 2020 disaster distributions received as a beneficiary (other than a surviving spouse);
- Required minimum distributions;
- Any distribution (other than from an IRA) that is one of a series of substantially equal periodic payments made (at least annually) for:
    - a period of 10 years or more,
    - the taxpayer's life or life expectancy, or
    - the joint lives or joint life expectancies of a taxpayer and a taxpayer's beneficiary.

1.4.2 Coronavirus-Related Distribution

The term ''coronavirus-related distribution'' means a distribution not exceeding $100,000 in the aggregate from a qualified retirement plan or IRA made in 2020 to a qualified individual. A qualified individual is one:

- Who is diagnosed with the virus SARS–COV-2 or with coronavirus disease 2019 (COVID– 19) by a CDC-approved test,
- Whose spouse or dependent is diagnosed with such virus or disease by such a test, or
- Who experiences adverse financial consequences as a result of –
    - being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, or
    - being unable to work due to –
        - lack of child care due to such virus or disease,
        - closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or
        - other factors as determined by the Secretary of the Treasury.

1.4.3 Form 8915-E

The coronavirus disease 2019 is considered, for IRS reporting purposes, to be a qualified 2020 disaster. Accordingly, a taxpayer who has received a coronavirus-related distribution must file 2020 Form 8915-E, Qualified 2020 Disaster Retirement Plan Distributions and Repayments, with his or her 2020 Form 1040, 1040-SR, or 1040-NR. If the taxpayer is not required to file an income tax return but is required to file Form 8915-E, the taxpayer should:

- Complete the address information on page 1 of Form 8915-E,
- Sign the Form 8915-E, and
- Send the completed and signed form to the Internal Revenue Service at the same time and place the taxpayer would otherwise file Form 1040, 1040-SR, or 1040-NR.

Include on 2020 Form 8915-E any repayments the taxpayer made before filing his or her 2020 return. Such pre-2020 return date repayments the taxpayer made will reduce the amount of qualified 2020 disaster distributions reported on the taxpayer's return for 2020. Don't include any repayments the taxpayer made later than the due date (including extensions) for filing the taxpayer's 2020 return on the taxpayer's 2020 Form 8915-E.

If the taxpayer made a repayment in 2021 after filing the 2020 return, the repayment will reduce the amount of the taxpayer's qualified 2020 disaster distributions included in income on the taxpayer's 2021 return if the taxpayer has spread the income over 3 years, unless the taxpayer is eligible to amend the 2020 return. Also, if the taxpayer has spread the income over 3 years, any excess repayments the taxpayer makes for 2020 will be carried forward to the taxpayer's 2021 return.

Repayments of coronavirus-related distributions from ***retirement plans other than IRAs*** made before the taxpayer filed his or her 2020 tax return (but not beyond the due date including extensions) should be entered on line 10 of Part II of Form 8915-E. For repayments of coronavirus-related distributions from ***traditional, SEP, SIMPLE, and Roth IRAs***, enter the amount repaid before filing the 2020 tax return (but not beyond the due date including extensions) on line 18 of Part III of Form 8915-E.

1.5 Recovery Rebate Credit

Recovery rebates, authorized by the CARES Act and Taxpayer Relief Act of 2020 (TRA 2020), were issued in 2020. And, in 2021, recovery rebates were authorized under the American Rescue Plan Act (ARPA).

1.5.1 2020 Recovery Rebates – CARES Act and TRA 2020

Direct payments to taxpayers are authorized under Section 2201 of the CARES Act. These rebates are referred to in the CARES Act as "2020 recovery rebates" and in IRS materials and elsewhere as "stimulus payments" or "economic impact payments." Subject to adjusted gross income (AGI) limitations, these refundable tax credit payments are authorized not exceeding:

- $1,200 for single filers and heads of household;
- $2,400 for joint filers; and
- $500 for each qualifying dependent child age 16 or under by the end of the tax year.

The rebate-related provisions of the CARES Act were modified by TRA 2020 to provide an additional 2020 refundable tax credit. Those additional tax credits provide a second round of direct payments and are authorized not exceeding:

- $600 per individual taxpayer;
- $1,200 for married taxpayers filing jointly; and
- $600 per qualifying child under age 17.

As a tax credit, the recovery rebate is nontaxable and is not counted as income with respect to determining a taxpayer's eligibility for income-based programs such as Medicaid or health insurance Marketplace subsidies.

1.5.2 2021 Recovery Rebates – American Rescue Plan Act

The American Rescue Plan Act (ARPA) provides tax-free, refundable, recovery rebate tax credits in 2021 of up to $1,400 for each eligible individual ($2,800 for married taxpayers filing jointly), plus $1,400 for each dependent, as defined in IRC § 152, including qualifying relatives and college students. An eligible individual means any individual other than:

- A nonresident alien;
- An individual who is a dependent of another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins; and
- An estate or trust.

1.5.2.1 2021 Recovery Rebate Limitation Based on Adjusted Gross Income

The amount of the recovery rebate tax credit authorized by ARPA is phased out for:

- Single taxpayers with AGIs beginning at $75,000, and is eliminated entirely at an AGI of $80,000;
- Married taxpayers filing jointly with AGIs beginning at $150,000 and is eliminated entirely at an AGI of $160,000; and
- Heads of household with AGIs beginning at $112,500 and is eliminated entirely at an AGI of $120,000.

For a single taxpayer having an AGI of more than $75,000, the amount of the reduction in the rebate for which he or she is eligible is determined by the following equation.

$$\text{Rebate} \times \frac{(\text{AGI} - \$75{,}000)}{\$5{,}000} = \text{Rebate reduction}$$

So, for a single taxpayer with an AGI of $77,000, the reduction in the rebate would be $560, as shown below:

$$\$1{,}400 \quad \times \quad \frac{(\$77{,}000 - \$75{,}000)}{\$5{,}000} \quad = \quad \$560$$

For married taxpayers filing jointly with an AGI more than $150,000, the amount of the reduction in the rebate for which they are eligible is determined by the following equation.

$$\text{Rebate} \quad \times \quad \frac{(\text{AGI} - \$150{,}000)}{\$10{,}000} \quad = \quad \text{Rebate reduction}$$

Married taxpayers with an AGI of $155,000, would have a reduction in the rebate amounting to $1,400, determined as shown below:

$$\$2{,}800 \quad \times \quad \frac{(\$155{,}000 - \$150{,}000)}{\$10{,}000} \quad = \quad \$1{,}400$$

Since the rebate for a taxpayer filing as HOH phases out over a $7,500 range, a taxpayer filing as HOH with an AGI exceeding $112,500 would have a reduction in the rebate determined by the following equation.

$$\text{Rebate} \quad \times \quad \frac{(\text{AGI} - \$112{,}500)}{\$7{,}500} \quad = \quad \text{Rebate reduction}$$

A taxpayer filing as HOH with an AGI of $114,000, would have a reduction in the rebate amounting to $280, determined as shown below:

$$\$1{,}400 \quad \times \quad \frac{(\$114{,}000 - \$112{,}500)}{\$7{,}500} \quad = \quad \$280$$

The taxpayer's 2019 AGI is used to determine eligibility unless the taxpayer has already filed a federal income tax return for 2020.

1.6 Adjustment for Charitable Contribution Deduction for Nonitemizers

A charitable deduction is available to taxpayers who do not itemize deductions. Sometimes referred to as a "universal deduction," this CARES Act provision permits a non-itemizing taxpayer to take an above-the-line deduction of up to $300 for charitable cash contributions made in taxable years beginning in 2020. A deduction that is "above the line" reduces AGI. It is a deduction that is made in calculating AGI in the first place. Such deductions may be taken regardless of whether a taxpayer itemizes deductions.

TRA 2020 extends the above-the-line charitable cash contribution deduction for taxpayers who do not itemize to include 2021 and increases the maximum deductible limit to $600 for married taxpayers filing jointly.

1.7 Current Status of Tax Extenders

When Congress enacts tax provisions—particularly tax cuts—they often are scheduled to expire at some date in the future; thus, they are considered temporary. This approach by legislators, according to the Tax Policy Center[6], is normally designed to meet one or more of the following legislative objectives by the provisions' proponents:

- To force a congressional review when the provisions are scheduled to expire;
- To address needs that are considered temporary; and/or
- To facilitate passage of the provision when budgetary resources are unavailable to offset its cost for longer than one or two years.

These tax provisions are referred to, in the aggregate, as "tax extenders" and are so-called because it is expected that lawmakers will consider extending some or all of them. Several tax benefits were extended or made permanent under the Coronavirus Aid, Relief, and Economic Security (CARES) Act

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[6] Source: Tax Policy Center may be accessed at https://www.taxpolicycenter.org/briefing-book/what-are-tax-extenders.

and the Consolidated Appropriations Act, 2021, while others were permitted to expire. The benefits addressed in the following text include the:

- 7.5% AGI limit for medical expense deductions;
- Tuition and fees deduction;
- Credit for non-business energy property;
- Itemized deduction for mortgage insurance premiums; and
- Exclusion from income of qualified principal residence debt cancellation.

1.7.1 Permanent Extension of 7.5% AGI Limit for Medical Expense Deduction

The threshold for deduction of unreimbursed medical expenses had been scheduled to increase from 7.5% of AGI to 10% of AGI several times but has been forestalled repeatedly by temporary tax extenders and was again expected to increase to 10% in 2021. However, the Consolidated Appropriations Act, 2021 makes permanent the 7.5% AGI floor for deduction of unreimbursed medical expenses applicable beginning for 2021.

1.7.2 Tuition and Fees Deduction Eliminated

Although the tuition and fees deduction expired at the end of 2016, it was extended under various Acts through December 31, 2020. The deduction, an adjustment to income that enabled an eligible taxpayer to reduce his or her income subject to tax by up to $4,000 for payment of qualifying tuition and fees, was allowed to expire at the end of 2020 and is unavailable for 2021.

1.7.3 Credit for Nonbusiness Energy Property Extended

The tax credit for nonbusiness energy property that had expired at the end of 2017 and extended through 2020 has been extended through 2021 under the Consolidated Appropriations Act, 2021. The credit is for expenditures for qualified energy property that is:

- Installed on or in connection with a taxpayer's existing principal residence located within the United States;
- Expected to last for at least 5 years; and
- Originally placed in service by the taxpayer.

This is a nonrefundable tax credit equal to the sum of:

1. 10 percent of amounts paid or incurred for qualified energy efficiency improvements installed during the year; and
2. The amount spent or incurred for residential energy property.

1.7.3.1 Limitations on Maximum Nonbusiness Energy Property Credit

The maximum total nonbusiness energy property credit available is limited as follows:

- A total combined credit limit of $500 for all tax years after 2005;
- A combined credit limit of $200 for windows for all tax years after 2005; and
- A credit limit for residential energy property costs for the year of –
    - $50 for any advanced main air circulating fan,
    - $150 for any qualified natural gas, propane or oil furnace or hot water boiler, and
    - $300 for any item of energy efficient building property.

The credit available in the current year is limited to no more than $500 *less* the total of any energy property credits allowed for all prior years after 2005. Accordingly, if a taxpayer made expenditures that qualify for the credit of $500 during the year but had received an energy property credit of $300 in total during the years after 2005, the energy property credit available for the current year would be $200 ($500 - $300 = $200).

1.7.3.2 Subsidized Energy Financing

The nonbusiness energy property credit is further limited in that amounts provided by subsidized energy financing cannot be used to determine the nonbusiness energy property credit. Subsidized energy financing, as used in this context, means financing provided under a federal, state or local program designed to provide subsidized financing for energy production or energy conservation projects.

1.7.3.3 Qualified Energy Efficiency Improvements

Qualified energy efficiency improvements are a house's building envelope components—materials that comprise the foundation, wall assembly, roofing systems, glazing, doors, etc.—installed on or in the taxpayer's principal residence that meet certain energy standards, and include:

- Insulation material designed to reduce heat loss or gain when installed;
- Exterior windows and skylights;
- Exterior doors; and
- Metal roof with appropriate pigmented coatings or asphalt room with appropriate cooling granules designed to reduce heat gain.

When figuring the credit, don't include amounts paid for onsite preparation, assembly or original installation of the component.

1.7.4 Mortgage Insurance Premiums Deduction Extended

The Consolidated Appropriations Act, 2021 also extended the deduction for mortgage insurance premiums paid during the year. Payment of a mortgage insurance premium is normally required only when a homebuyer is making a down payment of less than 20% of the price of the home. In such a case the mortgage lender may require the additional security of having its loan secured not only by the home but also by an insurer.

When qualified mortgage insurance premium is paid by a taxpayer under a mortgage insurance contract issued after December 31, 2006 in connection with home acquisition debt secured by the taxpayer's first or second home, the premiums may be tax-deductible for itemizing taxpayers. The deduction is taken on Form 1040 schedule A, and, although there are no limits on the amount of mortgage insurance premium deduction that may be taken, the deduction is limited based on the taxpayer's adjusted gross income (AGI).

1.7.4.1 Qualified Mortgage Insurance Defined

Qualified mortgage insurance—premiums for which are tax-deductible—is mortgage insurance provided by:

- The Department of Veterans Affairs (commonly known as a "funding fee");
- The Federal Housing Administration;
- The Rural Housing Service (or successor organizations); and
- Private mortgage insurance.

1.7.4.2 Prepaid Mortgage Insurance Premiums

Except in the case of mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service, qualified mortgage insurance premiums may be prepaid by the taxpayer. In such a case, premiums allocable to periods after the close of the tax year must be allocated over the shorter of:

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

Premiums are treated as paid in the year to which they are allocated. If the mortgage is satisfied before its term, no deduction is allowed for the unamortized prepaid mortgage insurance premiums.

1.7.4.3 Limitation of Deduction Based on Taxpayer's AGI

The amount of the taxpayer's qualified mortgage insurance premiums that may be deducted is reduced if the taxpayer's adjusted gross income is more than the applicable amount shown in the table below:

Filing Status	Applicable Amount	Deduction Eliminated
Married filing separately	$50,000	$54,500
All other statuses	$100,000	$109,000

Mortgage Insurance Premiums Deduction Worksheet—Line 8d *Keep for Your Records*

Before you begin: ✓ See the instructions for line 8d to see if you must use this worksheet to figure your deduction.

1. Enter the total premiums you paid in [illegible] for qualified mortgage insurance for a contract issued after December 31, 2006 . . . . . . **1.** ______
2. Enter the amount from Form 1040 or 1040-SR, line 8b . . . . . . **2.** ______
3. Enter $100,000 ($50,000 if married filing separately) . . . . . . **3.** ______
4. Is the amount on line 2 more than the amount on line 3?
   - ☐ **No.** Your deduction isn't limited. Enter the amount from line 1 of this worksheet on Schedule A, line 8d. **Don't** complete the rest of this worksheet.
   - ☐ **Yes.** Subtract line 3 from line 2. If the result isn't a multiple of $1,000 ($500 if married filing separately), increase it to the next multiple of $1,000 ($500 if married filing separately). For example, increase $425 to $1,000, increase $2,025 to $3,000; or if married filing separately, increase $425 to $500, increase $2,025 to $2,500, etc. . . . . . . **4.** ______
5. Divide line 4 by $10,000 ($5,000 if married filing separately). Enter the result as a decimal. If the result is 1.0 or more, enter 1.0 . . . . . . **5.** ___.___
6. Multiply line 1 by line 5 . . . . . . **6.** ______
7. **Mortgage insurance premiums deduction.** Subtract line 6 from line 1. Enter the result here and on Schedule A, line 8d . . . . . . **7.** ______

1.7.5 Exclusion of Cancellation of Principal Residence Debt Income

The Consolidated Appropriations Act, 2021 also extended the exclusion from income of certain qualified principal residence indebtedness. Under the five-year tax extender, a taxpayer may exclude income arising from discharge of qualified principal residence indebtedness provided one of the following applies:

- The debt was discharged before 2026; or
- The debt was discharged after 2020, and the discharge is subject to an arrangement entered into and evidenced in writing before January 1, 2026.

Properly reporting qualified principal residence indebtedness discharge requires preparation of IRS Form 982 and its attachment to the taxpayer's federal income tax return.

1.7.5.1 Qualified Principal Residence Indebtedness Defined

The term "principal residence" means the taxpayer's main home, i.e., the home where the taxpayer lives most of the time. A taxpayer may have only one main home at any one time.

The term "qualified principal residence indebtedness" is a mortgage meeting both of the following conditions:

- The taxpayer took out the mortgage to buy, build, or substantially improve his or her main home; and
- The mortgage is secured by the taxpayer's main home.

If the amount of the taxpayer's original mortgage is more than the cost of the taxpayer's main home plus the cost of any substantial improvements to the home, only the debt that is not more than the cost of the taxpayer's main home plus improvements is considered qualified principal residence indebtedness.

1.7.5.2 Refinancing of Qualified Principal Residence Indebtedness

Debt secured by the taxpayer's main home that was used to refinance qualified principal residence indebtedness is likewise treated as qualified principal residence indebtedness but only up to the amount of the old mortgage principal just before the refinancing. Any additional debt the taxpayer incurred to substantially improve the main home is also treated as qualified principal residence indebtedness.

1.7.5.3 Amount Eligible for Exclusion

The exclusion of residence indebtedness applies only to debt discharged after 2006 and, in most cases, only to debt discharged before 2026. The maximum amount the taxpayer can treat as qualified principal residence indebtedness is $750,000 ($375,000 if married filing separately). The taxpayer cannot exclude from gross income the discharge of qualified principal residence indebtedness if the discharge was:

- For services performed for the lender; or
- On account of any other factor not directly related to –
  - a decline in the value of the taxpayer's residence, or
  - the taxpayer's financial condition.

Review #2

1. Karl uses his personal vehicle for charitable purposes. If he drove 1,400 miles, spent $50 on gas and oil, $40 on parking fees, $60 on tolls and elected to use the standard mileage deduction, how much of the expenses would be tax-deductible?

   A. $0

   B. $196

   C. $296

   D. $346

2. Phil is age 67 and has just received a $20,000 taxable HSA distribution that he is using to supplement his retirement income. What tax penalty, if any, applies to his HSA distribution for other than qualified medical expenses?

   A. $4,000

   B. $3,000

   C. $2,000

   D. $0

Domain 2 – General Income Tax Review

Introduction

Although the tax laws change and applicable limits may be subject to cost of living adjustments and other changes, much of the tax code and the principles underlying federal income tax return preparation don't vary substantially from year to year. In the domain 2 text that follows, a general review of tax law related to preparation of 2021 individual 1040 tax returns will be provided.

Domain 2 Learning Objectives

When you have completed the domain 2 text, you should be able to:

- Identify those items included in a taxpayer's taxable earnings;
- Determine the tax treatment of foreign accounts and trusts;
- Apply the rules governing contributions to and distributions from IRAs;
- Describe the reporting and taxability of unemployment compensation;
- Recognize the items included in self-employment income and expenses;
- Distinguish between a hobby and a business for tax purposes;
- Calculate the tax deduction for business use of a home;
- Identify the recordkeeping requirements to substantiate Schedule C entries;
- Understand the tax treatment of retirement income;
- List the factors considered in determining the tax treatment of capital gains and losses;
- Recognize the eligibility requirements for various tax credits;
- Describe the rules governing a taxpayer's tax withholding and estimated tax payments;
- Recognize the options available to a taxpayer for paying any tax due or receiving a tax refund; and
- Identify the due dates of income tax returns.

2.1 Taxability of Earnings

Taxpayers who are employees should receive an IRS Form W–2 from their employers. The amount shown in box 1 of the form is the total of wages and/or salary received from the employer during the year. That amount, along with any other compensation received for services as other than an independent contractor, must be included on the taxpayer's income tax return.

Among the other types of compensation received by a taxpayer that may or may not be taxable are the following:

- Advance commissions and other earnings;
- Allowances and reimbursements;
- Back pay awards;
- Bonuses and awards;
- Differential wage payments;
- Government cost-of-living allowances;
- Nonqualified deferred compensation plans;
- Notes received for services;
- Severance pay;
- Sick pay;
- Social Security and Medicare taxes paid by the taxpayer's employer; and
- Stock appreciation rights.

Let's briefly consider each of these compensation types.

2.1.1 Advance Commissions and Other Earnings

If a cash method taxpayer receives advance commissions or other amounts for services to be performed in the future, the taxpayer must include those amounts in income in the year in which they are received. However, if the taxpayer repays any unearned commissions or other similar amounts in the same year in which they are received, the amount included in the taxpayer's income should be reduced by the amount of such repayment. In contrast, if the taxpayer repays advance commissions or other earnings in a later tax year, the taxpayer can deduct the repayment as an itemized deduction on his or her Schedule A or may be able to take a credit for that year.

2.1.2 Allowances and Reimbursements

An employer may provide a reimbursement or allowance for business expenses that a taxpayer incurs while performing his or her job functions for the employer. Such reimbursements or allowances may be provided under an accountable or nonaccountable plan. Depending upon which approach is taken by the employer—whether it is under an accountable or nonaccountable plan, in other words—the expense allowance or reimbursement may or may not be included in the taxpayer's IRS Form W-2.

Allowances and reimbursements provided by an employer under an accountable plan are not normally included in the taxpayer's IRS Form W-2. In contrast, amounts provided to a taxpayer as an allowance or reimbursement made under a nonaccountable plan are included and are taxable.

An accountable plan under which an employer provides a reimbursement or allowance for business expenses is characterized by the following:

1. The taxpayer employee's expenses for which an allowance or reimbursement is provided must be connected to the employer's business;
2. The employee must account for expenses incurred on the employer's behalf within a reasonable time period; and
3. The employee is required to return any reimbursement or allowance in excess of the actual business expenses incurred within a reasonable period.

A nonaccountable plan is simply a reimbursement or allowance plan provided by an employer for the taxpayer under which any of the characteristic requirements of an accountable plan are **not** required.

The exception to the non-taxable nature of allowances and reimbursements provided to a taxpayer under an accountable plan are employer payments under such a plan that either a) reimburse nondeductible expenses or b) are in excess of actual expenses incurred and which the taxpayer fails to return to the employer.

2.1.3 Back Pay Awards

Back pay awards are those awards granted in a settlement or judgment for back pay. These awards include payments made to the taxpayer for:

- Damages;
- Unpaid life insurance premiums; and
- Unpaid health insurance premiums.

Such back pay awards should be included in the IRS Form W-2 provided by the employer and must be included in the taxpayer's income.

2.1.4 Bonuses and Awards

Bonuses or awards the taxpayer receives from an employer for outstanding work—awards such as vacation trips for meeting sales goals, etc.—must be included in the taxpayer's income and should be shown on the IRS Form W-2. An exception to the requirement that awards be included in income for tax purposes applies to certain employee achievement awards.

If a taxpayer receives tangible personal property, other than cash or its equivalent, as an award from an employer for the taxpayer's length of service or safety achievement, the value of such an award can be excluded from the taxpayer's income within prescribed limits. Thus, the amount the taxpayer may exclude from income for a qualified plan award is limited to the taxpayer's employer's cost and cannot be more than $1,600 for all such awards the taxpayer receives during the year. A qualified plan award is an achievement award given as part of an established written plan or program that does not favor highly compensated employees as to eligibility or benefits. If the award is other than a qualified plan award, the excluded amount is limited to no more than $400.

The ability to exclude the value of certain awards from a recipient's income does not apply to the following awards:

- A length of service award if the taxpayer received it for less than five years of service or if the taxpayer received another length of service award during the year or in the previous four years; or
- A safety achievement award if the taxpayer is a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

2.1.5 Differential Wage Payments

A differential wage payment is defined as a payment made to the taxpayer by an employer for any period of more than 30 days during which the taxpayer was an active duty member of the uniformed services and represents all or a portion of the wages the taxpayer would have received from the employer during that period. Although differential wage payments are treated as wages subject to income tax withholding, they are not subject to FICA or FUTA taxes. The payments are reported as wages on IRS Form W-2 and must be included in income.

2.1.6 Government Cost of Living Allowances

If the taxpayer is stationed outside the continental United States or in Alaska, his or her gross income does not generally include cost-of-living allowances granted by regulations approved by the president of the United States, except as to amounts received under Title II of the Overseas Differentials and Allowances Act. The cost-of-living portion of any other allowance—a living and quarters allowance, for example—is not included in the taxpayer's income even if the underlying allowance is included in gross income. Cost-of-living allowances are not included on the taxpayer's IRS Form W-2

2.1.7 Nonqualified Deferred Compensation Plans

A taxpayer who is a participant in an employer's nonqualified deferred compensation plan will receive an IRS Form W-2 showing the amount of deferrals for the year under the plan in box 12, using code Y. Although the amount of deferrals is shown on IRS Form W-2, the amount shown is not included in the taxpayer's income for tax purposes until distributions from the plan are received or the plan fails to meet certain requirements.

If at any time during the tax year the plan fails to meet those requirements or is not operated pursuant to them, all amounts deferred under the plan for the tax year and all preceding tax years are included in the taxpayer's income for the current year. In such a case the amount thus shown would be included in the taxpayer's wages included in IRS Form W-2, box 1 and in box 12, using code Z.

2.1.8 Notes Received for Services

If a taxpayer receives a ***secured note*** as payment for his or her services, the taxpayer is required to include the fair market value—usually the discount value—in income in the year in which the note is received. When the taxpayer later receives payments on the note, a proportionate part of each payment is considered a tax-free recovery of the fair market value previously included in the taxpayer's income. The balance of the payment in excess of that tax-free amount must be included in income when received.

If a taxpayer receives a ***nonnegotiable unsecured note*** in payment for services, payments on the note that are credited towards the principal amount of the note are compensation income when received by the taxpayer. However, no income needs to be recognized in the year in which the nonnegotiable unsecured note is received by the taxpayer.

2.1.9 Severance Pay

The taxpayer must include in income any amount received from an employer as severance pay as well as any payment for the cancellation of the taxpayer's employment contract.

2.1.10 Sick Pay

Payments received from an employer while the taxpayer is sick or injured are considered part of the taxpayer's salary or wages and generally must be included in the taxpayer's income. Thus, the following sick pay benefits must be included:

- Payments from a welfare fund;
- Payments from a state sickness or disability fund;

- Payments from an association of employers or employees; and
- Payments from an insurance company if the employer paid for the plan.

However, if the taxpayer received benefits under an accident or health insurance policy for which he or she paid the premiums—a disability income policy, for example—such benefits would not be taxable.

2.1.11 Social Security and Medicare Taxes Paid by an Employer

Basic Social Security and Medicare taxes are normally paid by both the employer and employee. In some cases, however, an employer may agree to pay an employee's share of Social Security and Medicare taxes without deducting them from the taxpayer's gross wages. In such a case, the employee's share of Social Security and Medicare taxes paid by the employer are treated as taxable income. In addition, such payments are also treated as wages for figuring Social Security and Medicare taxes. The exception to this general rule applies in the case of a farm worker or household worker. In the case of such taxpayers, the Social Security and Medicare taxes paid by the employer are not treated as Social Security and Medicare wages.

2.1.12 Stock Appreciation Rights

A taxpayer who receives a stock appreciation right granted by his or her employer is not required to include the right in income until the taxpayer exercises it. When the taxpayer exercises the right, the taxpayer is entitled to a cash payment equal to the fair market value of the corporation stock on the date of exercise minus the fair market value on the date the right was granted. The taxpayer must include the cash payment in income in the year in which he or she exercises the right.

2.1.13 Tip Income

All tips the taxpayer receives are included in income and subject to federal income tax. Thus, the taxpayer is required to include in gross income any and all tips received directly, charged tips paid to the taxpayer by the employer and any tips received by the taxpayer under a tip splitting or tip pooling arrangement. Additionally, the value of non-cash tips—tickets to sporting events and other items of value, for example—are considered income and also subject to income taxes.

Taxpayers who receive tips must:

- Keep a daily tip record;
- Report tips to his or her employer; and
- Report all tips on the taxpayer's income tax return.

2.2 Schedule B, Interest, Dividends, Foreign Accounts and Trusts

Form 1040 Schedule B, interest and ordinary dividends, is filed if the taxpayer:

- Had more than $1,500 of taxable interest or ordinary dividends;
- Received interest from a seller-financed mortgage and the buyer used the property as a personal residence;
- Has accrued interest from a bond;
- Is reporting original issue discount (OID) in an amount less than the amount shown on Form 1099–OID;
- Is reducing his or her interest income on a bond by the amount of amortizable bond premium;
- Is claiming the exclusion of interest from series EE or I U.S. savings bonds issued after 1989;
- Received interest or ordinary dividends as a nominee; or
- Had a financial interest in, or signature authority over, a financial account in a foreign country or received a distribution from, or was a grantor of, or transferor to, a foreign trust.

Thus, Schedule B must be filed if ***any*** of the above-mentioned situations apply. However, even if Parts I and II of Schedule B must be completed, Part III of the Schedule needs to be completed only if certain specified conditions apply. Part III of Form 1040 Schedule B must be completed only if the taxpayer:

- Had more than $1,500 of taxable interest or ordinary dividends;
- Had a foreign account; or
- Received a distribution from, was a grantor of, or transferor to, a foreign trust.

The tax preparer must check the "yes" box on line 7a of Part III of the Schedule if the taxpayer had a financial interest in or signature authority over a financial account located in a foreign country.

For purposes of completing Schedule B, a **financial account** is broadly defined to include (but isn't limited to):

- A securities account, brokerage account, savings, demand, checking, deposit, time deposit or other account maintained with a financial institution;
- A commodity futures or options account;
- An insurance policy with a cash value;
- An annuity policy with a cash value; and
- Shares in a mutual fund or similar pooled fund.

A financial account is located in a foreign country if the account is physically located outside of the United States.

2.3 Retirement Income Reporting and Taxability

Retirement income includes income derived from a range of sources, both private and public. Although some retirement income is excludable, in whole or part, from income, most retirement income is taxable as ordinary income in the year received. This section will consider the taxability and reporting requirements of distributions received from:

- Social Security;
- Pensions;
- Annuities; and
- 401(k) plans.

2.3.1 Social Security Benefits

Social Security benefits include monthly retirement, survivor and disability benefits paid under the Social Security system. The benefits may be entirely tax-free or partially taxable.

2.3.1.1 Taxability of Benefits

The taxability of Social Security benefits received by a taxpayer depends on the recipient's total income. Social Security benefits may be entirely tax-free or partially taxable depending upon whether the total of:

- Half the net Social Security benefits received during the year by the taxpayer (total benefits received during the year less any Social Security benefits repaid during the year); plus
- All other income received by the taxpayer (including tax-exempt interest)

…exceeds the base amount for the taxpayer's filing status. In general, the higher the total of the taxpayer's Social Security benefits and other income, the greater will be the taxable part of the taxpayer's Social Security benefits.

To determine how much of the taxpayer's net Social Security benefits are taxable, if any, complete Worksheet 1 contained in IRS Publication 915. Tax preparation software also will normally figure the taxable portion of any Social Security benefits.

When calculating the total of ½ the net Social Security benefits plus the taxpayer's other income with which to compare to the base amount for the taxpayer's filing status, the total of certain adjustments is determined. The adjustments are:

- Educator expenses;
- Certain business expenses of reservists, performing artists and fee-basis government officials;
- Health savings account deductions;
- Moving expenses;
- The deductible part of self-employment tax;
- Contributions to various tax favored retirement plans;
- Self-employed health insurance premiums;
- The penalty paid on any early withdrawal of savings;
- Alimony paid under pre-2019 agreements; and
- Deductible contributions to an IRA.

If the sum of the adjustments equals or exceeds the total of ½ the net Social Security benefits plus the taxpayer's other income, none of the taxpayer's Social Security benefits are taxable. However, if the sum of the adjustments is less than the total of ½ the net Social Security benefits plus the taxpayer's other income, the sum of the adjustments must be deducted from the total of ½ the net Social Security benefits plus the taxpayer's other income. The resulting amount is then compared with the applicable base amount. If the resulting amount is less than or equal to the applicable base amount, the taxpayer's Social Security benefits are tax-free.

However, if the resulting amount is greater than the applicable base amount, a portion of the taxpayer's net Social Security benefits—up to 85%—must be included in income and is subject to income tax.

The base amount with which ½ the taxpayer's net Social Security benefits plus other income must be compared varies, depending upon the taxpayer's filing status and is:

- $25,000 if the taxpayer files as single, head of household, or a qualifying widow(er);
- $25,000 if the taxpayer files as married filing separately and lived apart from his or her spouse for all of the tax year;
- $32,000 if the taxpayer files as married filing jointly; or
- $0 if the taxpayer files as married filing separately and lived with his or her spouse at any time during the tax year.

2.3.1.2 Reporting

If any part of the taxpayer's Social Security benefit is taxable, the taxpayer must file a federal tax return.

The taxpayer's net Social Security benefits—the amount shown in IRS Form SSA–1099, box 5—must be entered on the line for Social security benefits, and the taxable portion of the benefit must be entered on the adjacent line "Taxable amount." If the taxpayer is married filing separately and has lived apart from his or her spouse for all the tax year, also enter "D" to the right of the word "benefits."

If the Social Security benefits are not taxable, the net benefits should be entered on the appropriate lines, and 0 should be entered on the line for "Taxable amount." If the taxpayer is married filing separately and lived apart from his or her spouse for all the tax year, also enter "D" to the right of the word "benefits" on IRS Form 1040.

2.3.2 Qualified Retirement Plans

The term "qualified retirement plan" refers to plans maintained by an employer that provide retirement income to employees or result in a deferral of income by employees for periods extending generally to the end of employment. Such plans include traditional pension plans, profit sharing plans, 401(k) plans, stock bonus plans and several other types of plans.

2.3.2.1 Contributions to Qualified Employee Plans

Funding plan participants' income in retirement requires that *someone* must make contributions. Depending on the qualified employee plan, those contributions may be made by employers and/or plan participants.

2.3.2.2 Employee Plan Contributions

Employee contributions to employer retirement plans are generally known as "elective deferrals" and are characteristic of 401(k) plans and 403(b) tax sheltered annuity plans. Unless elective deferrals are directed to a designated Roth account in the plan, the funds deferred are allocated to the plan before income taxes are paid. Funds allocated to a designated Roth account, in contrast, are made on an after-tax basis.

Plan participants are limited in the amounts they may defer under a 401(k) or 403(b) plan in any year to the lesser of:

- 100% of the plan participant's compensation; or
- A specified dollar amount that generally increases annually based on a cost of living adjustment.

The specified dollar amount in 2021 is $19,500.[7] The applicable limit on elective deferrals generally applies to the total of all elective deferral contributions (in the aggregate) made to such plans. Participants in 401(k) plans and 403(b) tax sheltered annuity plans that are age 50 or older by the end of the year may make catch-up contributions. The catch-up provision in the law permitting increased contributions by age 50 and older participants increases the otherwise applicable dollar limit on elective deferrals.

Accordingly, the additional elective deferral that age 50 and older participants in a 401(k) or 403(b) tax sheltered annuity plan are permitted is equal to the lesser of:

- The applicable catch-up dollar amount; or
- The amount of the participant's compensation (reduced by any other elective deferrals for the year).

The applicable dollar amount for 2021 catch-up contributions is $6,500 and is indexed for inflation in subsequent years.

2.3.2.3 Qualified Retirement Plan Distributions

The tax treatment of distributions from a qualified retirement plan—other than qualified distributions from a designated Roth 401(k) or Roth 403(b) account—are generally taxable as ordinary income to the plan participant or beneficiary who receives them. Any distribution made to a participant from a qualified plan—even if the distribution will be rolled over to another plan—requires that the trustee of the distributing plan withhold 20% of the distribution for taxes. Qualified distributions from a designated Roth 401(k) or Roth 403(b) account are tax free.

2.3.2.3.1 Early Distributions

A participant who takes a distribution from a qualified retirement plan before age 59 ½ is subject to a premature distribution tax penalty equal to 10% of the amount of the distribution the participant must include in income unless an exception applies. An exception applies if the participant is disabled or deceased or the distribution is:

- Part of a series of substantially-equal lifetime payments;
- Pursuant to a qualified domestic relations order;
- For medical care to the extent tax deductible;
- Made to correct excess contributions;
- Made on account of separation of service after attainment of age 55; or
- A qualified birth or adoption distribution not exceeding $5,000.

2.3.2.4 Required Qualified Plan Minimum Distributions

The Internal Revenue Code requires that distributions of qualified plan funds begin no later than the required beginning date. The required beginning date for qualified plan distributions is the later of:

1. The calendar year in which the participant attains age 72; or
2. The calendar year in which the participant retires, unless the participant is a 5% owner of the employer.

If the plan participant fails to take a distribution at least equal to the required minimum distribution, a tax penalty equal to 50% of the insufficiency is payable.

2.3.2.5 Qualified Plan Rollovers

When a participant in a qualified plan leaves the employ of the plan sponsor, the participant may roll over the assets to his or her credit in the plan—an amount equal to the participant's vested account balance, in other words—and avoid current taxation of the funds. To avoid the plan trustee's required 20% withholding, the rollover must be made by the plan trustee to the trustee of the new plan or IRA.

[7] IRC §402(g)(1).

2.3.2.6 Plan Death Benefits

Death benefits paid under a life insurance policy in a qualified plan receive different tax treatment than death benefits paid under life insurance policies not included in qualified plans. Such qualified plan death benefits are conceptually divided into two components:

- The net amount at risk; and
- The policy cash value.

The net amount at risk under a policy contained in a qualified plan—the difference between the policy's death benefit and its cash value—is generally received entirely free of income taxation. The policy cash value, less the amount of any imputed income recognized by the participant during lifetime due to the inclusion of life insurance in the plan, is subject to taxation at ordinary income rates.

For example, suppose a plan participant died, and $100,000 of life insurance in the plan was payable to the participant's beneficiary. If the policy's cash value at the time of death was $25,000 and the participant had recognized $4,700 of imputed income over the years the insurance was in force, the amount of the $100,000 death benefit that would be tax free to the beneficiary is $79,700, as illustrated below:

Death benefit	$100,000
Cash value	- 25,000
Tax-free net amount at risk	$75,000
Imputed income recognized by participant	+4,700
Tax-free death benefit	$79,700

2.3.2.7 Designated Roth Account Distributions

Elective deferrals designated to a 401(k) or 403(b) plan's Roth account do not enjoy the favorable before-tax treatment given contributions to non-Roth accounts. Instead, such Roth account elective deferrals are made with after-tax funds. The income tax benefits to which a participant in a Roth account may be entitled, in addition to tax-deferral, arise at the time of distribution.

2.3.2.7.1 Qualified Roth Account Distributions Tax-Free

Qualified distributions from a Roth account are received entirely tax-free. A qualified distribution from a Roth account is a distribution that is made no earlier than after a five taxable-year period beginning with the first year for which a contribution is made to the Roth account and which is:

- Made on or after the participant's age 59½;
- Attributable to the participant's disability;
- Made following the participant's death; or
- A qualified reservist distribution.

2.3.2.7.2 Nonqualified Roth Account Distributions

A nonqualified distribution from a designated Roth account on which earnings have been credited—a distribution that fails to meet the requirements of a ***qualified*** Roth distribution—is partially taxable. The portion of the nonqualified distribution that constitutes the employee's contribution is received tax-free. The balance of the distribution—the portion that is comprised of the earnings, in other words—is taxable. (Note that this tax treatment is different from the FIFO tax treatment given to nonqualified distributions from a Roth IRA.) The portion of the nonqualified Roth distribution that is nontaxable as a return of contributions is the same portion of the designated Roth account that is made up of the employee's contributions.

2.3.3 Annuities

Annuities may be classified according to a range of characteristics; however, the important classifications with respect to an annuity's tax treatment relate to whether the annuity is a deferred annuity or an immediate annuity and whether it is a qualified annuity or a nonqualified annuity. A deferred annuity is an annuity under which periodic income payments are delayed following the annuity purchase until some date in the future, often for a period of many years. Unlike a deferred annuity, an immediate annuity is one in which the first periodic income payment is due one income payment interval after the date the annuity was purchased. Thus, if the income will be paid monthly, the first payment will be received after one month; if the income will be paid semi-annually, the first payment will be received after 6 months.

A qualified annuity is an annuity that is included in a qualified plan or individual retirement account. Its tax treatment is generally determined by the nature of the plan in which it is included. Accordingly, if contributions to the plan are made on a before-tax basis, any contribution to an annuity contained in the plan is also made on a before-tax basis. A nonqualified annuity is an annuity that is purchased outside of a qualified plan or individual retirement account.

2.3.3.1 Nonqualified Annuity

A nonqualified annuity's tax treatment is governed by the rules that apply to commercial annuities. It is those rules that will be discussed.

Premiums that are paid for a nonqualified annuity contract are non-deductible, regardless of the type of annuity purchased. Interest credited to the cash value of an annuity is tax-deferred until distributed.

The taxability of a distribution from the cash value of a nonqualified annuity varies, depending on whether or not the distribution is considered:

- An amount not received as an annuity; or
- An amount received as an annuity, i.e., in periodic income payments.

Amounts not received as an annuity are distributions resulting from annuity surrenders, withdrawals and loans. Amounts received as an annuity are annuity distributions made as periodic payments. Although annuity contracts owned by natural persons enjoy deferred taxation of earnings, the earnings are not tax free. When the contract's cash value is distributed as *an amount not received as an annuity,* i.e., by surrender of the contract, by an annuity loan, or by withdrawal, any earnings on the contract are subject to taxation as ordinary income and are deemed to be distributed before any nontaxable premiums are distributed.

Payments received as periodic payments—either at the annuity starting date in a deferred annuity or upon purchase of an immediate annuity—are known as amounts received as an annuity and are generally taxed under the annuity rules. Under the annuity rules, distributions of the purchaser's investment in the contract are received in equal tax-free amounts over the payment period, and the balance of the periodic payment is ordinary income. When the taxpayer's entire investment in the contract has been fully recovered, all further periodic payments are taxable in their entirety.

In order to help assure that annuities are used for long-term accumulation and not for short-term investment purposes, the tax code prescribes a tax penalty for premature distributions. The tax penalty for premature distributions is equal to 10% of the distribution *that is includible in the recipient's income*. However, the tax penalty does not apply to any of the following:

- Payments made on or after the individual becomes age 59½;
- Payments attributable to the individual's becoming disabled;
- Payments allocable to investment in the contract before August 14, 1982;
- Payments made on or after the contract owner's death;
- Payments made under an immediate annuity contract;
- Payments made from an employer-purchased annuity upon the termination of a qualified employee plan; and
- Payments that are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual or the joint lives or joint life expectancies of the individual and his or her designated beneficiary.

2.4 Individual Retirement Accounts

Individual retirement arrangements (IRAs), qualified plans and annuity contracts enjoy certain tax benefits, including tax deferral, while funds are being accumulated within the plans. Accordingly, with some exceptions, distributions from these tax-favored plans are generally taxable as ordinary income.

An individual retirement account (IRA) is a personal retirement savings plan, funded by an annuity or a trust, provides for tax-deferral of earnings and may permit either tax-deductible contributions or tax-free qualified distributions. Unless the taxpayer is age 50 or older by the end of the year, the total contribution to all IRAs made for the year cannot exceed the lesser of $6,000 or the individual's compensation includable in gross income. If the taxpayer is age 50 or older by the end of 2021, a maximum additional contribution—a catch-up contribution—of $1,000 may be made.

Individual retirement accounts are fundamentally of two types:

- Traditional IRAs that may permit tax-deductible contributions and generally taxable distributions, and
- Roth IRAs whose contributions are not deductible but whose qualified distributions are entirely tax-free.

2.4.1 Traditional IRA – Contributions & Distributions

Contributions to traditional IRAs are normally fully tax-deductible to a taxpayer unless the taxpayer is an active participant in an employer-sponsored qualified plan and has a modified adjusted gross income in excess of a specified amount for his or her filing status. The specified amount tends to increase each year. The specified amount for 2021 is:

- $66,000 if the taxpayer's filing status is single or head of household; and
- $105,000 if the taxpayer's filing status is married filing jointly.

If the active-participant taxpayer's modified adjusted gross income exceeds the specified amount for his or her filing status, the deductibility of the traditional IRA contribution is reduced. The traditional IRA contribution deductibility is lost completely if the active participant single taxpayer's modified adjusted gross income is $76,000 or more or the modified adjusted gross income of the active participant taxpayer who files a federal income tax return as married filing jointly equals or exceeds $125,000. For active-participant taxpayers whose modified adjusted gross income is between those amounts, the deductibility of the contribution is reduced proportionally. A taxpayer who is not an active participant in an employer-sponsored qualified plan may deduct a traditional IRA contribution he or she is eligible to make ***regardless of income***.

Distributions from traditional IRAs to which no after-tax contributions have been made are fully taxable as ordinary income. Traditional IRA distributions of after-tax contributions are received tax-free as a return of basis on a pro rata basis, and the remainder of the distribution is taxable.

2.4.1.1 Premature Distributions

In order to ensure that traditional IRAs are used for the purpose for which they were designed—to accumulate retirement savings—Congress imposed a limitation on their liquidity by specifying a penalty for premature distributions. Usually, in order to avoid a premature distribution penalty, the taxpayer must be at least age 59½ before receiving a distribution from a traditional IRA.

The premature distribution penalty is equal to 10 percent of the amount of the distribution that is includible in the taxpayer's gross income. In many cases, because all contributions were deductible, the amount of the traditional IRA distribution that would be includible in gross income is the total amount of the distribution.

2.4.1.1.1 Premature Distributions Avoiding Tax Penalty

Although, tax penalties generally apply to IRA distributions before age 59 ½, there are certain premature distributions to which the 10 percent penalty tax doesn't apply. Those distributions include distributions:

- Made at the taxpayer's death;
- Attributable to the taxpayer's disability;
- Made for medical care to the extent allowable as a medical expense deduction;
- Made for the payment of health insurance premiums by unemployed taxpayers;
- Made to pay qualified higher education expenses for the taxpayer, his or her spouse, child or grandchild;
- Considered "first-time homebuyer distributions" up to a lifetime maximum of $10,000;
- That are part of a series of substantially equal periodic payments made for the life of the taxpayer or the joint lives of the taxpayer and his or her beneficiary; or
- That are qualified birth or adoption distributions not exceeding $5,000.

2.4.1.2 Required Distributions during Owner's Lifetime

The Internal Revenue Code requires that minimum distributions from a traditional IRA begin no later than the owner's age 72. The law permits the individual to delay taking these first required minimum distributions (RMD) until April 1st of the year following the year in which he or she turns age 72. The date on which RMDs must commence is known as the "required beginning date." Lifetime distributions never need to be taken from a Roth IRA.

2.4.2 Roth IRAs

Roth IRAs differ from traditional IRAs in providing their most significant tax benefits when funds are distributed rather than when contributed as is the case in a traditional IRA. A Roth IRA provides income tax deferral of gain before distribution and may provide tax-free distribution of earnings. It does not provide for contribution deductibility, however.

The significant differences found in Roth IRAs when compared with traditional IRAs are:

1. Roth IRA contributions are not deductible (and are, as a result, tax-free when distributed); and
2. Earnings on Roth IRA accumulations may be entirely tax-free when distributed in a *qualified distribution*.

A "qualified" distribution from a Roth IRA is one that is made no earlier than the fifth year following the year for which the owner made his or her first Roth IRA contribution and:

- The taxpayer is age 59 ½ or older;
- The distribution is a qualified first-time homebuyer distribution;
- The taxpayer is disabled; or
- The distribution is made to a beneficiary on or after the taxpayer's death.

There is an additional tax advantage on distributions that Roth IRA owners enjoy, even when the distribution isn't a qualified distribution: a nonqualified distribution—one that fails to meet the requirements to be a qualified distribution—from a Roth IRA receives FIFO tax treatment under which all contributions are deemed to be distributed tax free before any earnings are distributed.

2.4.2.1 Limits on Roth IRA Contributions

The maximum amount an individual can contribute to a Roth IRA is the same as a traditional IRA: that is $6,000 (in 2021) or, if he or she is age 50 or older, $7,000. The maximum contribution that may be made to a Roth IRA is reduced, based on the individual's modified adjusted gross income, according to the following formula:

$$\text{Contribution reduction} = \frac{\text{MAGI} - \text{applicable dollar amount}}{\$15{,}000\ (\$10{,}000 \text{ if joint or married filing separate return})} \times \text{Maximum contribution}$$

The "applicable dollar amount" in the Roth IRA formula is based on the individual's filing status, as shown in the following chart:

Federal Income Tax Filing Status	Applicable Dollar Amount (2020)	Applicable Dollar Amount (2021)
Single & head of household	$124,000	$125,000
Married, filing a joint return	$196,000	$198,000
Married, filing separately	$0	$0

2.4.2.2 Non-Qualified Roth IRA Distributions of Gain before 59 ½ Subject to Tax Penalty

It was noted earlier that a premature distribution—one made prior to the owner's age 59 ½—from a traditional IRA would result in a 10 percent tax penalty. The 10 percent premature distribution tax penalty is based on the amount that must be reported as a taxable distribution. The same is true of a Roth IRA.

Just as in the case of a traditional IRA, however, the penalty for a distribution of earnings before age 59½ from a Roth IRA is waived if the distribution is:

- Attributable to the IRA owner's death or disability;
- Made for medical care to the extent allowable as a medical expense deduction;
- Made by unemployed taxpayers for the payment of health insurance premiums;
- Used to pay qualified educational expenses;
- A qualified first-time homebuyer distribution;
- Part of a series of substantially equal periodic payments made for the life or life expectancy of the taxpayer or of the taxpayer and a designated beneficiary; or
- A qualified birth or adoption distribution not exceeding $5,000.

2.4.2.3 No Required Roth IRA Lifetime Distributions

Unlike ***traditional*** IRAs, Roth IRAs are not subject to required minimum distribution (RMD) rules during the owner's lifetime. Funds contributed to and accumulated within a Roth IRA can remain in the account as long as the owner wishes, even after age 72. However, required minimum distributions must be made following the owner's death.

2.4.3 IRA Rollover Per-Year Limit

Taxpayers are permitted to rollover an existing IRA to another IRA of the same type. They can choose to rollover an IRA in a direct trustee-to-trustee transfer or may withdraw funds from an IRA and deposit them in another (or the same) IRA within 60 days of the distribution without having to recognize any income as a result of the rollover. The rules to which an IRA-to-IRA rollover is subject when the funds are distributed to the individual for subsequent rollover require that the:

- Rollover may only be done once in any one-year period; and
- Rollover must be completed within 60 days of the distribution.

Trustee-to-trustee transfers from one IRA to another IRA are not subject to the one per-year limit and, thus, may be made at any time.

Review #3

1. Peter, age 45, made his first Roth IRA contribution ten years ago and has made contributions to the IRA every year since. His total contributions amount to $40,000, and he has never previously taken a distribution from the IRA. If he withdrew $50,000 this year from the Roth IRA in a nonqualified distribution, what is the maximum amount of the distribution, if any, he may exclude from income?

   A. $0

   B. $10,000

   C. $40,000

   D. $50,000

2. Bill Walters is a 52-year-old single client. His adjusted gross income in 2021 is $200,000, and he is not an active participant in an employer-sponsored retirement plan. What is the maximum 2021 traditional IRA contribution that he may deduct?

   A. $0

   B. $2,000

   C. $6,000

   D. $7,000

2.5 Reporting and Taxability of Unemployment Compensation

The term **unemployment compensation** includes any amount received under an unemployment compensation law of the United States or of a state. Accordingly, all the following benefits are considered unemployment compensation:

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund;
- State unemployment insurance benefits;
- Railroad unemployment compensation benefits;
- Disability payments from a government program paid as a substitute for unemployment compensation;
- Trade readjustment allowances under the Trade Act of 1974;
- Unemployment assistance under The Disaster Relief and Emergency Assistance Act of 1974;
- Unemployment assistance under the Airline Deregulation Act of 1978 Program; and
- Benefits from a private fund exceeding voluntary contributions to it made by the taxpayer.

2.5.1 Unemployment Compensation Taxable

Although the American Rescue Plan Act of 2021 provided for an exclusion of $10,200 of unemployment benefits received in 2020 by a taxpayer whose modified adjusted gross income was less than $150,000, recipients of unemployment compensation are generally required to include all such compensation in income for tax purposes. The taxpayer should receive a Form 1099–G showing (in box 1) the total unemployment compensation paid. In most cases, the total amount of unemployment compensation shown should be entered on line 7 of Form 1040, Schedule 1.

In some cases—those involving certain governmental unemployment compensation programs to which the taxpayer contributed and unemployment compensation that was repaid—not all of the amount received during the year should be included as unemployment compensation. Let’s consider each of these cases.

2.5.1.1 Nondeductible Contributions to Governmental Unemployment Compensation Plan

If the taxpayer made nondeductible contributions to a governmental unemployment compensation program, the amounts received by the taxpayer under the program are not includible as unemployment compensation until the taxpayer has received an amount equal to his or her entire contribution tax-free. In contrast, if the taxpayer deducted all his or her contributions to the program, the entire amount received under the program would be includible in the taxpayer’s income.

2.5.1.2 Repayment of Unemployment Compensation

If the taxpayer repaid employment compensation received in 2021 in the same year, the tax preparer should subtract the amount repaid from the total amount of unemployment compensation received and enter the difference on line 7 of Form 1040, Schedule 1. On the dotted line next to the entry, enter “repaid” and the amount repaid by the taxpayer.

If the amount of unemployment compensation repaid during the year was more than $3,000, the taxpayer may take a tax credit for the year of repayment. In order to take a tax credit for repayment the taxpayer must have believed that he or she had an unrestricted right to the unemployment compensation at the time it was received. Pursuant to tax law prior to 2018, a taxpayer who repaid unemployment compensation received and included in income in a prior year of $3,000 or less, could deduct the amount repaid on Form 1040 Schedule A as a miscellaneous deduction. However, beginning in 2018, taxpayers can no longer claim any miscellaneous itemized deductions, so if the amount repaid was $3,000 or less, the taxpayer may not deduct the repayment from income in the year repaid.

2.6 Alimony – Post 2018 Divorce Agreements

Under the tax code before TCJA passage, alimony (but **not** child support) is deductible by the payer and included in the income of the recipient for tax purposes. Under the TCJA, that tax treatment continues only for alimony payments made pursuant to a divorce or separation agreement entered into on or before December 31, 2018. Thus, alimony payments made in 2018 are deductible to the payer and includible in the recipient’s income.

However, under TCJA, §11051, alimony payments will no longer be tax-deductible to the payer or includible in the income of the recipient if made under:

a) A divorce or separation agreement entered into after December 31, 2018; or

b) A divorce or separation agreement entered into on or before December 31, 2018 but modified after that date if the modified agreement specifically provides that the provisions of the Tax Cuts and Jobs Act of 2017 will apply.

Alimony payments made under a divorce or separation agreement entered into on or before December 31, 2018 but paid after that date—with the exception of such payments made under a modified agreement described in b) above—will continue to be tax-deductible to the payer and includible in the income of the recipient.

2.7 Schedule C, Profit or Loss from Business (Sole Proprietorship)

Schedule C (Form 1040), Profit or Loss From Business, is the supplemental form attached to Forms 1040, 1040NR or 1041 and used to calculate the net profit or loss in a sole proprietorship.

A self-employed taxpayer is one who:

- Carries on a trade or business as a sole proprietor;
- Is an independent contractor;
- Is a member of a partnership; or
- Is in business for himself or herself in any other way.

2.7.1 Income & Expenses Defined

If there is a connection between any income the taxpayer receives and the taxpayer's business, the income is business income. A connection exists if it is clear that the payment of income would not have been made if the taxpayer did not have the business. Income from work the taxpayer performs on the side in addition to his or her regular job can be business income. It includes amounts the taxpayer received in his or her business that were properly shown on Forms 1099-MISC, including amounts reported as nonemployee compensation in box 7 of the form.

The amount of time spent carrying on the activity is unimportant for tax purposes. Thus, an individual is considered self-employed if the person spends all his or her working hours as a self-employed individual or works as a self-employed person only in addition to other duties performed as an employee. Regardless of the amount of time a taxpayer spends in a self-employed activity, the taxpayer must file a tax return if his or her gross income is at least as much as the filing threshold for the individual's filing status and age. In addition, the taxpayer must also file Form 1040 Schedule SE, Self-Employment Tax, if:

- Net earnings from self-employment, excluding church employee income, were $400 or more; or
- The taxpayer had church employee income of $108.28 or more.

If the taxpayer is self-employed, his or her gross income includes:

- The amount on Schedule C (Form 1040), Profit or Loss from Business;
- The amount on Schedule C–EZ (Form 1040), Net Profit from Business; and
- The amount on Schedule F (Form 1040), Profit or Loss from Farming.

Gross income from self-employment is equal to the following (Schedule C, Part I):

1. Gross receipts or sales	$
2. Returns and allowances	$
3. Subtract line 2 from line 1	$
4. Cost of goods sold	$
5. Gross profit (subtract line 4 from line 3)	$
6. Other income	$
7. Gross income (add lines 5 & 6)	$

The total gross income minus the total business expenses equals the net profit or loss from the business activity. The taxpayer's net profit or loss should be entered on:

- Schedule SE, line 2; and
- Form 1040, Schedule 1, line 3 Business income or (loss).

However, if some of the investment in the self-employed activity is not at risk, the taxpayer must attach IRS Form 6198, and his or her loss may be limited.

Business expenses are the costs of operating the taxpayer's business. These expenses are costs the taxpayer does not have to capitalize or include in the cost of goods sold but can deduct in the current year.

In order to be deductible, a business expense must be:

- Ordinary, i.e., one that is common and accepted in the taxpayer's field of business, and
- Necessary[8], i.e., one that is helpful and appropriate for the taxpayer's business.

However, if any expense is partly for business and partly personal, the personal part of the expense must be separated from the business part. The personal part is not deductible.

2.7.2 Business vs. Hobby

Schedule C (Form 1040) is used to report a taxpayer's income or loss from a ***business*** operated or ***profession*** practiced as a sole proprietor. It is not used in connection with a taxpayer's hobby. An activity qualifies as a business if:

- The taxpayer's primary purpose for engaging in it is for income or profit; and
- The taxpayer is involved in the activity with continuity and regularity rather than sporadically.

The IRS presumes that an activity engaged in by a taxpayer's is carried on for a profit if:

- It makes a profit during at least three of the last five tax years, including the current year; or
- It primarily involves breeding, showing, training or racing horses ***and*** it makes a profit in at least two of the last seven years.

To determine if an activity engaged in by the taxpayer is a business or hobby, the following factors should be considered:

- Does the time and effort put into the activity indicate the taxpayer intended to make a profit?
- Does the taxpayer depend on income from the activity?
- If the activity results in losses, are the losses due to circumstances beyond the taxpayer's control, or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

A hobby, for tax purposes, is an activity **not** engaged in for profit or income. Any income from a hobby is reported on Form 1040 as "Other income." However, because of the loss of the miscellaneous itemized deductions as a result of passage of the Tax Cuts and Jobs Act, hobby expenses not exceeding hobby income—at least through 2025—are no longer deductible.

2.7.3 Business Use of a Home

In addition to these expenses incurred in the self-employed business, a taxpayer who uses a portion of his or her home in which to conduct the self-employed activity may also include certain expenses for business use of the home.

Although certain exceptions apply, qualifying for a home-office deduction for business use of a taxpayer's home generally requires that the taxpayer use part of his or her home:

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[8] An expense does not have to be indispensable to be considered necessary.

- Exclusively and regularly as the principal place of business unless the space is used for the storage of inventory or product samples or as a daycare facility, in which case the requirement for exclusive use does not apply;
- Exclusively and regularly as a place where the taxpayer meets or deals with patients, clients or customers in the normal course of a trade or business;
- On a regular basis for certain storage use;
- For rental use; or
- As a daycare facility.

If the part of the taxpayer's home used is a separate structure, qualifying for a home-office deduction for its use requires that the separate structure be used exclusively and regularly in connection with the taxpayer's trade or business. However, the structure does not have to be the taxpayer's principal place of business or where he or she meets patients, clients, or customers.

2.7.3.1 Methods of Figuring the Home-Office Deduction

If a taxpayer qualifies for a home-office deduction by meeting the requirements, the next step is to figure the amount of tax deduction for which he or she qualifies. Two methods are available to calculate the home-office deduction:

- The actual expense method; and
- The simplified method.

2.7.3.1.1 Actual Expense Method

The actual expense method of figuring a home-office deduction uses the actual expenses incurred by the taxpayer as the basis for determining the deduction allowable for business use of the taxpayer's home. Bear in mind when using the actual expense method to figure the home-office deduction that a taxpayer cannot deduct expenses for the business use of a home incurred during any part of the year he or she did not use the home for business purposes. Thus, a taxpayer who begins using part of his or her home for business purposes beginning on July 1st of the year and who qualifies for a home-office deduction cannot consider expenses for the period prior to July 1st. Instead, the taxpayer may consider only those expenses for the period July 1 through December 31 in figuring the allowable deduction.

When using the actual expense method for figuring the home-office deduction for a client, a tax return preparer must determine:

- The nature of the expense, i.e., whether the expense is –
  - A direct expense,
  - An indirect expense, or
  - An unrelated expense; and
- The percentage of the home used for business purposes.

2.7.3.1.1.1 Nature of the Expense

When determining the nature of the taxpayer's expense, expenses are placed into one of the following three categories:

- Direct expenses;
- Indirect expenses; and
- Unrelated expenses.

Direct expenses are expenses applicable to and affecting only the business part of the taxpayer's home. These expenses are normally deductible in full, subject to any applicable deduction limit. (See **Deduction Limit** below.)

Indirect expenses are those expenses the taxpayer incurs for keeping up and running his or her entire home. Such indirect expenses are deductible under the home-office deduction ***only*** in an amount based on the percentage of the taxpayer's home used for business purposes. Similar to direct expenses, the deduction of indirect expenses is subject to the applicable deduction limit.

The third category of taxpayer expenses—expenses that are unrelated—are expenses applicable only to the parts of the taxpayer's home that are not used for business purposes. These unrelated expenses are not deductible.

2.7.3.1.1.2 Percentage of the Home Used for Business

Although direct expenses attributable to business purposes are deductible under the home-office deduction irrespective of the percentage of the home actually used by the taxpayer for business purposes, indirect expenses are not. Instead, indirect expenses are deductible under the permitted home-office deduction only in an amount equal to the total of such indirect expenses multiplied by the percentage of the home used for business.

2.7.3.1.1.3 Calculating Percentage of Home Used for Business

A taxpayer is permitted to use any reasonable method to determine the percentage of his or her home used for business purposes. Two methods commonly used for determining the applicable percentage of a home for purposes of the home-office deduction are:

1. Dividing the square footage of the home used for business purposes by the total square footage of the home; and
2. Dividing the number of rooms used for business by the total number of rooms in the taxpayer's home.

Determining the percentage of a taxpayer's home used for business purposes by dividing the number of rooms used for business by the total number of rooms in the house should be used only if the rooms in the house are all of approximately the same size.

2.7.3.1.1.4 Deductible Expenses for Home-Office Deduction

Expenses that are deductible under the home-office deduction fall into two categories and include the following:

- Expenses that are deductible by the taxpayer whether or not the taxpayer uses the home for business purposes, i.e. they are deductible by all homeowners; and
- Expenses that are deductible by the taxpayer only if the taxpayer uses the home for business purposes.

2.7.3.1.1.5 Expenses Deductible by All Homeowners

Expenses that are deductible by all homeowners, whether or not the home is used for business purposes, include the following:

- Real estate taxes, within prescribed limits;
- Deductible mortgage interest; and
- Casualty losses from a federally-declared disaster.

If the taxpayer qualifies for the home-office deduction, these amounts should be multiplied by the percentage of the home used for business purposes to figure the taxpayer's total deduction for business use of the home.

2.7.3.1.1.6 Expenses Deductible only by Taxpayers Using a Home for Business

In addition to those expenses that are deductible by all homeowners, many additional expenses are deductible by homeowners who use their homes for business purposes. These are expenses that would not normally be deductible by the homeowner except for the home's business use.

Principal among those expenses that are deductible by a homeowner who uses the home for business purposes, in an amount determined by the percentage of the home used for business, are the following:

- Depreciation, a deduction designed to reflect the wear and tear on the portion of the taxpayer's home used for business –
  - If the home was used for business in years before the current year, the taxpayer should continue using the same method of depreciation used in those prior years, or
  - If the home was placed in use for business purposes in the current year, the business part of the home should be depreciated as nonresidential business property under the modified accelerated cost recovery system (MACRS);
- Insurance premium for insurance covering the business part of the home only for the current tax year;

- Rent paid for the use of unowned property used in the taxpayer's trade or business calculated by multiplying the total rent payments for the period the home was used for business by the percentage of the home used for business purposes.;
- Repairs –
    - Deductible entirely if the repair costs are direct expenses, or
    - Deductible in part if the repair costs are indirect expenses in an amount equal only to the cost of repairs multiplied by the percentage of the home used as a home office;
- Security system maintenance and monitoring expenses –
    - Business part of costs of installation of the security system (based on percentage of home used for business) is depreciable, and
    - Business part of expenses to maintain and monitor the system is deductible if the security system protects all the doors and windows in the taxpayer's home; and
- Expenses for utilities and services, deductible in an amount equal to the expenses incurred for the utilities and services multiplied by the percentage of business use.

Although these expenses are deductible by a taxpayer using his or her home for business purposes, it is important to keep in mind that only the ***business percentage*** of these expenses is deductible.

2.7.3.1.1.7 Deduction Limit

The home-office deduction is not unlimited. Instead, if a taxpayer uses the actual expense method for claiming a home-office deduction, the deduction of otherwise nondeductible expenses—expenses such as insurance, utilities and depreciation allocable to the business—is limited to the taxpayer's gross income from the business use of the home minus the sum of the following:

1. The business portion of expenses the taxpayer could deduct even if he or she did not use the home for business purposes. Such expenses include eligible mortgage interest, real estate taxes (not exceeding prescribed limits) and net qualified disaster losses allowable as itemized deductions on Schedule A (Form 1040); and
2. The business expenses that relate to the business activity carried on in the home but not to the home itself. Such expenses include the costs of business telephone, supplies and equipment depreciation. (A self-employed taxpayer should not include the deductible one half of self-employment tax in the business expenses that must be subtracted from gross income.)

In applying the deduction limit to a taxpayer's home-office deduction, the depreciation deduction should be taken last. If the taxpayer's home-office deduction in any year is reduced by the deduction limit, the taxpayer may carry over the excess to the next year in which he or she uses the actual expense method in claiming a home-office deduction. The carried-over expenses are subject to the deduction limit for the year to which they are carried over, whether or not the taxpayer lives in the same home during that year.

2.7.3.1.2 Simplified Method

Instead of using the actual expense method of determining a taxpayer's home-office deduction, a simplified method—available for years beginning January 1, 2013—may be used. When calculating the home-office deduction using the simplified method, the deduction is equal to the area of the taxpayer's home used for a qualified business use (not exceeding 300 square feet) multiplied by the prescribed rate. The current prescribed rate is $5, but the Internal Revenue Service and the Treasury Department may update the prescribed rate from time to time.

Election of the simplified method is irrevocable for the year made. The taxpayer's election of whether to use the actual expense method or simplified method is one that is made each year. The election to use the simplified method to figure the home-office deduction must be made on a ***timely filed***, original federal income tax return.

In addition to the expense deduction for business use of a home calculated using the simplified method, business expenses not related to the taxpayer's use of a home are also deductible.

2.7.3.1.2.1 Depreciation and Actual Expenses Related to Use of Home not Deductible

If a taxpayer elects to use the simplified method of determining the home-office deduction, neither depreciation nor any actual expenses other than those not related to use of the home, may be deducted. (Business expenses not related to the taxpayer's use of the home continue to be deductible.)

2.7.3.1.2.2 No Deduction of Actual Expense Carryover for Simplified Method Users

If a taxpayer used the actual expense method to figure the home-office deduction in a previous year and has an expense carryover because the deduction was limited in that year, no portion of the carried-over amount may be deducted in any year in which the taxpayer uses the simplified method. In such a case, the taxpayer will continue to carry over the disallowed amount to the next year in which he or she uses actual expenses to figure the home-office deduction.

2.7.3.1.2.3 Expenses Deductible Irrespective of Business Use

The expenses that would be deductible by a taxpayer whether or not claiming a home-office deduction are treated differently, depending on whether the actual expense method or simplified method is used. Unlike the expense treatment under the actual expense method of expenses that are deductible irrespective of business use of the taxpayer's home—expenses such as mortgage interest, real estate taxes and casualty losses—such expenses must be treated as personal expenses by a taxpayer using the simplified method of determining the home-office deduction.

2.7.3.1.2.4 Special Rules Applicable to Simplified Method

Special rules apply to a taxpayer using the simplified method to determine the home-office deduction under certain circumstances. Those special rules are applicable in the case of:

- **Shared use of a home** - If a taxpayer shares his or her home with someone else who also uses the home in a business that qualifies for the home-office deduction, each user must make his or her own election as to the method used for calculating the deduction;
- **Multiple qualified business uses** - If a taxpayer conducts multiple businesses that qualify for the home-office deduction, the taxpayer's election to use the simplified method applies to all of the taxpayer's qualified business uses of that home;
- **Multiple homes** - A taxpayer who uses more than one home for business purposes can use the simplified method of calculating the home-office deduction for only one of the homes; and
- **Part year use or area changes** - A taxpayer may have a qualified business use only for part of the taxable year or may change the square footage of the home office during the year. In either case, the deduction for the home office is based on the average monthly allowable square footage used. To calculate the average monthly allowable square footage, the tax return preparer must add the amount of allowable square feet used by the taxpayer each month and divide the sum by 12. The preparer cannot take more than 300 square feet into account for any one month. Furthermore, if the taxpayer's qualified business use was for less than 15 days in any month, the preparer must use zero for that month.

2.7.3.1.2.5 Gross Income Limitation

Somewhat similar to the deduction limit applicable to the actual expense method for determining the home-office deduction, a gross income limitation applies to the home-office deduction available under the simplified method. Under the gross income limitation applicable to the simplified method, a taxpayer's home-office deduction is limited to an amount equal to the taxpayer's gross income derived from the qualified business use of the home reduced by the business deductions that are unrelated to the use of the taxpayer's home.

If the business deductions unrelated to the use of the taxpayer's home are greater than the gross income the taxpayer derived from the qualified business use, the home-office deduction for business use of the home is disallowed.

2.7.4 Recordkeeping Requirements

Although the law generally does not require that a self-employed taxpayer use any ***specific type*** of recordkeeping system, documents supporting the taxpayer's gross receipts, amounts paid for inventory and business expenses should be maintained for as long as they are material to the administration of tax law. If the self-employed taxpayer is involved in multiple businesses he or she should keep a complete and separate set of records and supporting documents for each business.

However, whether the taxpayer has a single business or multiple businesses, the records should include a summary of business transactions and show the following for the business:

- Gross receipts;

- Deductions; and
- Credits.

The supporting documents include sales slips, paid bills, invoices, receipts, deposit slips and canceled checks.

2.7.4.1 Gross Receipts

The documents supporting a self-employed taxpayer's gross receipts that should be kept for as long as they are material to the administration of tax law include:

- Cash register tapes;
- Bank deposit slips;
- Receipt books;
- Invoices;
- Credit card charge slips; and
- Forms 1099-MISC.

2.7.4.2 Inventory

Not all self-employed taxpayers maintain an inventory. However, if a self-employed taxpayer buys items for resale to customers, the supporting documents should show the amount paid and that the payment was for inventory. Such supporting documents include:

- Canceled checks;
- Cash register tape receipts;
- Credit card sales slips; and
- Invoices.

2.7.4.3 Expenses

Documents supporting a self-employed taxpayer's expenses—the cost incurred by the taxpayer, other than the cost of inventory, to carry on the business—should be kept as long as needed. In most cases, supporting documents should be kept for the later of 3 years following the date the taxpayer's original tax return was filed or 2 years following the date any tax payment was made. Such documents should show a) the amounts paid, and b) that the amounts paid were for business expenses.

Documents that should be kept to support a self-employed taxpayer's expenses include:

- Canceled checks;
- Cash register tapes;
- Account statements;
- Credit card sales slips;
- Invoices; and
- Petty cash slips for small cash payments.

2.7.5 Entertainment Expenses

Prior tax law permitted a taxpayer to deduct expenses for entertainment, amusement or recreation provided that the expenses were directly related to the taxpayer's trade or business. The TCJA, §13304, amends that provision and disallows a deduction for expenses incurred by a taxpayer after December 31, 2017 and before January 1, 2026, despite their being directly related to the taxpayer's trade or business, with respect to:

- Activities normally considered to be entertainment, amusement or recreation;
- Club dues or fees for any club organized for the purpose of –
    - business,
    - pleasure,
    - recreation, or
    - any other social purpose; or
- A facility used in connection with any of those activities.

2.7.5.1 Food and Beverage Expenses

Taxpayers are generally permitted to deduct 50% of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer's premises primarily for employees. However, the 50% limitation on the deduction of an employer's food and beverage expenses does not apply to any expenses if:

- The expenses are treated as compensation;
- The expenses, other than those treated as compensation, are for services performed by the taxpayer for another person under a reimbursement or other expense allowance arrangement;
- The expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees;
- The expenses are for goods, services and facilities made available by the taxpayer to the general public;
- The expenses are for goods or services sold by the taxpayer in a bona fide transaction for adequate compensation; or
- The expenses are includable in the gross income of a non-employee recipient.

2.7.5.1.1 Temporary Increase in Business Meal Deductibility

The Consolidated Appropriations Act, 2021 provides for temporarily increased deductions for business meals. Pursuant to the Act, businesses are permitted a 100% tax deduction for business meals—up from the current 50%—if the food or beverages are provided by a restaurant. The increased business meal deduction is available for 2021 and 2022.

2.7.6 Section 179 Expense Limits

The Tax Cuts and Jobs Act (TCJA) increased the amount a business is permitted to expense rather than being required to depreciate and made further enhancements under Code Section 179 with respect to section 179 property the taxpayer places in service in tax years beginning after December 31, 2017. Under the TCJA:

- The dollar limitation on the value of property that may be expensed in the year in which it is placed in service is $1,050,000 (2021);
- The phaseout threshold for a taxpayer's ability to expense eligible property is $2,620,000 (2021);
- The definition of Code Section 179 property is expanded to include –
  - depreciable tangible personal property used principally to furnish lodging, such as –
    - furniture,
    - appliances, and
    - other equipment for use in the living quarters, and
  - certain improvements to nonresidential real property, including –
    - roofs,
    - heating, ventilation and air-conditioning property,
    - fire protection and alarm systems, and
    - security systems.

It is important to note that improvements will not qualify if they are attributable to other than the building's interior. So, improvements attributable to:

- Enlarging the building;
- The internal structural framework of the building; or
- An escalator or elevator

… do not qualify for immediate expensing.

2.7.7 Depreciation

Depreciation is an annual income tax deduction that allows the taxpayer to recover the cost or other basis of certain property, referred to as "depreciable property," over the period of time the property is used. It is an allowance for the wear and tear, deterioration, or obsolescence of the property. The taxpayer can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. The taxpayer also can depreciate certain intangible property, such as patents, copyrights, and computer software.

To be depreciable, the property must meet all the following requirements:

- It must be property the taxpayer owns;
- It must be used in the taxpayer's business or income-producing activity;
- It must have a determinable useful life; and
- It must be expected to last more than one year.

2.7.7.1 Bonus Depreciation

Prior tax law permitted businesses to take a tax deduction—generally referred to as first-year bonus depreciation—equal to 50% of qualified properties' adjusted basis (see **Qualified Property** below). In addition, under prior tax law, the bonus depreciation arrangement was scheduled to end for qualified property purchased and placed in service before January 1, 2020.

The TCJA, §13201, both extended bonus depreciation and increased it. Under the enhanced bonus depreciation provisions of the TCJA, a business may take a 100% first year deduction equal to the adjusted basis of qualified property purchased and placed in service after September 27, 2017 and before January 1, 2023. The bonus depreciation percentage for qualified property purchased before September 28, 2017 and placed in service before January 1, 2018 continues to be 50%.

Property eligible for 100% bonus depreciation was expanded under the TCJA to include used qualified property acquired and placed in service after September 27, 2017 provided that all the following conditions apply:

- The property was not used by the taxpayer at any time before its acquisition;
- The property was not acquired by the taxpayer from a related party;
- The taxpayer did not acquire the property from a component member of a controlled group of corporations;
- The taxpayer's basis of the acquired used property is not figured by reference to the adjusted basis of the property in the hands of the seller or transferor; and
- The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.

The 100% expensing permitted under the TCJA declines by 20% each year for qualified property purchased and placed in service after December 31, 2022. Accordingly, the bonus depreciation deduction is reduced to:

- 80% for property purchased and placed in service during 2023;
- 60% for property purchased and placed in service during 2024;
- 40% for property purchased and placed in service during 2025; and
- 20% for property purchased and placed in service during 2026.

The bonus depreciation under the TCJA ends after 2026.

2.7.7.1.1 Qualified Property

The term "qualified property," as it is used in connection with 100% expensing, means property having a recovery period of 20 years or less and which is:

- Computer software;
- A qualified film or television production; or
- A qualified live theatrical production.

2.7.7.2 Luxury Auto Limits

The additional "bonus" first-year depreciation deduction does not apply to a passenger car placed in service by the taxpayer if the taxpayer:

- Did not use the passenger automobile during 2020 more than 50% for business purposes;
- Elected out of the additional first-year depreciation deduction for the class of property including passenger automobile;
- Acquired the passenger automobile used and the acquisition of it failed to meet the acquisition requirements of section 168(k)(2)(e)(ii); or
- Acquired the passenger automobile before September 28, 2017 and placed it in service after 2019.

The luxury auto depreciation limits applicable to passenger automobiles acquired after September 27, 2017 and placed in service during calendar year 2020 are as shown below:

Year	Limits When 1st Year Bonus Depreciation Deduction Applies	Limits When no 1st Year Bonus Depreciation Deduction Applies
Placed in service	$18,100	$10,100
2	$16,100	$16,100
3	$9,700	$9,700
4 and later	$5,760	$5,760

A "luxury vehicle" is a four-wheeled vehicle regardless the cost of the vehicle, used mostly on public roads, and which has an unloaded gross weight of no more than 6,000 pounds. It includes vehicles not normally considered "luxury" vehicles on the basis of their price.

2.7.7.3 Listed Property Updates

The term "listed property," as used in the tax law, is personal property used in a business which can also be used for personal purposes. Because listed property can have application for both personal and business uses, a taxpayer taking a tax deduction as a business expense must have sufficient evidence to prove the property's use in the business and the amount/date of the expense. Thus, property considered listed property is subject to increased documentation and scrutiny.

Under prior tax law, listed property included:

- Passenger automobiles;
- Other property used as a means of transportation;
- Any property generally used for purposes of entertainment, recreation or amusement; and
- Computers and related peripheral equipment.

Under the TCJA, computers and related peripheral equipment are no longer considered listed property subject to heightened substantiation requirements. This change applies to property placed in service after December 31, 2017. All other types of property considered listed property under prior law, however, continue to be listed property.

Deductions for listed property generally are subject to special rules and limits with respect to:

- Deductions for employees;
- Business use; and
- Passenger automobile limits and rules.

2.7.3.3.1 Deduction for Employees

If the taxpayer's use of the property is not for the taxpayer's employer's convenience or is not required as a condition of the taxpayer's employment, the taxpayer cannot deduct depreciation or rent expenses for the use of the property as an employee.

2.7.3.3.2 Business-use Requirement

If the property is not used more than half the time for qualified business use, the taxpayer cannot claim the section 179 deduction or a special depreciation allowance. In addition, the taxpayer must figure any depreciation deduction under the Modified Accelerated Cost Recovery System (MACRS) using the straight line method over the ADSrecovery period. The taxpayer may also have to recapture (include in income) any excess depreciation claimed in previous years. A similar inclusion amount applies to certain leased property.

2.7.3.3.3 Passenger Automobile Limits and Rules

Annual limits apply to depreciation deductions (including section 179 deductions and any special depreciation allowance) for certain passenger automobiles. The taxpayer can continue to deduct depreciation for the unrecovered basis resulting from these limits after the end of the recovery period.

2.8 Capital Gains and Losses

Most assets owned by a taxpayer for personal purposes, pleasure or investment are referred to as "capital assets," and the sale or exchange of a capital asset may result in a capital gain or loss. If the transaction involves personal use property, in contrast to property held for investment, any gain realized upon the sale of the property is a capital gain; however, any loss that results from the sale of personal use property cannot be deducted. If the sale or trade of investment property results in a gain or loss, such gain or loss is generally a capital gain or loss.

2.8.1 Short-Term and Long-Term Capital Gains and Losses

If a taxpayer sells or trades investment property, the capital gain or loss that results may be either a short-term capital gain/loss or a long-term capital gain/loss. The critical factor in determining whether a gain or loss is a short-term or long-term capital gain or loss is the length of the period of time the asset was owned by the taxpayer.

If the capital asset was owned by the taxpayer for longer than one year before the asset was sold or traded, any gain or loss on the transaction is a long-term capital gain or loss. In contrast, the sale or trade of a capital asset owned by the taxpayer for one year or less before being sold or traded would result in a short-term capital gain or loss.

2.8.2 Reporting Capital Gains and Losses

Capital gains and losses are reported on Schedule D, Capital Gains and Losses, attached to the taxpayer's IRS Form 1040 or Form 1040NR. However, before completing Schedule D, one or more IRS Forms 8949, Sales and Other Dispositions of Capital Assets, normally need to be completed and attached to the IRS Form 1040 or 1040NR along with Schedule D.

Note that a taxpayer may be able to combine certain transactions and report the totals directly on Schedule D, lines 1a (short-term transactions) or 8a (long-term transactions) rather than using IRS Form 8949. The transactions which may be reported directly on Schedule D are transactions for which the taxpayer:

- Received a Form 1099-B showing that basis was reported to the IRS and does not show a nondeductible wash sale loss in box 5; ***and***
- Does not need to make any adjustments to –
    - the basis or type of gain or loss reported on Form 1099-B, or
    - the taxpayer's gain or loss.

2.8.2.1 IRS Form 8949, Sales and Other Dispositions of Capital Assets

IRS Form 8949 is used to report sales and exchanges of capital assets. If the taxpayer received Form 1099-B or 1099-S, the proceeds shown on that form should be reported on IRS Form 8949 in column (d). Additionally, if the Form 1099-B shows that the cost or other basis was reported to the IRS, the basis shown on the form should be reported on IRS Form 8949 in column (e), making any correction or adjustment to either amount in Form 8949, column (g). The reason for the adjustment or correction needs to be indicated by placing the appropriate code or codes (contained in the instructions to IRS Form 8949) in column (f).

If all Forms 1099-B received by the taxpayer show that basis was reported to the IRS ***and*** no correction or adjustment is required, the taxpayer may not need to file Form 8949; instead, the totals may be entered directly on Schedule D, lines 1a or 8a, as appropriate (discussed above). The taxpayer needs to file as many Forms 8949 as required to report all transactions.

2.8.2.2 Schedule D

Schedule D provides a summary of the transactions reported on IRS Form 8949 in addition to certain other information. Thus, if an IRS Form 8949 is completed for the taxpayer, each of the columns (d), (e) and (h) should be totaled and the totals for all Forms 8949 should be shown in Schedule D on the following lines:

- 1a, 1b, 2 and 3 for short-term capital gains and losses; and
- 8a, 8b, 9 and 10 for long-term capital gains and losses.

In addition, any distribution of net realized ***long-term*** capital gains from a mutual fund should be shown on line 13. (Distributions of net realized ***short-term*** capital gains are shown on Form 1099-DIV issued by the mutual fund as ordinary dividends.) Schedule D should then be completed.

If the amount shown on Schedule D, line 16 is a loss, the smaller of the following should be entered on Form 1040 or Form 1040NR,"Capital gain or (loss)":

- The loss shown on line 16; or
- $3,000 ($1,500 if married filing separately).

If the amount shown on Schedule D, line 16 is a gain, enter the amount of the gain on Form 1040 or Form 1040NR.

Review #4

1. What is George's business expense deduction if he uses a 400 square foot office in his rented home, assuming he qualifies for a home office deduction, pays $1,200 for business telephone service, uses 20% of the home for business and elects the simplified home office deduction method?

   A. $1,500

   B. $1,740

   C. $2,000

   D. $2,700

2. Harold is a sole proprietor of a small company. He sponsors an employee picnic each year at a local park that costs him $25,000. If he incurs $15,000 in food and $10,000 in beverage expenses for his 2021 employee picnic, how much of the expense may he deduct for income tax purposes?

   A. $0

   B. $10,000

   C. $12,500

   D. $25,000

2.9 Standard Deduction Eligibility

The standard deduction is an alternative available to taxpayers choosing not to itemize actual deductions on their income tax returns. The general rule with respect to deductions is that a taxpayer may choose to take a standard deduction or itemize his or her deductions. Although that general rule applies in the case of most taxpayers, certain taxpayers are ineligible to take the standard deduction and must itemize.

Taxpayers who are ineligible to take the standard deduction are the following:

- Taxpayers whose filing status is "married filing separately" and whose spouse itemizes deductions;
- Taxpayers who are filing a tax return for a short tax year due to a change in their annual accounting period; and
- Taxpayers who were nonresident aliens or dual-status aliens during the year.

2.9.1 Standard Deduction Amounts

The standard deductions for 2021 are:

- $25,100 for married couples whose filing status is "married filing jointly" and surviving spouses;
- $12,550 for singles and married couples whose filing status is "married filing separately"; and
- $18,800 for taxpayers whose filing status is "head of household."

A taxpayer who can be claimed as a dependent is generally limited to a smaller standard deduction, regardless of whether the individual is actually claimed as a dependent. For 2021 returns, the standard deduction for a dependent is the greater of:

- $1,100; or
- The dependent's earned income from work for the year plus $350 (but not more than the standard deduction amount, generally $12,550).

2.9.2 Standard Deduction for Blind and Senior Taxpayers

Elderly and/or blind taxpayers receive an additional standard deduction amount added to the basic standard deduction. The additional standard deduction for a blind taxpayer—a taxpayer whose vision is 20/200 or poorer with glasses/contact lenses or whose field of vision is 20 degrees or less—and for a taxpayer who is age 65 or older at the end of the year is:

- $1,350 for married individuals; and
- $1,700 for singles and heads of household.

The additional standard deduction for taxpayers who are both age 65 or older at year-end and blind is double the additional amount for a taxpayer who is blind (but not age 65 or older) or age 65 (but not blind). For example, a 65 year-old single blind taxpayer would add $3,400 to his or her usual standard deduction: $1,700 for being age 65 plus $1,700 for being blind. ($1,700 x 2 = $3,400). Thus, his or her standard deduction would normally be $15,950. ($12,550 + $3,400 = $15,950)

2.9.3 Standard Deduction Summary

	2021	
Filing Status	**Standard**	**Blind/Age 65+ add**
Married filing jointly & surviving spouses	$25,100	$1,350
Unmarried (other than surviving spouses)	$12,550	$1,700
Married filing separately	$12,550	$1,350
Head of household	$18,800	$1,700
Dependent	$1,100 or earned income + $350	

2.10 Itemized Deductions Schedule A

The various Schedule A itemized deductions were affected by the Tax Cuts and Jobs Act, including deductions for:

- State and local taxes;
- Home mortgage interest;
- Charitable contributions;
- Casualty losses; and
- Moving expenses.

Let’s consider each of these changes and the required recordkeeping and documentation for deductions.

2.10.1 State and Local Tax Deduction

State and local taxes paid by an itemizing taxpayer have generally been a deductible item on the taxpayer’s federal income tax return without limit. The TCJA limits the federal income tax deduction for state and local taxes to $10,000 ($5,000 for married taxpayers filing separately) beginning in 2018.

2.10.2 Home Mortgage Interest and Home Equity Loans

Under tax law in effect prior to the passage of the TCJA, the home mortgage interest deduction was limited to home mortgage interest paid on mortgage debt—debt secured by a taxpayer’s residence—falling into three categories:

1. Mortgages taken out before October 13, 1987, called “grandfathered debt”;
2. Mortgages taken out by the taxpayer (or spouse if married filing a joint return) after October 13, 1987 to buy, build or improve the taxpayer’s home, i.e., “acquisition debt,” but only if the

total of such mortgages plus any grandfathered debt was $1 million or less ($500,000 or less if married filing separately) throughout the year; and

3. Mortgages taken out by the taxpayer (or spouse if married filing a joint return) after October 13, 1987 that were home equity debt, i.e., any indebtedness (other than acquisition indebtedness) secured by a qualified residence, but only if the total of such mortgages was $100,000 or less ($50,000 or less if married filing separately) and totaled no more than the fair market value of the taxpayer's home reduced by 1 and 2 above.

The dollar limits for mortgages in the second and third categories apply to the combined mortgages on the taxpayer's main home and any second home.

The TCJA made the following changes to the existing home mortgage interest deduction for taxable years 2018 through 2025:

- Interest paid on home equity indebtedness—home equity loans and lines of credit, in other words—incurred after December 15, 2017 is not tax-deductible ***unless used to buy, build or substantially improve the taxpayer's home that secures the loan***;
- Interest paid on acquisition debt incurred after December 15, 2017, less any acquisition debt incurred on or before December 15, 2017, is limited to interest paid on total acquisition indebtedness but only if the total of such mortgages is $750,000 or less ($375,000 or less if married filing separately); and
- Interest paid on acquisition debt incurred on or before December 15, 2017 is limited to interest paid on acquisition indebtedness of $1,000,000 or less ($500,000 or less if married filing separately).

2.10.2.1 Indebtedness Refinancing

The tax treatment of refinanced existing mortgage debt is treated, for purposes of the applicable dollar limits, as incurred on the date the original indebtedness was incurred, but ***only to the extent*** the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness.

2.10.3 Charitable Contributions

Charitable contributions are contributions made in cash or property to, or for the use of, churches and governments and to other organizations that have applied to the IRS and been approved to become qualified organizations. A contribution made to an individual, regardless of how needy the individual, is not a charitable contribution for which a tax deduction may be taken. The maximum amount of charitable contribution a taxpayer is permitted to deduct in any year may be limited by the taxpayer's contribution base—in most cases the contribution base is an amount equal to the taxpayer's adjusted gross income—and further limited depending on the type of property contributed. However, any charitable contribution exceeding the applicable tax deduction limit may be carried over to the following five years.

2.10.3.1 60% AGI Limit for Cash Contributions Suspended

The TCJA increased the limit on a taxpayer's deductible charitable cash contributions from 50% under prior tax law to 60% of the taxpayer's contribution base for qualified organizations to which the 50% limit normally applies. The increased limitation for cash contributions applies to contributions made in any taxable year beginning after December 31, 2017 and before January 1, 2026.

The CARES Act temporarily suspends some of the limitations imposed by the Internal Revenue Code with respect to certain individual taxpayer cash contributions. In general, qualified contributions are disregarded in applying IRC section 170 as it pertains to percentage limits[9] and carryovers of excess contributions.[10]

A qualified contribution is allowed as a deduction to the extent the total amount of such contributions doesn't exceed the excess of the taxpayer's contribution base—a taxpayer's adjusted gross income (computed without regard to any net operating loss carryback)—over the amount of all other charitable contributions allowed under the Code. In other words, an individual taxpayer may make a tax-deductible cash contribution of up to 100% of his or her AGI, i.e., an increase from the current

[9] Section 170(b)
[10] Section 170(d)

60% of AGI. If the aggregate amount of qualified contributions made in the contribution year exceeds the limitation, i.e., it exceeds 100% of the individual taxpayer's AGI, the excess may be carried over to the succeeding five years.

Non-cash charitable contributions made by an individual taxpayer may be deducted up to 50 percent of AGI (without regard to NOL carrybacks). The CARES Act did not provide for a 100%-of-AGI limit for personal property.[11]

2.10.3.1.1 Qualified Contributions

The term ''qualified contribution'' means a charitable contribution meeting the following two requirements:

1. The contribution is paid in cash during calendar year 2020 to an organization described in section 170 of the Internal Revenue Code,[12] and
2. The taxpayer has elected the application of this section with respect to the 2020 contribution.

However, the term "qualified contribution" doesn't include a contribution by a donor if the contribution is—

- To a supporting organization described in section 509(a)(3) of the Internal Revenue Code, or
- For the establishment of a new, or maintenance of an existing, donor advised fund.[13]

A "supporting organization" is a charity that supports other exempt organizations (usually public charities).[14] An entity that meets 501(c)(3) ***and*** 509(a)(3) requirements is treated for tax purposes as a public charity rather than a private foundation. Private foundations are subject to more restrictive regulations and receive less tax-favored treatment than public charities do.

The Taxpayer Relief Act of 2020 (TRA 2020) extends the period during which an otherwise eligible contribution will be considered a qualified contribution to include 2021. However, despite the temporary expansion of the charitable contributions authorized by recent legislation, no deduction is permitted for a payment to an institution of higher education that entitles the donor to receive the right to purchase tickets for seating at an athletic event at the institution's athletic stadium.

2.10.3.1.2 Partial Above-the-Line Deduction for Charitable Contributions

A new charitable deduction is available to taxpayers who do not itemize deductions. Sometimes referred to as a "universal deduction," this CARES Act provision permits a non-itemizing taxpayer to take an above-the-line deduction of up to $300 for charitable contributions made in taxable years beginning in 2020. A deduction that is "above the line" reduces AGI. It is a deduction that is made in calculating AGI in the first place. Such deductions may be taken regardless of whether a taxpayer itemizes deductions. TRA 2020 extends the above-the-line charitable deduction for taxpayers who do not itemize to include 2021 and increases the maximum deductible limit to $600 for married taxpayers filing jointly.

2.10.3.2 Contemporaneous Written Acknowledgement

Donors making charitable gifts of $250 or more are required to obtain a contemporaneous written acknowledgment of the gift from the charitable organization in order to substantiate the gift for tax purposes. Under prior law, an alternative form of charitable gift substantiation permitted the charitable organization to file a document with the IRS that contained detailed information concerning the donor

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[11] https://www.irs.gov/charities-non-profits/charitablecontributions

[12] Section 170(b)(1)(A)

[13] In general, the term "donor advised fund" means a fund or account—

- Which is separately identified by reference to contributions of a donor or donors,
- Which is owned and controlled by a sponsoring organization, and
- With respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

[14] At https://www.irs.gov/charities-non-profits/section-509a3-supporting-organizations

and the donor's gift rather than requiring the donor to obtain a contemporaneous written acknowledgement of the gift.

The TCJA eliminates the exception to a contemporaneous written acknowledgment of a donor's gift, effective for gifts made after December 31, 2016***.*** (Note: The effective date of the elimination of the exception to a contemporaneous written acknowledgment is retroactive to gifts made on and after 2016.)

2.10.3.2.1 Content and Timing of Contemporaneous Written Acknowledgement

In order to meet the requirements of the TCJA with respect to a contemporaneous written acknowledgment of a charitable gift, the acknowledgment should contain the following information:

- The amount of cash and a description of any property other than cash contributed;
- Whether the organization receiving the gift provided any goods or services in return for the gift; and
- A description and a good-faith estimate of the value of any goods or services given by the donor or, if the goods and services received by the donor consist solely of intangible religious benefits, a statement to that effect.

A written acknowledgment of a charitable gift is considered "contemporaneous" only if it is obtained by the donor on or before the ***earlier of***:

- The date the taxpayer files a tax return for the taxable year in which the contribution was made, or
- The due date, including extensions, for filing the tax return for the taxable year in which the contribution was made.

2.10.4 Casualty Loss Deduction

The tax treatment of personal casualty losses and thefts is changed under the TCJA. Pursuant to the TCJA, the itemized deduction for personal casualty and theft losses is temporarily limited in tax years 2018 through 2025 solely to losses attributable to federally-declared disasters.

In addition, casualty loss rules are revised for net disaster losses occurring in 2016 and 2017. Under the revision, the limitation applicable to each casualty is increased from the previous $100 to $500 for an individual who has a net disaster loss for tax years beginning in 2016 or 2017. However, the 10% of AGI limitation for such taxpayers is waived.

A federally–declared disaster means any disaster that is subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

2.10.4.1 Special Rules for Qualified Disaster-Related Personal Casualty Losses

In recognition of the taxpayers who recently experienced qualified disaster-related casualty losses but who do not itemize deductions, the Taxpayer Certainty and Disaster Tax Relief Act part of the Consolidated Appropriations Act, 2021 authorizes an increase of the standard deduction for such taxpayers equal to the taxpayer's net disaster loss. The "net disaster loss," for purposes of the standard deduction increase, means the excess of qualified disaster-related personal casualty losses over personal casualty gains.

A personal casualty gain is the recognized gain from any involuntary conversion of property. For example, such a gain could occur if a homeowner whose residence, insured for $300,000 but valued for tax purposes at $250,000, was destroyed. If the homeowner received $300,000 in insurance proceeds, he or she would have experienced a personal casualty gain of $50,000 ($300,000 - $250,000 = $50,000). The gain experienced would constitute taxable income and would reduce the net disaster loss.

If the taxpayer in the example was married and filed a federal income tax return as married filing jointly, the taxpayer's 2021 standard deduction (which would normally be $25,100) is increased by the amount of the net disaster loss from $25,100 to $75,100 ($25,100 + $50,000 = $75,100). Although the $100 floor on the casualty claim is increased to $500, the requirement that only the amount of the claimed loss that exceeds 10% of the taxpayer's adjusted gross income is eliminated.

2.10.5 Moving Expense Deduction

Many taxpayers change their residence each year, and many of those taxpayer relocations involve new jobs. Prior law permitted a taxpayer to deduct moving expenses by car provided the new location was at least 50 miles farther from the taxpayer's former home than the former main job location. However, except in the case of military relocations, the TCJA has suspended the moving expense deduction and made any moving expense reimbursement taxable income.

2.10.5.1 Moving Expenses in Military Relocations

The inclusion of reimbursed moving expenses in the recipient's gross income does not apply to military relocations meeting certain criteria. In the case of a military relocation, the taxpayer's move must be pursuant to a military order and involve a permanent change of station. If those criteria are met, no paid or incurred moving and storage expenses:

- Furnished in kind, or
- For which reimbursement or allowance is provided to the service member, spouse or dependents

…are includible in gross income or reported.

In addition, if the moving expenses paid or incurred in connection with a military relocation are furnished or reimbursed (or an allowance is provided) to the service member's spouse and dependents to move:

- To a location other than the one to which the service member moves, or
- From a location other than the one from which the service member moves

…such expenses are likewise neither includible in gross income nor reported.

2.10.6 Recordkeeping and Documentation of Deductions

The IRS advises that the length of time a taxpayer should keep a document, including the documentation of deductions, depends on the action, expense, or event which the document records. As a general rule, taxpayers must keep records that support an item of income, deduction or credit shown on a tax return until the period of limitations for that tax return runs out. The period of limitations is the period of time in which the:

- Taxpayer can amend his or her tax return in order to claim a credit or refund, or
- IRS can assess additional tax.

The period of limitations applicable to income tax returns is as shown in the chart below:

Action, Event or Expense Recorded	**Duration of Recordkeeping Requirement***
Records generally related to income tax returns	Three years after the later of: • The tax return due date, or • The date the return was filed
Claim for credit or refund after taxpayer filed an income tax return	The later of: • 3 years after the taxpayer filed the original tax return, or • 2 years after the date the taxpayer paid the tax
Claim for a loss from worthless securities or bad debt deduction	Seven years
If taxpayer failed to report income that should have been reported ***and*** it is more than 25% of gross income shown on the return	Six years
If taxpayer did not file a return	Indefinitely
If taxpayer filed a fraudulent return	Indefinitely
Employment tax records	At least 4 years after the later of the date: • The tax becomes due, or • The tax is paid

*Years shown generally refer to the period after the return was filed.

Review #5

1. Bob, an Army colonel, was transferred from Germany to Moscow for a permanent change of station. His spouse chose not to accompany him and returned to the United States. If she received a $10,000 relocation allowance and was later reimbursed an additional $2,500, how much of the allowance, if any, must she include in her income?

   A. $0

   B. $2,500

   C. $10,000

   D. $12,500

2. Howard and Sharon, a married couple, purchased their primary residence in 2021 and took out a $400,000 mortgage for the purchase. Since the house required repairs and updating, they took an additional home equity loan of $150,000 which they used to improve their home. If their 2021 interest paid on the $400,000 mortgage was $12,000 and on the home equity loan was $7,000, what is their 2021 mortgage interest deduction?

   A. $0

   B. $7,000

   C. $12,000

   D. $19,000

2.11 Tax Credit Eligibility

The U.S. tax code provides for a substantial number of tax credits, generally designed to meet various socially-desirable objectives. Tax credits are categorized as:

- Refundable tax credits that are treated as having been withheld from the taxpayer's income and payable to the taxpayer regardless of income tax liability; and
- Nonrefundable tax credits that are payable to the taxpayer only to the extent of any income tax liability.

Among the most frequently-claimed tax credits are:

1. Child tax credit
2. Credit for other dependents
3. Child and dependent care tax credit
4. Education tax credit
5. Earned income tax credit

Let's consider each of them.

2.11.1 Child Tax Credit

The passage of ARPA made several changes to the child tax credit applicable to 2021:

1. The credit is increased to $3,000 per qualifying child age 6 or older ($3,600 per qualifying child who has not attained age 6) for taxpayers whose MAGI does not exceed the applicable threshold amount;
2. A qualifying child is one who, in addition to meeting other existing requirements, is under the age of 18 by the end of the year;
3. The child tax credit will no longer require that the taxpayer have any federal income tax liability in order to receive it, i.e., the child tax credit is refundable; and
4. The credit may be paid monthly in advance[15] and reconciled when filing the tax return.

[15] The IRS will create an Internet portal to enable taxpayers to opt out of the monthly periodic payment regime.

2.11.1.1 Child Tax Credit Increase Subject to Separate Phase-Out

The increased child tax credit amount begins phasing out at higher incomes. Thus, the increased portion of the aggregate credit is reduced by $50 for each $1,000 (or fraction) of MAGI in excess of the following amounts:

- $150,000 for married taxpayers filing jointly;
- $112,500 for taxpayers filing as head of household; and
- $75,000 for other taxpayers.

2.11.1.1.1 Reduction Limitation

The child tax credit for 2021 may be estimated, based on the taxpayer's most recent tax return—2019 tax return if 2020 tax return was not yet filed—and 1/12th of the annual credit paid each month beginning in July 2021 and ending in December 2021. Although the periodic payments made between July and December are such that the total amount advanced will not normally exceed 50% of the child tax credit, if the credit is paid in advance, the possibility exists that some or all of the child tax credit may need to be repaid when the advanced credit is reconciled at the time the 2021 tax return is filed.

In such a case, the amount of the tax credit reduction based on the taxpayer's MAGI will not generally exceed the lesser of:

a. The applicable credit increase amount, or
b. 5% of the applicable phaseout threshold range.

2.11.1.2 Social Security Number Requirement

No Child Tax Credit is allowed to a taxpayer with respect to any qualifying child unless the taxpayer includes on the tax return the Social Security number of that child, issued:

- Before the due date of the taxpayer's tax return;
- To a U.S. citizen, or
- To an alien at the time of U.S. admission for permanent residence or under a law permitting engagement in U.S. employment, or
- To an alien at the time of a change in status permitting engagement in U.S. employment.

However, a qualifying child for whom no child tax credit is allowed solely because of the taxpayer's failure to include a Social Security number may qualify for a partial child tax credit, called the Credit for Other Dependents, discussed next.

2.11.2 Credit for Other Dependents

A taxpayer may be eligible for a Credit for Other Dependents (ODC) of up to $500 with respect to:

- A dependent other than a child—a dependent parent or sibling, for example; and
- A qualifying child for whom a credit is disallowed solely because the taxpayer failed to include the child's Social Security number on the tax return for the taxable year.

The ODC is in addition to the credit for child and dependent care expenses and the earned income credit and is limited to no more than $500 for each dependent who qualifies.

Qualifying for the ODC requires that the person meet all the following conditions:

- The person must be claimed as a dependent on the taxpayer's income tax return;
- The person cannot be used by the taxpayer to claim the child tax credit (CTC); and
- The person must be –
  - a U.S. citizen,
  - a U.S. national, or
  - a U.S. resident alien.

2.11.2.1 Limits on the ODC

The maximum credit available to a taxpayer as a credit for other dependents (ODC) may be reduced if the taxpayer's:

- Tax liability for the year is less than the total of the credit; or
- Modified adjusted gross income (MAGI) is more than the following threshold amounts –

    - $400,000 if married filing jointly, or
    - $200,000 if any other filing status applies.

If the taxpayer's MAGI exceeds these amounts for his or her filing status, the available credit is reduced by $50 for each $1,000 (or fraction) by which the taxpayer's MAGI exceeds the threshold amount.

2.11.2.2 Claiming CTC and ODC

In order to claim the CTC or ODC, the taxpayer must meet the following requirements:

- The taxpayer must file Form 1040, Form 1040–SR or Form 1040–NR and include the name and TIN of each dependent for whom the taxpayer is claiming the CTC or ODC;
- The taxpayer must file Form 8862, Information to Claim Certain Refundable Credits After Disallowance, if applicable;
- The taxpayer must enter a timely issued TIN (for both spouses if married filing jointly);
- The taxpayer must enter the required Social Security number for each claimed qualifying child under 17 in column (2) and check the Child Tax Credit box in column (4) of the tax return; and
- The taxpayer must enter the timely issued TIN for the ODC claimed dependent in column (2) and check the Credit for Other Dependents box in column 4 of the tax return.

Return to Tax Preparation Due Diligence

2.11.3 Child and Dependent Care Credit

ARPA makes various changes to the child and dependent care tax credit that are effective only for 2021. These changes include:

- Making the credit refundable;
- Increasing the percentage from 35% to 50% of eligible expenses;
- Increasing the maximum credit to –
    - $4,000 for one qualifying individual, and
    - $8,000 for two or more qualifying individuals;
- Changing the threshold income at which credit reduction begins from $15,000 to $125,000; and
- Changing the maximum possible credit reduction to less than 20% for household incomes exceeding $400,000.

2.11.3.1 Eligible Care Recipients Limited to Qualifying Persons

The tax credit for child and dependent care expenses is limited to a portion of those expenses incurred and paid for the care of a qualifying person. A qualifying person is:

- The taxpayer's qualifying dependent child under age 13;
- The taxpayer's spouse who –
    - Was not physically or mentally able to care for himself or herself, and
    - Lived with the taxpayer for more than half the year; or
- A person who is not physically or mentally able to care for himself or herself, lived with the taxpayer for more than half the year and –
    - Was the taxpayer's dependent, or
    - Would have been the taxpayer's dependent except for certain specified reasons.

2.11.3.2 Eligible Taxpayers

A taxpayer eligible for the child and dependent care credit must have paid child and dependent care expenses for the care of a qualifying person during the year in order to work or to look for work. Although the requirement that the taxpayer have earned income for the year has been waived for 2021, the taxpayer normally must have earned income during the year; if the taxpayer and spouse are filing jointly, both must have earned income during the year unless an exception applies because the spouse is a student or unable to care for him or herself.

2.11.4 Education Credits

Two tax credits are available to assist taxpayers in offsetting the costs of higher education: the American opportunity credit and the lifetime learning credit. Although these tax credits have certain similarities they also differ from one another in several respects.

2.11.4.1 American Opportunity Credit

A taxpayer whose income does not exceed certain limits may be able to claim an American opportunity tax credit of up to $2,500 for qualified education expenses paid for *each eligible student*, part of which is a refundable credit. Thus, the maximum American opportunity credit for any taxpayer is equal to $2,500 *times* the number of eligible students.

The American opportunity credit is available only for the first four years of postsecondary education during which time the student must be pursuing a degree or other recognized credential. The following is an overview of the credit:

Maximum credit	Up to $2,500 credit per eligible student (taxpayer, spouse or dependent)
Income limitations	Ineligible if MAGI is $180,000 or more (married filing jointly) or $90,000 or more (single, head of household, or qualifying widow(er))
Credit type	40% of credit may be refundable; balance nonrefundable
Eligible education years	Available only for first four years of postsecondary education
Maximum tax years	Available only for four tax years per eligible student
Degree requirement	Must be pursuing a degree or other recognized education credential
Enrollment status	Must be enrolled at least half-time for at least one academic period beginning during the tax year
Qualified expenses	Tuition, required enrollment fees and course materials the student needs for a course of study as a condition of enrollment or attendance. Room & board not a qualified expense.
Drug convictions	Student must not have been convicted of a felony for controlled substance possession or distribution
Academic periods	Payments made during the tax year for academic periods beginning during the tax year or in the first three months of the following year

2.11.4.1.1 Figuring the American Opportunity Credit

The maximum amount of the American opportunity credit for each eligible student is $2,500 and is equal to the sum of:

- 100% of the first $2,000 of qualified education expenses paid by the taxpayer for the eligible student; plus
- 25% of the next $2,000 of qualified education expenses the taxpayer paid for the eligible student.

Thus, in order to claim the full $2,500 American opportunity credit for each eligible student, the taxpayer must have paid at least $4,000 of qualified education expenses. (100% x $2,000 = $2,000; $25% x $2,000 = $500; $2,000 + $500 = $2,500) However, a taxpayer's American opportunity credit may be reduced based on his or her MAGI.

2.11.4.2 Lifetime Learning Credit

Taxpayers may also reduce their federal income tax liability by claiming the lifetime learning credit. A taxpayer whose income does not exceed certain limits may be able to claim a nonrefundable lifetime learning tax credit of up to $2,000 per return.

The following is an overview of the lifetime learning credit:

Maximum credit	Up to $2,000 credit per return
Income limitations (2021)	Ineligible if MAGI is $180,000 or more (married filing jointly) or $90,000 or more (single, head of household, or qualifying widow(er))
Credit type	Credit is nonrefundable, i.e., it is limited to the amount of taxpayer’s federal income tax liability

Eligible education years	Available for all years of postsecondary education and for courses to acquire or improve job skills
Maximum tax years	Available for an unlimited number of tax years
Degree requirement	Student **not** required to be pursuing a degree or other recognized credential
Enrollment status	Available for one or more courses
Qualified expenses	Tuition, required enrollment fees (and course materials, i.e. books, supplies and equipment the student needs for a course of study **only if paid to the institution**)
Drug convictions	Felony drug convictions **do not** disqualify
Academic periods	Payments made during the tax year for academic periods beginning during the tax year or in the first three months of the following year

2.11.4.2.1 Figuring the Lifetime Learning Credit

The maximum annual amount of lifetime learning credit a taxpayer may claim is $2,000 per return. The credit is equal to 20% of the first $10,000 of qualified education expenses paid for all eligible students but may be reduced if the taxpayer's MAGI exceeds an income threshold of $80,000 ($160,000 for a joint return).

To return to education tax credits due diligence, click here.

2.11.5 Earned Income Tax Credit

The earned income credit is a refundable tax credit for certain lower-income working taxpayers who meet income, filing status and other requirements. Eligibility to claim the credit requires, among other things, that the taxpayer have an earned income and also have an adjusted gross income (AGI) that is below a specified level, have no excluded foreign income or have investment income exceeding $10,000 (2021). The applicable AGI level generally changes annually. The rules that apply to claiming the earned income credit fall into three categories: a) rules that apply to everyone, b) rules that apply if the taxpayer has a qualifying child, and c) rules that apply if the taxpayer does not have a qualifying child.

If the taxpayer meets all the rules applicable to his or her claiming EITC, the amount of EITC for which the taxpayer is eligible is determined using EITC Worksheet A—for taxpayers who were not self-employed, not a member of the clergy, not a church employee who files Schedule SE, nor a statutory employee filing Schedule C—or EITC Worksheet B for those taxpayers who can be included in one of those categories. Worksheets A and B may be found in the IRS Instructions for Form 1040.

2.11.5.1 Adjusted Gross Income Limits

To meet the rule concerning adjusted gross income limits, a taxpayer must have an AGI that is less than the maximum amount for his or her filing status and number of qualifying children. The applicable AGI limits generally change each year and, for 2020 and 2021, are as shown in the following chart:

EITC Income Limits				
	2020 Limits		2021 Limits	
Children	**Married Filing Jointly**	**Other Than Married Filing Jointly***	**Married Filing Jointly**	**Other Than Married Filing Jointly***
3 or more qualifying children	$56,844	$50,954	$57,414	$51,464
2 qualifying children	$53,330	$47,440	$53,865	$47,915

1 qualifying child	$47,646	$41,756	$48,108	$42,158
No qualifying children	$21,710	$15,820	$27,380**+	$21,430**+

*Taxpayer's filing status cannot be married filing separately.
**See Temporary Special Rule for Taxpayers with no Qualifying Children
+See IRS Rev. Proc. 2021-23 (applicable only for 2021)

> **Note:** See **Temporary Special Rule for Determining Earned Income** for 2021.

2.11.5.1.1 Temporary Special Rule for Determining Earned Income

ARPA provides a special rule for determining a taxpayer's 2021 earned income for purposes of the earned income tax credit. Specifically, if the taxpayer's earned income for 2021 is less than his or her earned income in 2019, the earned income tax credit may be determined based on the income providing the higher credit.

2.11.5.2 Valid Social Security Number Required

In order to claim the EITC, the taxpayer—and spouse, if filing a joint return—must also have a valid social security number issued by the Social Security Administration. In addition, if a qualifying child is listed on Schedule EITC the child must also have a valid social security number. A social security card stating "Not valid for employment" is not sufficient for purposes of the EITC.

(Note: if a child was born and died during the year, no social security number is required for the child. In such a case, a tax preparer should attach a copy of the child's birth certificate, death certificate, or hospital records showing a live birth to the taxpayer's return.)

2.11.5.3 Tax Filing Status

A taxpayer who is otherwise eligible to claim the EITC may have a tax filing status of single, married filing jointly or head of household. However, a married taxpayer cannot qualify for the EITC if he or she has a "married filing separate" filing status. If the taxpayer is married, he or she must normally file a joint return to claim the EITC. (An exception may apply if the taxpayer's spouse did not live with the taxpayer during the last 6 months of the year. In such a case, the taxpayer may be able to file as head of household and claim the EITC.)

2.11.5.3.1 Separated Spouses

Internal Revenue Code § 32(d) requires that otherwise eligible married individuals file a joint tax return in order to claim the earned income tax credit. The American Rescue Plan Act (ARPA), § 9623, effectively eliminates this requirement for a separated spouse by a special rule, effective for taxable years beginning after December 31, 2020, providing that the individual will not be treated as married, for purposes of the credit, if he or she meets the following requirements:

- The individual is married and does not file a joint tax return for the year;
- The individual resides with a qualifying child for more than one half of the taxable year; and
- Either of the following is true –
  - during the last six months of the taxable year, the individual does not have the same principal place of abode as the individual's spouse, or
  - the individual has a separation agreement with respect to the individual's spouse and is not a member of the same household by the end of the taxable year.

2.11.5.4 Citizenship or Residency

If the taxpayer (or spouse, if married) was a nonresident alien for any part of the tax year, the taxpayer cannot claim the EITC unless the taxpayer's filing status is married filing jointly. (Such filing status is available only if one spouse is a U.S. citizen or resident alien and chooses to treat the nonresident spouse as a U.S. resident. It is important to keep in mind that making the election to treat the nonresident spouse as a U.S. resident will cause the worldwide income of both spouses to be subject to U.S. taxation.)

If the taxpayer or spouse was a nonresident alien for any part of the year and the taxpayer's filing status is other than married filing jointly, the EITC is not available.

2.11.5.5 EITC Rules That Apply Only if the Taxpayer Has a Qualifying Child

If the taxpayer meets all the EITC eligibility rules applicable to all filers—the rules just discussed—then proceed to the next step. The appropriate next step depends on whether or not the taxpayer has a qualifying child. We will turn our attention now to the rules that apply to a taxpayer who has met the EITC rules that apply to everyone ***and*** has a qualifying child.

In addition to meeting the EITC rules that apply to everyone, a taxpayer who has a qualifying child must meet certain other rules in order to be eligible to receive the EITC. The rules that a taxpayer with a qualifying child must also meet are:

1. The relationship, age, residence and joint return tests;
2. The qualifying child of more than one person rule; and
3. The qualifying child of another taxpayer rule.

2.11.5.6 EITC Rules That Apply if Taxpayer Does Not Have a Qualifying Child

A taxpayer may claim the EITC without a qualifying child, provided the taxpayer meets all the rules that apply to everyone and all the following rules that apply to taxpayers without qualifying children. The EITC rules applicable to a taxpayer with no qualifying child are:

1. The age rule - at least age 25 but less than age 65 at the end of the tax year;
2. The dependent of another person rule;
3. The qualifying child of another taxpayer rule; and
4. The main home rule.

Note, however, that certain of these rules have changed for 2021, as discussed below.

2.11.5.6.1 Temporary Special Rules for Taxpayers with no Qualifying Children

ARPA provides special rules, applicable only in 2021, designed to strengthen the tax credit for individuals with no qualifying children. The special rules provide for the following:

- A decrease in the minimum age at which a taxpayer is eligible for the credit to –
    - age 19,
    - age 24 in the case of a specified student, i.e., an individual who is an eligible student during at least five calendar months in the taxable year,
    - age 18 in the case of a qualified former foster youth[16] or homeless youth;[17]
- Elimination of the maximum age for the credit; and
- An increase in the maximum earned income tax credit available to individuals with no qualifying children from $543 to $1,502.

To return to the EITC due diligence requirements, go to 3.5.2.

Review #6

1. Tanya is a single taxpayer who has two qualifying children and qualifies for the earned income credit in 2021. What is the maximum investment income she can have in 2021 and still be eligible for the credit?

    A. A taxpayer eligible for EIC cannot have any investment income

    B. $1,000

    C. $3,650

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[16] a "qualified former foster youth" is defined as an individual who, on or after age 14, was in foster care and who provides consent for disclosure of that status.
[17] a "qualified homeless youth" is defined as an individual who certifies as either an unaccompanied youth who is a homeless child or youth, or is unaccompanied, at risk of homelessness, and self-supporting.

D. $10,000

2. Sharon and Bill, a married couple filing a joint tax return, have three children, ages 5, 8 and 18, and a modified adjusted gross income of $160,000. For what child tax credit are they eligible in 2021?

   A. $4,000

   B. $6,100

   C. $6,600

   D. $9,100

2.12 Overview Topics

2.12.1 Tax Treatment of Virtual Currency

The term "virtual currency" refers to a digital representation of value not issued by any public authority but which may be, nonetheless, accepted as a means of payment between persons. It functions as a medium of exchange and/or a store of value although it doesn't have status as legal tender. Such virtual currency having an equivalent value in real currency is referred to as "convertible" virtual currency. The IRS in Notice 2014–21[18] describes how existing general tax principles apply to transactions using virtual currency, and a brief description of that application follows:

- **Virtual Currency Treated as Property** – The general tax principles applicable to property transactions apply to transactions using virtual currency.
- **Virtual Currency Not Treated as Currency** – Current U.S. tax law does not treat virtual currency as currency that could generate foreign currency gain or loss for tax purposes.
- **Virtual Currency as Payment** - U.S. taxpayers receiving virtual currency as payment for goods or services must include the fair market value of the virtual currency in U.S. dollars received in computing their gross income.
- **Virtual Currency Basis** – The basis of virtual currency received by a taxpayer as payment for goods and services is its fair market value in U.S. dollars as of the date of receipt.
- **Virtual Currency Fair Market Value** - Transactions using virtual currency must be reported in U.S. dollars, and taxpayers are required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt.
- **Gain or Loss on Exchange of Virtual Currency** – If the fair market value of property received by a taxpayer in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency the taxpayer has taxable gain. Similarly, the taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of virtual currency exchanged.
- **Type of Gain or Loss Realized** – The character of the gain or loss realized on the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Thus, a taxpayer will generally realize capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. In contrast, inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.
- **Mining Virtual Currency** – A taxpayer who successfully "mines" virtual currency will realize gross income for tax purposes upon receipt of the virtual currency to the extent of its fair market value as of the date of receipt.
- **Virtual Currency Mining as a Trade or Business** – If a taxpayer's "mining" of virtual currency constitutes a trade or business and the activity is not undertaken as an employee, the net earnings from self-employment resulting from the mining activity constitute self-employment income subject to the self-employment tax.
- **Virtual Currency Received by Independent Contractors for Performing Services** – Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Accordingly, the fair market value of the virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income subject to self-employment tax.

[18] Notice 2014-21 may be accessed at https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

- **Virtual Currency Paid to an Employee** – Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Thus, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement.
- **Information Reporting of Virtual Currency Payment** – A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. So, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. nonexempt recipient in a taxable year is required to report the payment to the IRS and to the payee.
- **Information Reporting of Virtual Currency Payments to Independent Contractors** – Generally a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services must report that payment to the IRS and to the payee on Form 1099–MISC; when that payment is in virtual currency, it should be reported using the fair market value in U.S. dollars as of the date of payment.
- **Virtual Currency Payments Subject to Backup Withholding** – Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. So, a payor must backup withhold from a payment of virtual currency if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required.
- **Third-Party Settlement Organizations (TPSO)** – A third-party settlement organization (TPSO)— an organization that contracts with a substantial number of unrelated merchants to settle payments between them and their customers—must report payments made to a merchant on Form 1099-K, *Payment Card And Third-Party Network Transactions*, if a) the number of transactions is settled before the merchant exceeds 200, **and** b) the gross amount of payments made to the merchant exceeds $20,000.
- **Penalties for Incorrect Tax Treatment of Virtual Currency Transactions** – Failure to treat a virtual currency transaction in a way consistent with IRS notice 2014–21 will subject a taxpayer to penalties for failure to comply with tax laws.

2.12.2 Alternative Minimum Tax (AMT)

Imposition of an alternative minimum tax was designed to ensure that at least a minimum amount of tax is paid by higher-income taxpayers who enjoy significant tax savings through the use of certain tax deductions, exemptions, losses and credits. Absent the alternative minimum tax, such taxpayers could conceivably avoid federal income tax liability completely despite their high income level. After various tax-preference items are added back to the taxpayer's income, the applicable alternative minimum taxable income (AMTI) exemption, discussed below, is subtracted.

2.12.2.1 Alternative Minimum Tax Exemption Amount Increased

The tax code provides for an AMTI exemption for purposes of determining the alternative minimum tax amount. The amount of the AMTI exemption varies according to the taxpayer's filing status and the tax year. The applicable AMTI exemption amounts[19] for 2021 are as follows:

Filing Status	Threshold for Phaseout of Exemption Amount	Alternative Minimum Taxable Income Exemption
Single or Head of Household	$523,600	$73,600
Married Filing Jointly & Qualifying Widow(er)	$1,047,200	$114,600
Married Filing Separately	$523,600	$57,300
Estates and Trusts	$85,650	$25,700

[19]AMTI exemption amounts are indexed for inflation.

The AMTI exemption amount is reduced (but not below zero) by 25 percent of the amount by which the taxpayer's alternative minimum taxable income exceeds the phaseout threshold.

2.12.3 QBI Deduction

The Tax Cuts and Jobs Act of 2017 added a tax deduction—frequently referred to as the section 199A deduction or QBI deduction—of up to 20% of qualified business income derived from a qualified trade or business. The total of 20% of the qualified business income and 20% of the REIT and PTP income is referred to as the "combined qualified business income amount."

The deduction is generally equal to the ***lesser*** of:

1. The combined qualified business income amount; and
2. 20% of the taxpayer's taxable income reduced by the taxpayer's net capital gain.

2.12.3.1 Qualified REIT Dividend

The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which is neither a capital gain dividend nor qualified dividend income.

2.12.3.2 Qualified Publicly Traded Partnership Income

The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of A and B where:

A is the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss from a publicly traded partnership which is not treated as a corporation; and

B is any gain recognized by the taxpayer upon disposition of its interest in the partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset.

2.12.3.3 Deduction Eligibility

Taxpayers who may be eligible for the deduction are those who operate a business as a sole proprietorship or under a pass-through entity, i.e., a partnership, a limited liability company (LLC) taxed as a partnership or an S corporation. Accordingly, individuals, trusts and estates with qualified business income, qualified REIT dividends or qualified PTP income may qualify for the deduction. Income earned as an employee or through a C Corporation, however, is ineligible for the deduction.

Furthermore, eligibility for the pass-through deduction authorized by the TCJA does not require that the taxpayer itemize tax deductions. Accordingly, eligibility for the pass-through deduction is unaffected by the taxpayer's election to itemize deductions or take the standard deduction.

2.12.3.4 Pass-Through Deduction Generally Limited to Qualified Trade or Business

The deduction of up to 20% of a pass-through business' qualified business income, depending upon the amount of qualified business income and other factors affecting it, may reduce the taxpayer's income tax liability significantly. However, the "other factors" that may affect the deduction include:

- Whether the business is a qualified trade or business;
- The taxpayer's taxable income; and
- If the business owner's taxable income exceeds the applicable threshold –
    - The amount of W-2 wages paid; and
    - The value of qualified property.

2.12.3.4.1 Qualified Trade or Business

A qualified trade or business, as the term is used with respect to the pass-through deduction, means any trade or business ***other than***:

- A specified service trade or business (SSTB);
- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners; or
- The trade or business of performing services as an employee. (In other words, an employee of a trade or business would not be considered a "qualified trade or business" whose income from such employment would qualify for the pass-through deduction.)

2.12.3.4.1.1 Exception for Specified Service Trade or Business

The rule cited just above that disqualifies specified service trades or businesses from being considered qualified trades or businesses eligible for the pass-through deduction does not apply to individuals whose taxable income is less than the threshold amount[20]. The threshold amount and phase-in range are as shown in the chart below:

Taxpayer's Filing Status	2021 Threshold Amount	Phase-In Range
Married filing jointly	$329,800	$100,000
Married filing separately	$164,925	$50,000
Single & head of household filers	$164,900	$50,000

However, the pass-through deduction is not available for specified service trades or businesses if the taxpayer's taxable income is equal to or greater than the applicable threshold amount plus $100,000 in the case of a taxpayer filing a joint tax return or the applicable threshold amount plus $50,000 for all other taxpayers.

For specified service trades or businesses of taxpayers whose taxable income falls within the phase-in range, i.e., between the threshold amount and $100,000 or $50,000 more than the threshold amount, as appropriate, the deduction may be reduced by being subject to a phase-in. Under the phase-in reduction, only the applicable percentage of qualified business income, W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business is taken into account in determining the § 199A deduction. Thus, if an individual's taxable income is above the threshold amount but within the phase-in range then the taxpayer must calculate an applicable percentage that limits the QBI, W-2 wages, and UBIA of qualified property from an SSTB used to calculate the individual's § 199A deduction.

2.12.3.5 IRS Forms for Qualified Business Income Deduction – 8995 & 8995-A

The IRS created two forms for use in determining the appropriate amount of pass-through deduction available to taxpayers owning eligible trades or businesses who have:

- Qualified business income (QBI);
- Qualified real estate investment trust (REIT) dividends; or
- Qualified publicly traded partnership (PTP) income or loss.

Determining which of the forms to use to figure the deduction is based on whether the taxpayer's taxable income is greater than the applicable threshold or the taxpayer is a patron in a specified agricultural or horticultural cooperative. The IRS also added a worksheet to the instructions for each form that provides a method to track and compute your clients' previously disallowed losses or deductions to be included in your qualified business income deduction calculation for the year allowed.

Samples of both Forms 8995 and 8995-A are provided below. Let's briefly consider each of them.

2.12.3.5.1 Qualified Business Income Deduction Simplified Computation - Form 8995

Form 8995, Qualified Business Income Deduction Simplified Computation, permits a taxpayer or preparer to compute the pass-through deduction for a taxpayer whose taxable income doesn't exceed the applicable threshold amount and who is not a patron in a specified agricultural or horticultural cooperative. (Cooperatives are not eligible for the deduction. Instead, cooperatives provide the necessary information to their patrons on Form 1099-PATR to help eligible patrons to figure their deduction.)

Thus, in addition to not being a patron in a specified agricultural or horticultural cooperative, a taxpayer eligible to use Form 8995 in connection with 2021 income is one who has QBI, qualified REIT dividends and/or qualified PTP income or loss and whose taxable income does **NOT exceed**:

- $329,800if married filing a joint tax return (MFJ);
- $164,925 if married filing a separate return (MFS); or
- $164,900 with any other filing status.

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[20] The threshold amount is annually adjusted for inflation.

2.12.3.5.2 Qualified Business Income Deduction - Form 8995-A

Form 8995-A, Qualified Business Income Deduction, permits a taxpayer or preparer to compute the pass-through deduction for a taxpayer whose taxable income exceeds the applicable threshold amount or who is a patron in a specified agricultural or horticultural cooperative.

So, in contrast to taxpayers eligible to use Form 8995, a taxpayer eligible to use Form 8995-A in connection with 2021 income is one who has QBI, qualified REIT dividends and/or qualified PTP income or loss and who is either a patron in a specified agricultural or horticultural cooperative **or** whose taxable income **exceeds**:

- $329,800if married filing a joint tax return (MFJ);
- $164,925 if married filing a separate return (MFS); or
- $164,900 with any other filing status.

Form **8995**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction Simplified Computation

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8995* for instructions and the latest information.

OMB No. 1545-0123

Attachment Sequence No. 55

Name(s) shown on return | **Your taxpayer identification number**

1	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
i			
ii			
iii			
iv			
v			

2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2			
3	Qualified business net (loss) carryforward from the prior year	3	( )		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4			
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6			
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	( )		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8			
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	
11	Taxable income before qualified business income deduction	11			
12	Net capital gain (see instructions)	12			
13	Subtract line 12 from line 11. If zero or less, enter -0-	13			
14	Income limitation. Multiply line 13 by 20% (0.20)			14	
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ▶			15	
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	( )
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	( )

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form **8995** (2019)

Form **8995-A**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8995A* for instructions and the latest information.

OMB No. 1545-0123

Attachment Sequence No. **55A**

Name(s) shown on return	**Your taxpayer identification number**

Part I Trade, Business, or Aggregation Information

Complete Schedules A, B, and/or C (Form 8995-A), as applicable, before starting Part I. Attach additional worksheets when needed. See instructions.

1	**(a)** Trade, business, or aggregation name	**(b)** Check if specified service	**(c)** Check if aggregation	**(d)** Taxpayer identification number	**(e)** Check if patron
A		☐	☐		☐
B		☐	☐		☐
C		☐	☐		☐

Part II Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2			
3	Multiply line 2 by 20% (0.20). If your taxable income is $ or less ($ if married filing separately; $ if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3			
4	Allocable share of W-2 wages from the trade, business, or aggregation	4			
5	Multiply line 4 by 50% (0.50)	5			
6	Multiply line 4 by 25% (0.25)	6			
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7			
8	Multiply line 7 by 2.5% (0.025)	8			
9	Add lines 6 and 8	9			
10	Enter the greater of line 5 or line 9	10			
11	W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11			
12	Phased-in reduction. Enter the amount from line 26, if any. See instructions	12			
13	Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13			
14	Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15	Qualified business income component. Subtract line 14 from line 13	15			
16	Total qualified business income component. Add all amounts reported on line 15 ▶	16			

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71661B Form **8995-A** (2019)

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $ but not $ ($ and $ if married filing separately; $ and $ if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

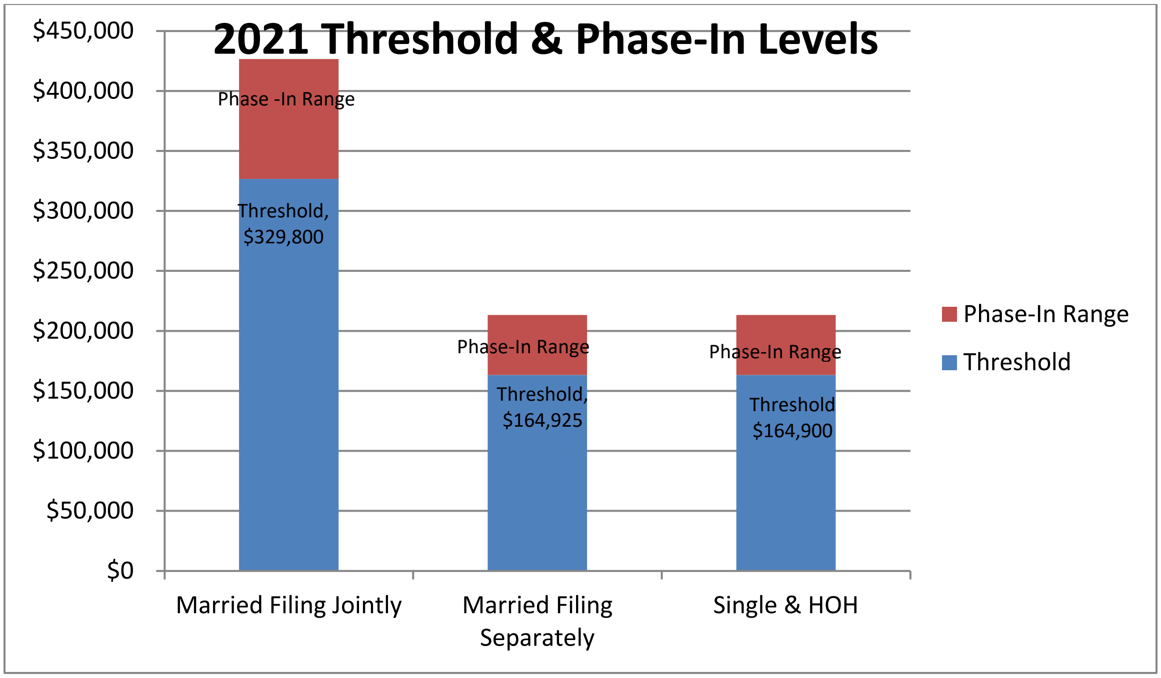
				A	B	C
17	Enter the amounts from line 3		17			
18	Enter the amounts from line 10		18			
19	Subtract line 18 from line 17		19			
20	Taxable income before qualified business income deduction	20				
21	Threshold. Enter $ ($ if married filing separately; $ if married filing jointly)	21				
22	Subtract line 21 from line 20	22				
23	Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23				
24	Phase-in percentage. Divide line 22 by line 23	24 %				
25	Total phase-in reduction. Multiply line 19 by line 24		25			
26	Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business		26			

Part IV Determine Your Qualified Business Income Deduction

27	Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27			
28	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29	Qualified REIT dividends and PTP (loss) carryforward from prior years	29	( )		
30	Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31	REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32	Qualified business income deduction before the income limitation. Add lines 27 and 31 ▶			32	
33	Taxable income before qualified business income deduction	33			
34	Net capital gain. See instructions	34			
35	Subtract line 34 from line 33. If zero or less, enter -0-			35	
36	Income limitation. Multiply line 35 by 20% (0.20)			36	
37	Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ▶			37	
38	DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39	Total qualified business income deduction. Add lines 37 and 38 ▶			39	
40	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	( )

2.12.3.6 Taxable Income Threshold

Graphically represented, the applicable thresholds and phase-in ranges are as depicted in the following chart:



2.12.3.7 Pass-Through Deduction for Qualified Trade or Business Owners

For a pass-through business owner whose taxable income exceeds the applicable threshold, two additional limitations come into play for owners of qualified trades or businesses: wages paid and business investment. Somewhat similar to SSTBs, these limits begin to phase-in when the business owner's taxable income exceeds the applicable threshold and apply in full when the business owner's taxable income exceeds the applicable threshold plus $50,000 ($100,000 for married taxpayers filing jointly). If the applicable phase-in range is $100,000 and the taxpayer's taxable income is $60,000 greater than the threshold amount, the reduction in the W-2 wages and UBIA would be 60%. ($60,000 ÷ $100,000 = .60)

The section 199A pass-through deduction is determined for qualified trade or business owners with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component—an amount equal to 20% of the qualified business income modified by the wage and investment limitations—(see **QBI Component Calculation** below) and the qualified REIT dividend/qualified PTP income component. That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

2.12.3.7.1 QBI Component Calculation

Notice that when the taxpayer's taxable income exceeds the threshold amount, computation of the pass-through deduction changes by the addition of the term "QBI *component,*" a term that considers both the QBI and the wage and business investment limitations. The W-2 wage and UBIA of qualified property limitations begin phasing in for those owners of pass-through qualified trades or businesses whose taxable income exceeds the applicable threshold and are fully phased-in when the business owner's taxable income equals the sum of the threshold *plus* the applicable phase-in range. Only after the QBI component is computed can the business owner whose taxable income exceeds the threshold determine the pass-through deduction.

2.12.3.7.2 Qualified Property

Qualified property plays a part in the calculation of the pass-through deduction for business owners whose taxable income exceeds the applicable threshold.

The term "qualified property," as used with respect to the pass-through deduction, means tangible property:

- Subject to depreciation under IRC §167;
- Held by and available for use in a qualified trade or business at the close of the taxable year;
- Held at any point during the taxable year in the production of qualified business income; and
- The depreciable period (defined later) for which has not ended before the close of the taxable year.

2.12.3.7.2.1 UBIA of Qualified Property

The abbreviation UBIA simply means unadjusted basis immediately after acquisition and, in the context of the § 199A pass-through deduction, refers to qualified property. The term "qualified property" means, with respect to any trade or business, tangible property of a character subject to the allowance for depreciation under § 167(a):

- Held by, and available for use in, the trade or business at the close of the taxable year,
- Used at any point during the taxable year in the trade or business's production of QBI, and
- The depreciable period for which has not ended before the close of the taxable year.

The term "depreciable period" means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service and ending on the later of:

- The date that is 10 years after the date first placed in service, or
- The last day of the last full year in the applicable recovery period that would apply to the property under § 168(c), regardless of any application of § 168(g), i.e., alternative depreciation system for certain property.

2.12.3.8 Rental Real Estate Safe Harbor

As discussed in Notice 2019-07, a safe harbor is available to individuals and owners of pass through entities. Under the safe harbor, a rental real estate enterprise will be treated as a trade or business for purposes of the QBI deduction. Taxpayers may still treat rental real estate that doesn't meet the requirements of the safe harbor as a trade or business for purposes of the QBI deduction if it is a section 162 trade or business.

Solely for the purposes of section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

(A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
(B) For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and
(C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding –
  (i) hours of all services performed;
  (ii) description of all services performed;
  (iii) dates on which such services were performed; and
  (iv) who performed the services.

The records must be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

2.12.4 Kiddie Tax

The kiddie tax was introduced as part of the Tax Reform Act of 1986 and was intended to discourage parents from placing investments in their children's names rather than in their own in hopes of reducing their income taxes. Under the kiddie tax provisions in the prior law, all of the child's unearned income exceeding the applicable threshold was taxed in the parent's marginal tax rate, i.e., the highest tax rate applied to the last dollar the parents earned. No preferential tax rate for capital gains or qualified dividends applied to the kiddie tax.

The SECURE Act, signed into law on December 20, 2019 repealed the provision of the TCJA addressing the unearned income of children. Effective for taxable years beginning after December 31, 2019, any income subject to the Kiddie Tax is taxable at the child's parents' marginal tax rate. Although the change is effective for years after December 31, 2019, taxpayers can elect to apply the tax rules effective for years after December 31, 2019 to the 2018 and 2019 tax year. Thus, taxpayers whose children had substantial unearned income in 2019 can choose to use the new rules and should consider doing so unless the trust tax rates were more favorable in any individual taxpayer's case.

2.12.5 Section 529 Plans

Before passage of the TCJA, an eligible educational institution at which a distribution for expenses of enrollment or attendance would be considered "qualified education expenses" under a §529 Tuition Savings Plan included an educational institution eligible to participate in a student aid program administered by the U.S. Department of Education such as a:

- College;
- University;
- Vocational school; or
- Other post-secondary educational institution.

However, elementary and secondary school expenses were not considered qualified education expenses. The TCJA broadens the definition of qualified education expenses by authorizing an annual qualified distribution of contributions made after 12/31/17 (and income on such contributions) of up to $10,000 from all of a taxpayer's §529 plans for elementary or secondary school tuition. Such schools may be:

- Public;
- Private; or
- Religious.

The SECURE Act expands the definition of *qualified higher education expense* applicable to distributions made after December 31, 2018 to include:

- Expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program; and
- Principal or interest paid on a qualified education loan of the designated beneficiary or a sibling of the designated beneficiary in an amount not exceeding $10,000 in the aggregate; the deduction otherwise allowable for education loan interest is reduced (but not below zero) by the amount of the distributions treated as a qualified higher education expense. (The term "sibling" means a brother, sister, stepbrother, or stepsister.)

2.12.6 Achieving a Better Life Experience (ABLE) Account

In 2014, legislation called the Achieving a Better Life Experience Act of 2014—better known as the ABLE Act—became law. The ABLE Act permits individuals with significant disabilities who are younger than age 26 at the time of onset of disability and who are receiving benefits under SSI and/or SSDI to establish a tax-deferred ABLE account to provide tax-free distributions to meet the additional expenses associated with living with a disability.

2.12.6.1 Tax-Deferred Account

An ABLE account is a tax-advantaged account to which a designated beneficiary (who is also the account owner) and others may make after-tax cash contributions not exceeding applicable limits for the purpose of meeting the designated beneficiary's qualified disability expenses. Earnings on the amount contributed to the ABLE account are tax-deferred. A designated beneficiary is limited to only one ABLE account.

2.12.6.2 ABLE Account Distributions

If a designated beneficiary takes a distribution from an ABLE account for purposes of meeting qualified disability expenses, the distribution not exceeding those expenses is tax-free. Any distribution in excess of qualified disability expenses is taxable as ordinary income and subject to a tax penalty equal to 10% of the amount of such distribution includable in income.

A "qualified disability expense" is any expense related to the designated beneficiary as a result of living a life with disabilities, and includes expenses for:

- Education,
- Housing,
- Transportation,
- Employment training and support,
- Assistive technology,
- Personal support services,
- Healthcare,
- Financial management and administrative services, and
- Other expenses that help improve health, independence and/or quality of life.

2.12.6.3 ABLE Account Contributions

Cash contributions to an ABLE account may be made by the designated beneficiary and others. The maximum amount of annual contribution to the account, in total, is generally limited to the annual gift tax exclusion amount ($15,000 in 2021).

2.12.6.4 TCJA Changes to ABLE Accounts

The TCJA made three important changes to ABLE accounts:

1. Additional annual contributions are permitted;
2. A designated beneficiary is permitted to claim the saver's credit for contributions made to the account; and
3. Rollovers from §529 Tuition Savings Plans to ABLE accounts are permitted.

Let's briefly examine the nature of these changes.

2.12.6.4.1 Additional Designated Beneficiary Contributions Permitted

Under the provisions of the TCJA, a designated beneficiary who meets the special rules related to the contribution limit may make an additional contribution, after the overall limitation on contributions is reached, in an amount not exceeding the lesser of:

- The designated beneficiary's compensation includable in gross income for the taxable year: or
- The poverty line for a one-person household for the calendar year preceding the calendar year in which the taxable year begins. (The federal poverty line for a one-person household for other than Alaska and Hawaii is $12,760 for 2020.)

The special rules applicable to the increased contribution limit apply to a designated beneficiary who is an employee with respect to whom no contribution is made for the taxable year:

- To a defined contribution plan;
- To a 403(b) Tax Sheltered Annuity plan; or
- To a §457(b) deferred compensation plan.

2.12.6.4.2 Saver's Credit

The retirement savings contribution credit—better known as the saver's credit—is available to designated beneficiaries of ABLE accounts and to taxpayers who make a wide range of retirement plan contributions. To be eligible to claim the saver's credit, the taxpayer must be:

1. Age 18 or older,
2. Not claimed as a dependent on another person's return, and
3. Not a student.

If all other criteria are met, the contributions made to an ABLE account are treated in the same manner as contributions to other qualifying retirement plans and IRAs.

The tax credit is a *nonrefundable* credit that is limited to the applicable percentage of the taxpayer's eligible contribution; the credit cannot exceed $1,000 per taxpayer. A nonrefundable tax credit is a tax credit that is limited by the individual's tax liability and acts to reduce the amount of federal income tax payable. If a taxpayer has no income tax liability, or has an income tax liability that is less than the tax credit, a nonrefundable tax credit will not result in a payment of any amount in excess of the taxpayer's tax liability from the federal government.

The percentage of the contribution (not exceeding a contribution of $2,000) available to the taxpayer as a tax credit, up to a $1,000 maximum tax credit, depends upon the individual's adjusted gross income and income tax filing status. The applicable percentages for 2021 contributions are as shown below:

Adjusted Gross Income						
Joint Return		Head of Household Return		All Other Status		Applicable Percentage for Tax Credit
Over	Not over	Over	Not over	Over	Not over	
$0	$39,500	$0	$29,625	$0	$19,750	50%
$39,500	$43,000	$29,625	$32,250	$19,750	$21,500	20%
$43,000	$66,000	$32,250	$49,500	$21,500	$33,000	10%
$66,000		$49,500		$33,000		0%

2.12.7 Discharge of Student Loan Indebtedness

Certain student loans provide for cancellation of indebtedness if the person receiving the loan works for a specified period of time in identified professions and/or in underserved areas. Under prior tax law, student loan indebtedness canceled as a result of such a provision was not included in the taxpayer's gross income if the loan was made by:

- Federal, state or local government;
- A tax-exempt public benefit corporation that has assumed control of a state, county or municipal hospital; or
- Certain educational institutions.

Additionally, relief is also provided when the federal loans are discharged by the Department of Education under the Closed School or Defense to Repayment discharge process, or where the private loans are discharged based on settlements of certain types of legal causes of action against nonprofit or other for-profit schools and certain private lenders. This includes, but is not limited to, schools owned by Corinthian College Inc. or American career Institute Inc. Student loan indebtedness discharged in other cases was normally included in the individual debtor's gross income for tax purposes.

The TCJA expanded the tax-free nature of student loan forgiveness when the loan indebtedness is discharged after December 31, 2017 and before January 1, 2026 because of the student's:

- Death; or
- Total and permanent disability.

In addition, the American Rescue Plan Act provides for the exclusion from income of the partial or complete discharge—effective after December 31, 2020 and before January 1, 2026—of certain loans for postsecondary education made, insured or guaranteed by:

- The U.S.;
- A state, territory or possession of the U.S.;
- The District of Columbia; or
- Certain educational institutions.

Thus, ARPA modifies the tax treatment of student loan forgiveness occurring in 2021 through 2025. Pursuant to the act, no amount of student loan forgiveness taking place in years 2021 through 2025 that would be includible in income except for passage of ARPA is includible in income, provided the loan discharge is not made on account of services performed.

2.12.8 Net Operating Loss (NOL)

An individual taxpayer incurs a net operating loss (NOL) if certain tax-deductible expenses exceed taxable revenues for the year. The amount of the NOL is equal to the amount of loss incurred in the current year and, under prior tax law, could generally be carried back to the two prior tax years (carrybacks), up to five or 10 years for specified liability losses and certain disaster losses, or carried forward for up to 20 future years (carryforwards) to offset taxable income in those years. When using an NOL carryover, the taxpayer's taxable income could not be less than zero.

Under the TCJA, the NOL two-year carryback and certain special extended carryback provisions are repealed for tax years after December 31, 2017. An exception, however, applies to losses incurred in the trade or business of farming to which a two-year carryback is applicable. Also, the 20 year carryforward limitation under the prior law is repealed except for insurance companies other than life insurance companies, and NOLs may be carried forward indefinitely for losses arising in tax years beginning after December 31, 2017.

Additionally, unlike the maximum NOL carryover under prior law that could equal 100% of the taxpayer's taxable income, the NOL deduction arising in tax years beginning after December 31, 2017 under the TCJA is limited to no more than 80% of the individual taxpayer's taxable income (without regard to the NOL deduction). Although the 80% of taxable income limit applies to NOL carrybacks and carryforwards attributable to losses arising in tax years after 2017, NOL carrybacks and carryforwards that arose in prior years are not subject to the 80% limitation.

2.12.8.1 Modifications for Net Operating Losses

A business's profit and loss volatility can cause fundamentally unequal income tax treatment among different business entities. The ability of a firm to carryover net operating losses helps to equalize that treatment.

The CARES Act alleviates some of the taxation inequality for firms with volatile incomes by:

- Providing for a five-year carryback for losses occurring in 2018 through 2020,
- Temporarily removing the 80% NOL deduction limit, and
- Permitting owners of pass-through businesses to disregard the prior $250,000/$500,000 limits to offset non-business income for years 2018 through 2020.

Thus, a NOL arising in tax years beginning in 2018, 2019, and 2020 generally would be carried back, under IRC Section 172, to each of the five years preceding the tax year in which the loss was incurred. A 2018 loss can be carried back as far as 2013, when the highest corporate tax rate was 35%. Prior year returns may be amended and tax refunds collected. A taxpayer may make an irrevocable election to waive the carryback period for the NOL for any tax year.[21]

For the owner of certain pass-through entities, the TCJA had placed a limitation on the amount that could be used for these losses. A single taxpayer was limited to $250,000 and a joint filer was limited to $500,000. These limits were removed, as noted above, so that taxpayers may offset non-business income by greater than those amounts to the extent they had income in the years to which NOLs are carried back.

2.12.9 Premium Tax Credit

The Affordable Care Act provides for a premium tax credit to assist lower-income taxpayers to purchase health coverage. Under the Affordable Care Act, taxpayers who obtain qualifying health insurance from a marketplace and who meet certain household income levels relative to the federal poverty line and certain other requirements are eligible to receive premium subsidies. For 2021, prior to ARPA passage, premium subsidies for 2021 were to be as shown in the following table:

[21] At https://www.irs.gov/pub/irs-drop/rp-20-24.pdf

In the case of household income (expressed as a percent of poverty line) within the following income tier:	The initial premium percentage is—	The final premium percentage is—
Up to 133%	2.0%	2.0%
133% up to 150%	3.0%	4.0%
150% up to 200%	4.0%	6.3%
200% up to 250%	6.3%	8.05%
250% up to 300%	8.05%	9.5%
300% up to 400%	9.5%	9.5%.

ARPA significantly expands the subsidies provided under the ACA in two ways:

1. By increasing the level of subsidy to those taxpayers who currently qualify for a subsidy; and
2. By including taxpayers who, solely because their income, would not qualify for a subsidy under the law prior to passage of ARPA.

Under ARPA, the above chart is revised for years 2021 and 2022 to be as follows:

In the case of household income (expressed as a percent of poverty line) within the following income tier:	The initial premium percentage is—	The final premium percentage is—
Up to 150%	0.0%	0.0%
150% up to 200%	0.0%	2.0%
200% up to 250%	2.0%	4.0%
250% up to 300%	4.0%	6.0%
300% up to 400%	6.0%	8.5%
400% and higher	8.5%	8.5%

As can be seen from the above chart, applicable taxpayers whose household income is 150% of the federal poverty level or less will not normally be required to pay any premium when purchasing a health plan whose premium does not exceed the premium for a benchmark plan through an ACA marketplace. Those applicable taxpayers with household income exceeding 150% of the federal poverty level but less than 400% will have an expected contribution of gradually increasing percentages up to 8.5% for such a plan, and those taxpayers with household incomes of 400% or more of the federal poverty level will have expected contributions of 8.5% of household income.

ARPA also addresses repayment of excess advanced subsidies. Specifically, under the ACA prior to passage of ARPA, taxpayers who were granted advanced subsidies were required to reconcile the advance credit when filing their federal tax return, and, in the case of overpayment, a limitation on repayment was applied to those whose household income was less than 400% of the federal poverty line. The limitation for 2021 is as shown in the chart below:

If the household income (expressed as a percent of poverty line) is:	Limitation Amount for Unmarried Individuals (other than surviving spouses or heads of households)	Limitation Amount for All Other Taxpayers
Less than 200%	$325	$650
At least 200% but less than 300%	$800	$1,600
At least 300% but less than 400%	$1,350	$2,700

As a result of the passage of ARPA, no repayment of excess advanced premium tax credit received in 2020 is required.

Additionally, a taxpayer who has received, or who has been approved to receive, unemployment compensation for any week beginning during 2021 will be eligible to receive health insurance premium tax credits in an amount sufficient to cover the entire cost of ACA marketplace insurance premiums for a plan whose premiums do not exceed those for a benchmark plan.

2.12.10 Employee Fringe Benefits

Under the tax law prior to the passage of the Tax Cuts and Jobs Act of 2017 (TCJA), employers could offer their employees various commuting benefits that were tax-deductible to the employer. These benefits, referred to in the tax law as "qualified transportation fringes," include transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, any transit pass, qualified parking and qualified bicycle commuting reimbursement.

Under the TCJA, the following changes are made to these employee fringe benefits for tax years after December 31, 2017:

- No tax deduction will be allowed an employer for any expense incurred for providing any transportation or for any payment or reimbursement to an employee in connection with travel between the employee's residence and place of employment except as necessary for ensuring the employee's safety.
- Although qualified bicycle commuting reimbursements will continue to be tax-deductible, within applicable limits, to the employer providing them, employees' exclusion of qualified bicycle commuting reimbursements from income for tax purposes is suspended for taxable years beginning after December 31, 2017 and before January 1, 2026. Accordingly, bicycle commuting reimbursements, if provided by an employer, will be includable in the employee's income.

2.12.11 Depreciation of Rental Property

Generally, when a taxpayer pays for a purchased item intended to be used to help produce income, the cost of the purchased item is tax-deductible. In many cases, the entire cost is deductible in the year the item is purchased. Consider, for example, the purchase of office supplies and similar products used in a business whose cost is immediately deductible. Certain other property, including income-producing rental property, is deductible only in part each year over its useful life; in other words, it is depreciated rather than expensed.

In the case of depreciable property, the amount that may be deducted from a taxpayer's income each year is affected by three factors:

1. The taxpayer's basis in the property;
2. The property's recovery period (a duration assumed to be its useful life); and
3. The depreciation method used by the taxpayer.

After briefly looking at the nature of depreciable rental property, we will examine the three factors.

2.12.11.1 Depreciable Rental Property

For a taxpayer to be able to depreciate property, several requirements must be met. Those requirements are:

- The taxpayer must own the property;
- The taxpayer must use the property in the taxpayer's business or income-producing activity, such as rental property;
- The property must have a determinable useful life— it must decay, wear out, or in some other way have its value exhausted; and
- The property must be expected to last more than one year.

Some property, however, cannot be depreciated. The two important categories of non-depreciable property are:

1. Land; and
2. Excepted property, including –
   - property placed in service and taken out of service in the same year, and
   - equipment used to build capital improvements.

2.12.11.1.1 Beginning and Ending Depreciation

The taxpayer begins to depreciate rental property at the time it is placed in service for the production of income. Depreciation ends on the earlier of the date the taxpayer has:

- Fully recovered the property's basis; or
- Taken the property out of service.

Although property placed in service in a personal activity cannot be depreciated while being used in the personal activity, property changed from personal use to use in the taxpayer's business or for the production of income can be depreciated. In the case of such a change from personal to business use, the property is considered placed in service on the date of the change.

2.12.11.2 Depreciable Property Basis

The depreciable basis of property used in a rental activity is its "adjusted basis." ***Adjusted basis*** is the cost or other basis of the property when acquired by the taxpayer, adjusted (up and/or down) for certain items occurring before the taxpayer placed it in service in the rental activity.

The taxpayer's basis of purchased property is normally its cost. Cost, for purposes of depreciation, includes:

- The amount paid in cash for the property by the taxpayer;
- The amount of any debt obligation (including unreimbursed real estate taxes[22] owed by the seller) assumed by the taxpayer in return for the property;
- The amount paid by the taxpayer in other property;
- The amount paid by the taxpayer in services provided to the seller;
- Any sales tax charged on the purchase (unless the taxpayer deducted state and local general sales taxes as an itemized deduction on schedule A);
- Freight charges paid by the taxpayer to obtain the property;

[22] If taxes owed by the seller are assumed by the buyer, such taxes cannot be deducted as taxes paid.

- Any installation and testing charges paid by the taxpayer with respect to the property; and
- Certain amounts paid incident to the purchase of real property, including –
    - abstract fees,
    - charges for installing utility services,
    - legal fees,
    - recording fees,
    - survey costs,
    - transfer taxes,
    - title insurance fees, and
    - any amounts owed by the seller the purchaser has agreed to pay, such as back taxes, interest, mortgage fees, sales commissions, etc.

Sometimes property title is transferred to a taxpayer in other than a traditional sale. The taxpayer's cost cannot be used as the basis for purposes of depreciation in such cases, including property received by the taxpayer:

- In return for services performed by the taxpayer;
- In exchange for other property;
- As a gift or inheritance; or
- From a spouse or from a former spouse in a divorce settlement.

2.12.11.3 Recovery Period

The MACRS recovery period applicable to rental property depends on the type of property being rented and the depreciation system being used. Such property first placed in service during 2018 generally falls into one of the following classes:

- Five-year property, a property class that includes –
    - computers and peripheral equipment,
    - office machinery,
    - automobiles and light trucks,
    - appliances, carpeting and furniture used in a residential rental real estate activity;
- Seven-year property, a property class that includes –
    - office furniture and equipment, and
    - any property that doesn't have a class life that has not been designated by law as being in any other class;
- 15 year property, a property class that includes roads, fences and shrubbery; and
- Residential rental property, a property class that includes any real property that is a rental building or structure for which 80% or more of the gross rental income for the tax year is from dwelling units.

Residential rental property depreciated under the Alternative Depreciation System (ADS) is 30 years if placed in service after 2017. The recovery period applicable to residential rental property placed in service prior to 2018 and depreciated under ADS is 40 years. In contrast, the recovery period for residential rental property depreciated under GDS is 27.5 years.

In general, the recovery period is somewhat longer for certain types of property under ADS than under GDS and is as shown in the chart below:

	MACRS Recovery Period

Type of Property	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: • Typewriters • Calculators • Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: • Stoves • Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: • Desks • Files	7 years	10 years
Any property that doesn't have a class life and that hasn't been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, waterpipes, venting, etc.	27.5 years	30 years
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

2.12.11.4 Depreciation Method

Most business and investment property that was placed in service after 1986 is depreciated using the MACRS. MACRS consists of two systems:

1. The General Depreciation System (GDS); and
2. The Alternative Depreciation System (ADS).

Unless the taxpayer elects to use ADS or is required by law to use ADS, a taxpayer must use GDS. The straight line method of depreciation is used for a taxpayer electing to use ADS, and such a taxpayer must make the election in the first year residential rental property and nonresidential real property is placed in service; once made, the taxpayer cannot revoke the election.

The IRS provides MACRS percentage tables in Publication 527 that a preparer may use to compute annual depreciation. Although complete tables may be found in Publication 946, the first few years of a residential rental property 27.5–year GDS percentage table with a mid-month convention is shown below:

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

2.12.11.5 Special Depreciation Allowance

Some properties used in connection with residential real property activities may qualify for a special depreciation allowance. This allowance is figured before you figure the taxpayer's regular depreciation deduction.

2.12.11.5.1 How to figure the Special Depreciation Allowance.

Figure the special depreciation allowance by multiplying the depreciable basis of the property by the applicable percentage. To figure the depreciable basis, subtract from the business/investment portion of the cost or other basis of the property any credits and deductions allocable to the property. For credits and deductions that affect the depreciable basis, see section 1016 and Pub. 946.

2.12.11.5.2 Election not to Take the Special Depreciation Allowance

The taxpayer can elect, for any class of property, not to deduct any special depreciation allowances for all property in the class placed in service during the tax year. To make an election, attach a statement to the return indicating what election the taxpayer is making and the class of property for which the election is being made. The election must be made separately by each person owning qualified property (for example, by the partnerships, by the S corporation, or for each member of a consolidated group by the common parent of the group).

2.12.11.5.2.1 When to Make Election

Generally, the taxpayer must make the election on a timely filed tax return (including extensions) for the year in which the taxpayer placed the property in service. However, if the taxpayer timely filed the return for the year without making the election, the taxpayer can still make the election by filing an amended return within 6 months of the due date of the original return (not including extensions). Attach the election statement to the amended return. On the amended return, write "Filed pursuant to section 301.9100-2."

2.12.11.5.3 Revoking an Election

Once the taxpayer elects not to deduct a special depreciation allowance for a class of property, the election cannot be revoked without IRS consent. A request to revoke the election is a request for a letter ruling. If the taxpayer elects not to have any special depreciation allowance apply, the property placed in service after 2015 will not be subject to an alternative minimum tax adjustment for depreciation.

Note. See sections 4 and 5 of Revenue Procedure 2020-25, 2020-19 I.R.B. 785, available at IRS.gov/irb/2020-19_IRB#REV-PROC-2020-25, for special rules for making a late election or revoking the election, to not deduct any special depreciation allowance for any class of property for tax years ending in 2018, 2019, and 2020. Also, see sections 5 and 6 of Revenue Procedure 2020-50, 2020-48 I.R.B. 1122, available at IRS.gov/irb/ 2020-48_IRB#REV-PROC-2020-50, for special rules for making a late election or revoking the election, to not deduct any special depreciation allowance for any class of property for tax years beginning in 2016 through 2020.

2.13 Tax Withholding and Estimated Tax Payments

Despite the annual due date for filing tax returns, federal income tax is a pay-as-you-go tax; thus, the tax is due and payable at the time income is received by the taxpayer. Two methods are used by the federal government to collect income taxes and facilitate the pay-as-you-go nature of the tax:

- Tax withholding; and
- Estimated tax payments.

When the taxpayer's tax return is prepared, credit is taken for the income tax withheld and any estimated tax payments made.

2.13.1 Tax Withholding

Income tax is withheld from the salaries and wages of most employees and may also be withheld from certain other income, such as pensions, bonuses, tips, taxable fringe benefits, sick pay, unemployment compensation and gambling winnings. The amount withheld is paid to the IRS on behalf of the taxpayer.

2.13.1.1 Form W-4

The amount of income tax withheld by an employer from a taxpayer's regular pay depends on the amount earned by the taxpayer in the payroll period and the information provided by the taxpayer to his or her employer on IRS Form W–4. The taxpayer-provided information includes whether to withhold at the single, head of household, or married rate, the number of withholding allowances claimed, whether an additional withholding amount is requested, and whether an exemption from withholding is claimed.

Information previously provided by the taxpayer to his or her employer on Form W-4 may change during the year. Although a taxpayer can submit a new W-4 at any time, the taxpayer is ***required*** to provide the employer with a new Form W-4 within 10 days following any change that would affect withholding. If events during the current year will decrease the number of withholding allowances for the following year, the taxpayer must provide the employer with a new Form W-4 by December 1 of the current year; if the event affecting the number of allowances occurs in December of the current year, a new Form W-4 must be submitted within 10 days following the event.

Usually, the tax withheld from the taxpayer's wages by his or her employer will closely approximate the taxpayer's tax liability. However, in some cases tax may be under withheld because the taxpayer has more than one job, is married and has a working spouse, receives nonwage income, or for some other reason. Since the taxpayer should try to have withholding match his or her actual income tax liability in order to avoid interest and/or penalties, the taxpayer should provide the employer with a new Form W-4 to change the amount of withholding if too little tax is likely to be withheld.

Taxpayers who hold more than one job at a time or who are married filing jointly with a working spouse may choose to use the multiple jobs worksheet, included in the Form W-4 instructions, or use the estimator to determine the correct amount of withholding. Taxpayers should consider using the estimator, found at www.irs.gov/W4App, if they:

- Expect to work only part of the year;
- Have dividend or capital gain income, or are subject to additional taxes, such as Additional Medicare Tax;
- Have self-employment income; or
- Prefer the most accurate withholding for multiple job situations.

Income taxes are also withheld from an employee's tips (indirectly by withholding from the employee's regular pay), taxable fringe benefits and sick pay.

2.13.1.2 Exemption from Withholding

A taxpayer may claim an exemption from income tax withholding if both the following situations apply:

1. The taxpayer had a right to a refund of all federal income tax withheld because of having no tax liability in the current year; and

2. The taxpayer expects a refund of all federal income tax withheld in the next year because of having no income tax liability.

2.13.1.3 Penalties

In addition to possibly being required to pay interest and penalties for being under withheld, a taxpayer may be subject to a penalty of $500 if both the following apply:

- The taxpayer made statements or claimed withholding allowances on Form W-4 that reduced the amount of tax withheld; and
- The taxpayer had no reasonable basis for those statements or allowances at the time Form W-4 was prepared.

A criminal penalty may also apply for willfully supplying false or fraudulent information on the form or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be a fine of up to $1,000 or imprisonment for up to one year, or both.

2.13.1.4 Withholding from Nonwage Income

Although a taxpayer is generally required to have income tax withheld from his or her gambling winnings, a taxpayer may also have income tax withheld from other types of nonwage income. Accordingly, a taxpayer may have income tax withheld from:

- Pensions and annuities;
- Unemployment compensation; and
- Federal payments, such as Social Security benefits.

If the taxpayer chooses not to have income tax withheld from nonwage income, he or she may have to pay estimated tax.

2.13.2 Estimated Tax

The payment of estimated taxes is the method used to pay tax on income that is not subject to income tax withholding. Thus, it is used to pay both income tax and self-employment tax as well as other taxes and amounts reported on the taxpayer's tax return. If the taxpayer does not pay enough tax, either through withholding or by paying estimated tax (or a combination of both), he or she may be subject to a penalty.

2.13.2.1 Requirement to Pay Estimated Tax

The general rule with respect to the payment of estimated taxes requires that a taxpayer pay estimated tax if both of the following apply:

1. The taxpayer expects to owe at least $1,000 for the year after subtracting withholding and refundable credits; and
2. The taxpayer expects withholding plus refundable credits to be less than the smaller of –
   a. 90% of the tax to be shown on the current year's tax return, or
   b. 100% of the tax shown on the previous year's tax return (provided the return covers all 12 months).

However, a taxpayer may avoid paying estimated tax if:

- The taxpayer receives a salary or wages and asks his or her employer to take more tax out of earnings; or
- All the following conditions apply –
    - The taxpayer had no tax liability for the previous year,
    - The taxpayer was a U.S. citizen or resident alien for the whole year, and
    - The taxpayer's previous tax year covered a 12-month period.

Estimated tax payments are generally due in four installments. Although an installment may be due on the following business day if the normal due date falls on a weekend or legal holiday, the estimated tax payment due dates are April 15, June 15, September 15 and January 15.

Estimated income taxes may be paid using any of the following methods:

- Crediting an overpayment of tax on the previous year's tax return to the current year's estimated tax;

- Payment of the estimated tax by direct transfer from the taxpayer's bank account, making payment by use of a credit or debit card, by using a pay-by-phone system, or via the Internet; or
- Remitting a payment using a check or money order along with a payment voucher Form 1040-ES.

2.14 Balance Due and Refund Options

After the taxpayer's income tax liability, if any, is determined and the tax return prepared, the taxpayer will usually have paid more or less income tax than owed. Accordingly, the taxpayer will either be required to pay an additional tax amount or will be due a tax refund. The taxpayer has several options in either case.

2.14.1 Payment of Income Tax Owed

If the taxpayer has paid less income tax than due—through employer withholding, the payment of estimated taxes, or both—several methods are available to him or her to pay any amount owed. When paying the taxes owed, no estimated tax payment for the following year should be included; such estimated tax should be paid separately.

A taxpayer may make income tax payments:

- Online or by telephone using a –
    - Direct transfer from the taxpayer's bank account, or
    - Credit or debit card;
- By check or money order; or
- In cash.

Individuals wishing to take advantage of the cash payment option should visit the IRS.gov payments page, select the cash option in the "Other Ways You Can Pay" section of the web page and follow the instructions:

- Taxpayers will receive an email from ACI Payments, Inc. (acipayonline.com) confirming their information.
- Once the IRS has verified the information, the Cash Processing Company sends the taxpayer an email with a link to the payment code and instructions.
- Individuals may print the payment code provided or send it to their smart phone.
- The retail store listed in the Cash Processing Company's email provides a receipt after accepting the cash. The receipt is confirmation of the taxpayer's payment and should be kept for the taxpayer's records. The payment usually posts to the taxpayer's account within two business days.
- Payment frequency and amount limits and fees apply.

2.14.2 Refunds

Taxpayers who are due a tax refund also have several choices with respect to its receipt. The options available to a taxpayer owed a refund include that the refund:

- Be applied to the taxpayer's estimated tax for the following year;
- Be deposited to a prepaid debit card;
- Be deposited into two or three accounts at a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) in the United States; (See **Limit on Direct Deposit Refunds** below)
- Be credited to a TreasuryDirect® online account in order to buy U.S. Treasury marketable securities or savings bonds;
- Be deposited directly to a traditional, Roth or SEP IRA; or
- Be sent to him or her in a check.

If the taxpayer is due an income tax refund but has not paid certain amounts owed, the refund may be used to pay any past-due amounts. Thus, a tax refund may be used to pay:

- Past-due federal income taxes;

- Federal debts, such as student loans;
- State income taxes;
- Child and spousal support payments; and
- State unemployment compensation debt.

Recovery rebate payments will not be reduced to pay past-due taxes under a payment agreement with the IRS or to pay other state or federal debts. In general, creditors cannot get access to the money for reduction or offset and direct payment to themselves. The CARES Act only allows offsets to cover past-due child support payments.

2.14.2.1 Limit on Direct Deposit Refunds

As a way to combat fraud and identity theft, the IRS implemented certain refund procedures designed to offer additional protection. Under the refund procedures, the IRS will limit the number of refunds electronically deposited into a single financial account—a bank savings or checking account, for example—or pre-paid debit card to three. Any refunds in excess of three will be made as a paper refund check and will be mailed to the taxpayer.

Although this procedural change is not expected to affect many taxpayers, it may affect families in which the parent's and children's refunds are deposited into a family-held bank account. Such taxpayers should make other deposit arrangements or expect to receive paper refund checks. Tax return preparers are prohibited from negotiating client refund checks or accepting such payments in an account owned or controlled by the preparer. No direct deposits of tax refunds should be requested to an account not in the taxpayer's name.

2.15 Federal Income Tax Return Filing Due Dates and Filing for Extensions

The due date for filing a federal income tax return depends on whether the taxpayer uses the calendar year or a fiscal year. In addition, the applicable due date may be extended. Such extensions are available:

- Under an automatic extension;
- If the taxpayer is outside the United States; or
- If the taxpayer is serving in a combat zone.

2.15.1 Calendar Year and Fiscal Year Taxpayers

For taxpayers who use the calendar year, the due date for filing the federal income tax return is generally April 15th of the year following the end of the calendar year for which the tax return is being filed, although 2021 tax return due date is delayed until Monday, April 18, 2022 because of Good Friday falling on April 15th. The federal income tax returns for taxpayers who use a fiscal year, i.e., a year ending on the last day of any month except December, are due by the 15th day of the fourth month after the close of the taxpayer's fiscal year. For example, the federal income tax return of a taxpayer whose fiscal year ends on June 30th is due on the following October 15th.

When the due date for performing any act for tax purposes—such as paying taxes or filing a tax return—falls on a Saturday, Sunday or legal holiday, the due date is delayed until the next business day. When April 15th falls on a Saturday or Sunday, federal tax returns are due the following Monday unless that Monday is a federally recognized holiday. Federal individual tax returns reflecting 2021 income (2022 filing season) are due Monday, April 18, 2022. A taxpayer's failure to file a timely income tax return may subject the taxpayer to a failure-to-file penalty and interest.

An exception to the usual federal income tax filing due dates applies to nonresident aliens who do not earn wages subject to U.S. income tax withholding. The federal income tax return of a nonresident-alien taxpayer who does not earn wages subject to such withholding is:

- June 15th for calendar year taxpayers; or
- The 15th day of the 6th month after the end of the taxpayer's fiscal year for fiscal year taxpayers.

The federal income tax return of a decedent, i.e., a taxpayer who died during the year, must be filed by the decedent's representative. The return is due by the 15th day of the fourth month after the end of the decedent's normal tax year.

2.15.2 Extensions of Time to File

A taxpayer may be able to get an extension of the time to file his or her federal income tax return. However, despite obtaining an extension of the time to file, any tax due must generally be paid by the regular due date. Failure to pay any tax due by the regular date will result in the imposition of interest and possible penalties on the unpaid amount from the date due until the date actually paid.

A taxpayer may qualify for an extension of time to file:

- Under an automatic extension;
- If the taxpayer is outside the United States; or
- The taxpayer is serving in a combat zone.

2.15.2.1 Automatic Extension of Time to File

A taxpayer who is unable to file a federal income tax return by the normal due date may be able to get an automatic six-month extension of the time to file. The automatic extension may be obtained by:

- Using IRS e-file; or
- Filing a paper form.

An automatic six-month extension of the time to file a federal income tax return may be obtained by timely filing IRS form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. The application for automatic extension is considered timely filed if filed by the due date for the taxpayer's income tax return. A representation of that form is shown below:

Form **4868**
Department of the Treasury
Internal Revenue Service (99)

Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

For calendar year 20XX, or other tax year beginning ,20XX, ending ,20

OMB No. 1545-0074

20**XX**

Part I Identification

1 Your name(s) (see instructions)

Address (see instructions)

City, town, or post office | State | ZIP Code

2 Your social security number | 3 Spouse's social security number

Part II Individual Income Tax

4 Estimate of total tax liability for 20XX $

5 Total 20XX payments

6 **Balance due**. Subtract line 5 from line 4 (see instructions)

7 Amount you're paying (see instructions)

8 Check here if you're "out of the country" and a U.S. citizen or resident (see instructions) ☐

9 Check here if you file Form 1040NR and didn't receive wages as an employee subject to U.S. income tax withholding ☐

When the taxpayer's income tax return is subsequently filed, enter any payment made when the application for extension was filed on Schedule 3 (Form 1040), line 10, i.e., on the line stating "Amount paid with request for extension to file."

2.15.2.2 Individuals Outside the United States

A taxpayer is allowed an automatic two-month extension, without filing Form 4868, to file the federal income tax form ***and pay any federal income tax due*** if:

- The taxpayer is a U.S. citizen or resident, and
- On the due date of the taxpayer's return, he or she is –
  - Living outside the United States and Puerto Rico, and the taxpayer's main place of business or post of duty is outside the United States and Puerto Rico, or
  - In the military or naval service on duty outside the United States and Puerto Rico.

If the taxpayer files a joint return, only one spouse needs to qualify in order to take advantage of this automatic extension. However, if the taxpayer and spouse file separate returns, the automatic extension applies only to the spouse who qualifies. To obtain the automatic extension, the taxpayer simply needs to attach a statement to his or her federal income tax return explaining what situation qualified him or her for the extension. Although a taxpayer who meets the criteria for an automatic two-month extension may defer payment of any federal income tax due, if the tax due is paid after the regular due date, interest—but no penalties—will be charged from the regular due date until the date the tax is paid.

If the taxpayer cannot file his or her federal income tax return within the automatic two-month extension period, the taxpayer may be able to get an additional four-month extension by filing IRS Form 4868 and checking the box on line eight of the form.

2.15.2.3 Individuals Serving in a Combat Zone

Individuals serving in a combat zone receive a substantial deferral with respect to their income tax returns. The due date for filing the taxpayer's federal income tax return, paying any tax owed, and filing a claim for refund is automatically extended if the taxpayer serves in a combat zone. The deferral applies to:

- Members of the Armed Forces;
- Merchant marines serving aboard vessels under the operational control of the Department of Defense;
- Red Cross personnel;
- Accredited correspondents; and
- Civilians under the direction of the Armed Forces in support of the Armed Forces.

For taxpayers who serve in a combat zone, the deadline for filing the federal income tax return, paying any taxes due, and filing a claim for refund is extended for at least 180 days after the later of:

- The last day the taxpayer is in a combat zone or the last day the area qualifies as a combat zone; or
- The last day of any continuous qualified hospitalization for injury from service in the combat zone.

In addition to the 180 day extension, the taxpayer's deadline for filing the income tax return is also extended by the number of days the taxpayer had left to take action with the IRS when entering the combat zone.

Review #7

1. As a single taxpayer, Arthur's alternative minimum taxable income exemption in 2021 would be $73,600 if his income does not exceed $523,600. What is his AMTI exemption amount if his alternative taxable income is $623,600?

   A. $0

   B. $25,000

   C. $48,600

   D. $73,600

2. Audrey is a single sole proprietor who owns and operates an accounting business, a business considered an SSTB. She has no REIT or PTP interests. She has no capital gains or losses and, after allowable deductions not relating to her business, her total taxable income for 2021 is $110,000. The applicable taxable income threshold in 2021 is $164,900. The business's QBI is $100,000. What is her pass-through deduction, if any?

   A. $20,000

   B. $22,000

   C. $32,145

   D. Audrey is ineligible for a deduction because her business is an SSTB

Domain 3 – Practices, Procedures & Professional Responsibility

Introduction

Tax return preparers are held to a high standard of conduct in their preparation of clients' income tax returns. Their failure to maintain that standard may subject them to financial, reputational and other penalties. The following textual material addresses certain of those standards and the applicable penalties for failing to maintain them.

Domain 3 Learning Objectives

When you have completed the domain 3 text, you should be able to:

- Identify the red flags indicating possible tax-related identity theft and suggested assistance to its victims;
- Understand the laws and regulations requiring privacy and security of taxpayer data and the best practices tax preparers may implement to help assure it;
- Describe the purpose of individual taxpayer identification numbers, their effect on tax credits and how to renew them;
- Recognize the penalties applicable to a tax return preparer under Title 26;
- Identify the due diligence requirements imposed on tax return preparers with respect to claiming head of household filing status, EITC, CTC and AOTC;
- Understand the e-file requirements; and
- Recognize the Annual Filing Season Program requirements.

3.1 Tax Related Identity Theft (Publication 5199)

All types of identity theft leave their mark on unsuspecting victims and account for losses well into the millions of dollars. The filing of a tax return may also place a client at risk for identity theft.

Tax-related identity theft usually occurs when someone uses a stolen Social Security number to file a tax return claiming a fraudulent refund. Thieves may also use stolen Employer Identification Numbers to create false Forms W-2 to support refund fraud schemes.

The IRS has created and published Publication 5199[23], Tax Preparer Guide to Identity Theft, which identifies the various warning signs of identity theft and suggests additional identity theft-prevention resources for preparers. Among the identified warning signs for individual clients that the client's Social Security number has been compromised, putting him or her at risk, are the following:

- A client's return is rejected and IRS reject codes indicate the taxpayer's Social Security number has already been used;
- The client notices activity on or receives IRS notices regarding a tax return after all tax issues have been resolved, refund paid or account balances have been paid; and
- An IRS notice indicates the client received wages from an employer unknown to the client.

To prevent filing returns with stolen identities, tax preparers should ask taxpayers not known to them to provide two forms of identification—preferably forms of identification containing the individual's picture—that include the taxpayer's name and current address. In addition, tax return preparers must confirm the identities and Social Security numbers of taxpayers, spouses and dependents.

Preparers should require taxpayers to show the Social Security cards for themselves, their spouses and dependents and should take special care to ensure that they transcribe all Social Security numbers correctly. Furthermore, the Social Security number entered on the IRS Form W-2, Wage and Tax Statement must be identical to the taxpayer's Social Security number on the Social Security card provided by the taxpayer. Tax return preparers should enter the Social Security number exactly as shown on the Form W-2 provided to them by taxpayers.

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[23] http://www.irs.gov/pub/irs-pdf/p5199.pdf.

In order to minimize Social Security number-related rejects, it is important to verify taxpayer Social Security numbers and names before submitting a return to the IRS.

3.1.1 Assisting Victims of Identity Theft

The Federal Trade Commission (FTC) is the lead federal agency for identity theft, and the agency recommends the following steps for an identity theft victim:

1. Report the identity theft to the FTC at www.identitytheft.gov.
2. Contact one of the major credit bureaus to place a fraud alert on the victim's records. The contact information for the bureaus is as follows –
    i. www.Equifax.com 800-525-6285;
    ii. www.Experian.com 888-397-3742; and
    iii. www.TransUnion.com 800-680-7289.
3. Close any financial or credit accounts opened fraudulently.

Additional suggested steps may be found on the FTC Website.

3.2 Safeguarding Taxpayer Data (Publication 4557)

We live in a dangerous time with respect to the theft of information about ourselves. We see evidence of it repeatedly as major retailers suffer severe business declines when it becomes known that their computer data has been compromised and our credit card and other personal information has been exposed. According to Javelin Strategy & Research[24], a research-based advisory firm, 5.1% of U.S. consumers experienced a loss totaling $16.9 billion in 2019 resulting from fraud and identity theft.

Tax preparers, frequently required to warehouse sensitive personal information needed to prepare clients' tax returns, are increasingly being targeted for data theft. Unsurprisingly, safeguarding taxpayer data—defined as any information obtained or used in the preparation of a tax return—is an important IRS priority. Safeguarding that data is a legal responsibility and needs to be an equally important priority for tax preparers.

3.2.1 Laws and Regulations Requiring Privacy/Security

Various federal laws have been passed and regulations promulgated to safeguard taxpayer data. Principal among those laws and regulations are the:

- FTC Safeguards Rule under which professional tax preparers are required to ensure the security and confidentiality of customer records and information. The Rule requires that tax preparers develop, implement and maintain an information security program. Such a program should contain –
    - Administrative safeguards,
    - Technical safeguards, and
    - Physical safeguards;
- Sarbanes-Oxley Act of 2002 (17 CFR Parts 232, 240 and 249) section 404, applicable to all SEC reporting companies having a market capitalization in excess of $75 million, that requires companies to preserve records and data from destruction, loss, unauthorized alteration or other misuse;
- FTC Financial Privacy Rule requiring professional tax preparers to give customers privacy notices explaining the preparer's information collection and sharing practices;
- IRC §301.7216 and IRC §6713 that impose criminal and monetary penalties, respectively, on preparers who make unauthorized disclosures or uses of information provided to them by taxpayers; and
- Internal Revenue Procedure 2007-40 that requires authorized IRS e-file providers to have security systems in place to prevent unauthorized access to taxpayer accounts and personal information.

[24] 2020 Identity Fraud Study, Published by Javelin Strategy & Research, may be accessed at https://www.javelinstrategy.com/coverage-area/2020-identity-fraud-study-genesis-identity-fraud-crisis.

3.2.2 Best Practices to Safeguard Data

The IRS makes a 21-page publication available to tax preparers titled "Safeguarding Taxpayer Data: A Guide for your Business." The publication is a guide that can help preparers understand and meet their obligations with respect to safeguarding taxpayer data. It provides various checklists and other information preparers should consult that address:

- Administrative activities;
- Facilities security;
- Personnel security;
- Information systems security;
- Computer systems security;
- Media security;
- Certifying information systems for use; and
- Reporting incidents.

In addition, the publication provides a list of resources (Appendix A) that may be accessed for additional information and guidance on various data-security concerns, including:

- Writing effective financial privacy notices;
- Complying with the Safeguards Rule;
- How to safely dispose of taxpayer data; and
- Reducing risks to your computer systems.

The IRS has also made available other information specifically for tax professionals concerning identity theft and creating a data-security plan.

3.3 Individual Taxpayer Identification Numbers

Individual Taxpayer Identification Numbers (ITINs) are tax processing numbers issued by the IRS to individuals who:

- Are required to have a U.S. taxpayer identification number;
- Do not have a Social Security number; **and**
- Are NOT eligible to obtain a Social Security number from the Social Security Administration.

ITINs are used only for federal tax reporting and are not intended to serve any other purpose.

3.3.1 Who Needs an ITIN?

As discussed in Notice 2016-48, the IRS issues ITINs to foreign nationals and others who have federal tax reporting or filing requirements and who don't qualify for a Social Security number. Applicants for an ITIN must have a valid filing requirement and file an original valid U.S. federal income tax return with their ITIN applications.

3.3.2 ITIN Effect on Tax Credits

A taxpayer using an ITIN is ineligible for the earned income tax credit (EITC) since qualifying for EITC requires that the claimant, spouse and qualifying child or children generally must possess valid work related Social Security numbers. In addition, a child must be a U.S. citizen, U.S. national or U.S. resident to be considered a "qualifying child" for purposes of the Child Tax Credit.

Under Internal Revenue Code § 32(c)(1)(F), no earned income tax credit was permitted to an otherwise eligible individual with one or more qualifying children if no qualifying child was taken into account due to a failure to meet the existing identification requirements. ARPA, § 9622, eliminates this restriction by providing that a taxpayer with a qualifying child who fails to meet the earned income tax credit identification requirements (that is, the ***child*** fails to meet the identification requirements) will, nonetheless, be eligible for a childless earned income credit. This provision is effective for years beginning after December 31, 2020.

3.3.3 ITIN Renewals

Before passage of the PATH Act, ITINs generally remained in effect until and unless the taxpayer applied for and received a Social Security number (SSN); the PATH Act changed that approach, and ITINs may now expire. Tax returns filed by individuals whose ITINs have expired and not been renewed will be accepted by the IRS; however, such taxpayers:

- May experience a delay in having their tax returns processed; and
- Are ineligible for certain tax credits, including –
    - The Child Tax Credit, and
    - The American Opportunity Tax Credit.

But, the change brought about by the Act depends on whether an ITIN was issued a) before 2013 or b) in 2013 or later.

3.3.3.1 ITINs Issued in 2013 or Later

Under the Act, an ITIN issued in 2013 or later will remain in effect only until it has not been used on a federal tax return—either as the filing taxpayer or a dependent on a return—for three consecutive tax years. If the ITIN has not been so used for the consecutive three-year period, it will expire on the last day of the third year.

For example, if an ITIN was not used on a federal tax return for tax years 2018, 2019 and 2020, the ITIN would expire on December 31, 2020, i.e., the third year of non-use.

3.3.3.2 ITINs Issued Before 2013

Unless an ITIN issued before 2013 has already expired for nonuse, it will no longer be in effect according to the following schedule:

ITIN Issue Date	Will Remain in Effect Until
Before 2008	January 1, 2017
2008	January 1, 2018
2009 or 2010	January 1, 2019
2011 or 2012	January 1, 2020

Accordingly, all ITINs issued before 2013 expired on or before January 1, 2020.

3.3.3.3 Renewing an ITIN

ITINs that ***expired due to nonuse*** in the last three consecutive years may be renewed at any time by submitting a Form W-7 and required documentation. These individuals may renew their ITIN without having to attach a tax return to the Form W-7.

Individuals with expired ITINs who have received a CP-48 notice from the IRS may renew their ITINs by submitting a Form W-7 along with original or certified documents. To expedite processing of the renewal, filers should also include a copy of notice CP-48. The W-7 need not be attached to a tax return.

Note: To make renewal easier, the IRS will accept Forms W-7 from each member of a family in a ***single family submission*** if at least one member of the family is required to renew an ITIN because the middle digits are "70," "71," "72" or "80."

3.4 Preparer Penalties

Professional tax preparers are expected to demonstrate a high level of competence, diligence and ethical behavior in their preparation of taxpayers' tax returns and are penalized for their failure to meet those expectations. The penalties that may be imposed under Title 26 for various preparer failures are as follows:

Scenario	Per Return or Claim for Refund	Maximum Penalty
Failure to furnish copy of tax return to taxpayer (§ 6695(a))	$50	$27,000
Failure to sign taxpayer's return (§ 6695(b))	$50	$27,000
Failure to furnish identifying number (§ 6695(c))	$50	$27,000
Failure to retain a copy or list of a return or claim (§ 6695(d))	$50	$27,000
Failure to file correct information returns (§ 6695(e))	$50 per return and item in return	$27,000
Negotiation of a check issued to a taxpayer (§ 6695(f))	$545 per check	No limit
Failure to be diligent in determining eligibility for head of household filing status, child tax credit, American opportunity tax credit, and earned income credit (§ 6695(g))	$545 per failure	No limit
Unauthorized disclosure or use of information furnished for, or in connection with, the preparation of a return (§ 6713)	$250	$10,000

In addition, tax preparer penalties may also be imposed for the following:

Scenario	Penalty
Understatement of taxpayer's liability due to unreasonable positions (§ 6694(a))	Greater of $1,000 or 50% of income derived by preparer with respect to the return or claim for refund.
Understatement of taxpayer's liability due to willful or reckless conduct (§ 6694(b))	Greater of $5,000 or 75% of income derived by preparer with respect to the return or claim for refund.
Aiding and abetting understatement of a taxpayer's tax liability (§ 6701)	$1,000 ($10,000 if the conduct relates to a corporation's tax return)
Fraud and false statements (§ 7206)	Guilty of a felony; upon conviction, a fine of $100,000 ($500,000 in the case of a corporation), imprisonment of not more than three years or both, together with costs of prosecution.
Fraudulent returns, statements or other documents (§ 7207)	Guilty of a misdemeanor; upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year or both.

3.5 Due Diligence in Tax Preparation

Due diligence is the care and attention to detail appropriate to the subject to which it refers. Thus, due diligence with respect to tax preparation is the care and attention to detail required of each preparer in his or her preparation of taxpayers' tax returns. Not surprisingly, the tax issues that create the greatest amount of confusion and resultant errors are the ones that require the highest level of diligence. Among the tax preparation topics responsible for a significant level of errors are:

- Qualifying for head of household (HOH) filing status; and
- Claiming the –
    - Child and dependent care tax credit (CTC),
    - Education tax credits (AOTC), and
    - Earned income tax credit (EITC).

Filing as head of household and claiming the refundable tax credits are each governed by different eligibility rules. In order to avoid errors, it is important to take the following three steps:

1. Know the tax law for filing as head of household and claiming each refundable credit including its eligibility rules;
2. Remember that your software is not a substitute for your knowledge of the tax law; and
3. Follow the Due Diligence Must Do's.

In addition, the due diligence requirements require the preparer to meet four standards in preparing a tax return claiming the EITC, American Opportunity Tax Credit or the Child Tax Credit. Those requirements call for the preparer to:

1. Complete and submit the Paid Preparer's Due Diligence Checklist, IRS Form 8867;
2. Complete the applicable worksheet;
3. Know the law relative to claiming the credit and, by interviewing and asking questions, the taxpayer; and
4. Document and maintain appropriate records related to preparation of the tax return, including keeping the following records for 3 years:
   - A copy of form 8867,
   - The applicable worksheet(s) or your own worksheet(s) for any credits claimed,
   - Copies of any documents provided by the taxpayer on which you relied to determine the taxpayer's eligibility for the credit(s) and/or HOH filing status and to figure the amount(s) of the credit(s),
   - A record of how, when, and from whom the information used to prepare Form 8867 and the applicable worksheet(s) was obtained, and
   - A record of any additional information you relied upon, including questions you asked and the taxpayer's responses, to determine the taxpayer's eligibility for the credit(s) and/or HOH filing status and to figure the amount(s) of the credit(s).

The various questions posed on Form 8867, Paid Preparer's Due Diligence Checklist, act as memory-joggers and identify areas about which the tax preparer should obtain information from the taxpayer when filing as Head of Household, or claiming the Earned Income Tax Credit, the Child Tax Credit or the American Opportunity Tax Credit.

Treasury Regulations prescribe the due diligence requirements a paid tax return preparer must meet with respect to completion and submission of IRS form 8867. According to the regulations, a paid tax return preparer is required to complete the form based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the preparer and provide the completed form for submission as follows:

- In the case of a ***signing tax return preparer who electronically files*** the tax return or claim for refund, the completed Form 8867 must be electronically filed with the tax return or refund claim;
- In the case of a ***signing tax return preparer who does not file the tax return or claim for refund electronically***, the completed Form 8867 must be provided to the taxpayer for inclusion when filing the tax return or claim for refund; and
- In the case of a ***non-signing tax return preparer***, the completed Form 8867 must be provided to the taxpayer in electronic or non-electronic format for inclusion when filing the tax return or claim for refund.

Pay particular attention to the important eligibility issues to avoid errors with respect to filing HOH and claiming EITC, CTC or AOTC. In every case, make sure your client has the documents needed to show the IRS if audited.

3.5.1 Head of Household Filing Status

A taxpayer who is eligible may find head of household (HOH) filing status advantageous when compared to filing as single or married filing separately, including:

- Possible eligibility for the earned income tax credit and dependent care credit;
- Higher income limits at which various tax credits are reduced;
- A lower tax rate; and
- A higher standard deduction.

However, eligibility to file as HOH is limited to those taxpayers who meet the qualification requirements. Those requirements are as follows:

- The taxpayer must be either unmarried or considered unmarried on the last day of the tax year;
- The taxpayer must have paid more than half the cost of keeping up the taxpayer's home for the tax year; and
- A qualifying person must live with the taxpayer in the taxpayer's home for more than half the tax year, not counting temporary absences for school, illness, business, vacation or military service.

Let's consider each of these requirements.

3.5.1.1 Taxpayer Considered Unmarried

To be considered unmarried on the last day of the tax year, the:

- Taxpayer must file a separate tax return, i.e., other than married filing jointly;
- Taxpayer must have paid more than half the cost of keeping up the taxpayer's home for the tax year;
- Taxpayer's spouse must not have lived in the taxpayer's home during the last six months of the tax year;
- Taxpayer's home must be the main home for the taxpayer's child, stepchild or foster child for more than half of the tax year; and
- Taxpayer must be able to claim the child.

3.5.1.1.1 Required Marriage Test Supporting Documents

The supporting documents required to substantiate the taxpayer's meeting the marriage test depends upon whether the taxpayer is:

- Single,
- Divorced or legally separated, or
- Married but not living with spouse during last 6 months of the tax year.

If the taxpayer is single, no documents supporting the taxpayer's meeting the marriage test need to be obtained.

If the taxpayer is divorced or legally separated, photocopies of the following documents should be obtained:

- Entire divorce decree;
- Separate maintenance decree; or
- Separation agreement.

If the taxpayer is married but did not live with the taxpayer's spouse during the last six months of the tax year, obtain photocopies of documents verifying the taxpayer did not live with his or her spouse during the last six months of the year. Appropriate documents include:

- A lease agreement;
- Utility bills;
- A letter from a clergy member, or
- A letter from social services.

All such documents obtained by the paid preparer should be retained by the preparer as verification that supports his or her decision for the filing.

3.5.1.2 Keeping up the Taxpayer's Home

A taxpayer is keeping up a home only if the taxpayer pays more than half the cost of its upkeep for the year. The cost of keeping up a home includes:

- Rent;
- Mortgage interest (***but not principal payments***);
- Real estate taxes;
- Insurance on the home;
- Repairs;
- Utilities; and
- Food eaten in the home.

The cost of keeping up a home doesn’t include the cost of clothing, education, medical treatment, vacations, life insurance, or transportation for any member of the household.

3.5.1.2.1 Required Keeping Up a Home Test Supporting Documents

The tax preparer should obtain the following supporting documents to substantiate the taxpayer’s meeting the keeping up a home test including:

- Rent receipts;
- Utility bills;
- Grocery receipts;
- Property tax bills;
- Mortgage interest statement;
- Upkeep and repair bills;
- Property insurance statement; and
- Other household bills.

All such documents obtained by the paid preparer should be retained by the preparer as verification that supports his or her decision for the filing.

3.5.1.3 Qualifying Person

A person is a qualifying person for purposes of the taxpayer’s filing as head of household if the person is the taxpayer’s:

- Qualifying child (such as a son, daughter, or grandchild who lived with the taxpayer more than half the year) if –
    - Single, or
    - Married <u>and</u> the taxpayer can claim him or her as a dependent;
- Qualifying relative who is the taxpayer’s father or mother and the taxpayer can claim the relative as a dependent;
- Qualifying relative other than the taxpayer’s father or mother (such as a grandparent, brother, or sister) who lived with the taxpayer more than half the year, <u>and</u> is related to the taxpayer in one of the following ways –
    - The taxpayer’s brother, sister, half brother, half sister, stepbrother, or stepsister,
    - The taxpayer’s stepfather or stepmother,
    - A son or daughter of the taxpayer’s brother or sister,
    - A son or daughter of the taxpayer’s half brother or half sister,
    - A brother or sister of the taxpayer’s father or mother, or
    - The taxpayer’s son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Note: Neither the taxpayer’s mother nor father is required to live with the taxpayer in order for the taxpayer to qualify for HOH filing status based on the relative.

3.5.1.4 Qualifying Child

A child is considered a qualifying child if both the taxpayer and child satisfy five tests:

- The child must be the taxpayer’s son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.
- The child must be (a) under age 19 at the end of the year and younger than the taxpayer (or the taxpayer’s spouse if filing jointly), (b) under age 24 at the end of the year, a student, and younger than the taxpayer (or the taxpayer’s spouse if filing jointly), or (c) any age if permanently and totally disabled.
- The child must have lived with the taxpayer for more than half of the year.
- The child must not have provided more than half of his or her own support for the year.
- The child isn’t filing a joint return for the year (unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid).

3.5.1.4.1 Required Qualifying Person Test Supporting Documents

The tax preparer should obtain and send to the IRS the supporting documents needed to substantiate the taxpayer’s meeting the qualifying person test including, as appropriate:

- Birth certificate or other official document of birth;
- Marriage certificate;
- Letter from an authorized adoption agency;
- Letter from the authorized placement agency; or
- Applicable court document.

In order to show that both the taxpayer and the taxpayer's child lived together for more than half of the year, obtain:

- School, medical, day care, or social service records; or
- A letter on the unofficial letterhead from a school, medical provider, social service agency, or place of worship that shows –
    - Names,
    - Common address, and
    - Dates.

Note: If the taxpayer furnishes a letter from a relative who provides the taxpayer's day care services, the preparer should obtain at least one additional letter.

3.5.1.5 Common Head of Household Errors

Common errors involving head of household filing status include the following:

- Both parents file as head of household, using the same child as a qualifying child;
- Both parents file as head of household, claiming that they each provided more than half the cost of upkeep for the same home;
- The taxpayer claims head of household status but did not pay for more than half the cost of keeping up a home (for example, the parent is living with a grandparent or the other parent paid for the cost of the home);
- The taxpayer is divorced and lives with his or her ex-spouse in the same home and both file as head of household;
- The taxpayer is married and the taxpayer's spouse lived in the taxpayer's house for one or more days during the last six months of the tax year;
- The taxpayer is married and lives with his or her spouse who does not work (for example income below the IRS filing threshold);
- A qualifying child did not live with the taxpayer for more than half of the tax year;
- The qualifying child was age 19 or older (or, if a student, age 24 or older) as of the last day of the tax year;
- The qualifying child was age 19-23 and a student, but was an enrolled on less than a full-time basis;
- The qualifying child was age 19-23 and a full-time student, but only for four or fewer months during the tax year (for example, the child enrolled in college starting in September after a gap year);
- The child provided more than half of his or her own support during the tax year; or
- The child filed a joint federal income tax return with his or her spouse.

IRS Form 886-H-HOH may be accessed to help ensure the necessary supporting documents to prove head of household filing status have been obtained.

3.5.2 Earned Income Tax Credit

The eligibility requirements for the earned income tax credit may be found in this document at 2.11.5. Click on eligibility requirements to review them before proceeding.

3.5.2.1 EITC Due Diligence Requirements

In addition to completing and submitting IRS Form 8867, the due diligence requirements require the preparer to:

- Compute the applicable earned income credit using a worksheet—either Worksheet A or B, as applicable;
- Know the law relative to claiming the earned income credit and his or her client; and
- Maintain appropriate records related to preparation of the tax return.

3.5.2.2 Most Common EITC Errors

The most common EITC errors are:

- ***Claiming EITC for a child who does not meet the qualifying child requirements*** – To help avoid errors involving qualifying child requirements make sure you find out if the child –
    - Lived with your client for more than half the year,
    - Is related to him or her, and
    - Meets the age test.

  Thus, you must ask the client how long the child lived with your client, at what address, and did anyone else live with the child for more than half the year. Also, find out how the child is related to the client, i.e., by blood, by marriage or by law. To determine if the age test is met for an older child, determine if the child is a student or permanently and totally disabled.

- ***Filing as single or head of household when married*** – To avoid errors with respect to filing status, ask questions to find out if your client –
    - Is married under state law, including common law, or
    - Was ever married.

  If your client is married, make sure your client did not live with his or her spouse at any time during the last six months of the year.

- ***Incorrectly reporting income or expenses*** – To avoid errors involving the incorrect reporting of income or expenses, consider the following:
    - Does the Form W-2 look similar to the Forms W-2 of other clients who have the same employer?
    - Is your client saying they own a business but not claiming any business expenses? In such a case, ask enough questions to make sure your client has a true business and claims all income and deducts all allowable expenses.

3.5.3 Education Tax Credits

The eligibility requirements for the education tax credits may be found in this document at 2.11.4 Click on eligibility requirements to review them before proceeding.

In addition to completing and submitting IRS Form 8867 when the American Opportunity Tax Credit is claimed, the due diligence requirements require the preparer to:

- Complete the AOTC Credit Limit Worksheet and Adjusted Qualified Education Expenses Worksheet found in the instructions to Form 8863, Education Credits;
- Document the inquiries made of the taxpayer; and
- Obtain substantiation for the claimed AOTC, such as –
    - Form 1098-T, and/or
    - Receipts for qualified tuition and related expenses.

3.5.3.1 Most Common AOTC Errors

The most common AOTC errors are:

- ***Claiming AOTC for a student who didn't attend an eligible educational institution*** - The AOTC is for post-secondary education, which may include education at a college, university or technical school. It does not include a high school. To be an eligible institution, the school must be able to participate in the student aid program administered by the U.S. Department of Education (note: they don't have to participate but must be eligible to participate).

- ***Claiming AOTC for a student who didn't pay qualifying college expenses*** – Ask questions to ensure the educational expenses were paid or considered paid by –
    - Your client,
    - Your client's spouse or
    - The dependent student claimed on the tax return.

- ***Claiming AOTC for a student for too many years*** - The AOTC is only available for the first four years of post-secondary education and your client can only claim it for four tax years per eligible student. This limitation includes any year(s) your client claimed the Hope Credit.

3.5.4 Child Tax Credit

The eligibility requirements for the Child Tax Credit may be found in this document at 2.11.1 Click on eligibility requirements to review them before proceeding.

In addition to completing and submitting IRS Form 8867 when the Child Tax Credit is claimed, due diligence requires the preparer to:

- Complete the Child Tax Credit and Credit for Other Dependents worksheet found in the instructions to Form 1040;
- Document the inquiries made of the taxpayer; and
- Determine that each qualifying person for the CTC/ACTC/ODC is the taxpayer's dependent who is a citizen, national or resident of the United States;
- Determine that all children for whom the taxpayer is claiming the CTC/ACTC reside with the taxpayer;
- If not all children for whom the taxpayer is claiming the credit reside with the taxpayer inquire whether there is an active Form 8332, Release/Revocation of Claim to Exemption for Child by Custodial Parent, or a similar statement in place? (Must be attached to the return if applicable.)

3.5.4.1 Most Common CTC/ACTC/ODC Errors

The most common CTC/ACTC/ODC errors involve:

- ***Claiming the CTC/ACTC for a child who does not meet the age requirement*** - The child must be under the age of 18 at the end of 2021.

- ***Claiming the CTC/ACTC/ODC for a child or other person who doesn't meet dependency requirements*** - The child must be claimed as a dependent on your client's return and meet all the eligibility rules for a dependent.

- ***Claiming the CTC/ACTC for a child who does not meet the residency requirement*** - The child must be a U.S. citizen, U.S. national or a resident alien and the child must have lived with your client for more than half the year. If the qualifying child uses an ITIN, Individual Taxpayer Identification Number, the child must meet the substantial presence test to qualify.

3.6 Compliance with E-file Procedures

Section 6011(e)(3) of the Internal Revenue Code requires specified tax return preparers to electronically file certain federal income tax returns that they prepare and file for individuals, trusts, or estates.

3.6.1 Affected Tax Return Preparers

A tax preparer generally required to electronically file federal income tax returns is one who reasonably expects to file 11 or more covered returns in a calendar year. The returns that are "covered" under the e-file requirement are income tax returns on individuals, trusts or estates, such as Forms 1040 and 1041.

The requirement to e-file does not apply to individuals who do not meet the definition of "tax return preparer" under the Internal Revenue Code, such as an individual who provides tax assistance under a Volunteer Income Tax Assistance (VITA) program, a person who merely prepares a return of the employer by whom employed or a person who prepares a return as a fiduciary.

3.6.2 Timing of Taxpayer Signature

Both taxpayers and paid preparers are required to sign an electronic income tax return. Taxpayers must sign individual income tax returns electronically under one of two methods:

- Self-Select PIN method requires taxpayers to provide their prior year adjusted gross income (AGI) amount or prior year PIN for use by the IRS to authenticate the taxpayer; or
- Practitioner PIN method.

Regardless of the method used, taxpayers must agree by signing an IRS e-file signature authorization containing the PIN *after reviewing the completed return*.

3.6.3 Timing of Filing

A return is considered filed by a tax return preparer when the preparer submits the return to the IRS either electronically or in paper form. When received by the IRS, the return is automatically checked by computers for errors and missing information. If the return cannot be processed, it is returned to the originating transmitter to clarify any needed information. Within 48 hours of electronically sending the return to the IRS, the IRS sends an acknowledgment to the transmitter stating that the return is accepted for processing. The notice is proof of filing and assurance that the IRS has the return information.

3.6.4 Recordkeeping

A tax return preparer who originates the electronic submission of returns to the IRS must make various records easily accessible until the end of the calendar year. The required records must be kept at the business address from which the preparer originated the return or at a location that allows the tax return preparer to readily access the material if requested by the IRS.

The records that must be retained are:

- A copy of Form 8453, U.S. Individual Income Tax Transmittal for an IRS e-file Return, and supporting documents not included in the electronic records submitted to the IRS;
- Copies of Forms W-2, W-2G and 1099-R;
- A copy of signed IRS e-file consent to disclosure forms;
- A complete copy of the electronic portion of the return that can be readily and accurately converted into an electronic transmission that the IRS can process; and
- The acknowledgement files for IRS-accepted returns.

Forms 8878 and 8879, IRS e-file Signature Authorization forms, must be available to the IRS for three years from the due date of the return or the IRS received date, whichever is later. Preparers may electronically image and store all paper records they are required to retain for IRS e-file.

3.6.5 Prohibited Filing with Pay Stub

If a taxpayer is unable to secure and provide a correct Form W-2, W-2G, or 1099-R, the return may be electronically filed after Form 4852 is completed. This is the only time that information from pay stubs is allowed.

3.6.6 Proper Handling of Rejects

E-file rejects identify problems that usually lead to IRS correspondence and slow down processing of tax returns. This e-file feature enables preparers to correct mistakes before returns are processed, decreasing overall processing time and shortening the time it takes to receive a refund. If the reject is for a simple mistake, the preparer should correct the error and resubmit the return electronically. This usually solves the problem.

However, you may not be able to correct some rejects. For example, if the return rejects because an exemption has been claimed on another taxpayer's return, check that the Social Security number of the exemption was entered correctly on the return. If the SSN is correct, you will not be able to file this return electronically unless the exemption is removed from the return. If you believe the taxpayer is entitled to claim the exemption, it is not necessary to remove the exemption, but the return must be filed on paper. Attach Form 8948, Preparer Explanation for Not Filing Electronically, to the paper return; check box 4 and enter the reject code number. The number of attempts to resolve is zero.

There are other situations where the reject may or may not be corrected but it takes one or more tries to resolve. When this happens, the return must be filed on paper. Attach Form 8948 to the paper return and check box 4; enter the reject code number and the number of attempts you made to resolve the reject before deciding that the error could not be fixed. Preparers generally learn from experience when trying to resolve an error is no longer productive.

Some reject conditions permit returns to be e-filed without correcting the error. If you encounter a reject that you try to resolve but cannot and this option is available, submit the return electronically.

3.7 Annual Filing Season Program Requirements

The annual filing season program is a voluntary program designed to encourage non-credentialed tax return preparers to participate in continuing education courses. After successfully completing the program, the preparer:

1. Will receive a Record of Completion that may be displayed by the preparer; and
2. Will be included, if desired, in a public database on IRS.gov that taxpayers may use when searching for a qualified tax return preparer.

The searchable public database—known as the Directory of Federal Tax Return Preparers with Credentials and Select Qualifications—includes the name, type of credential possessed and location of:

- Attorneys,
- Certified public accountants (CPAs),
- Enrolled agents (EAs),
- Enrolled retirement plan agents (ERPAs),
- Enrolled actuaries, and
- Individuals who have received an Annual Filing Season Program Record of Completion.

Participation in the Annual Filing Season Program (AFSP) requires that a tax return preparer:

- Possess an active Preparer Tax Identification Number (PTIN) for the year of participation;
- Have completed all required continuing education credits from an IRS-approved CE provider no later than December 31st of the year prior to the year of participation;
- Obtain an Annual Filing Season Program—Record of Completion from the IRS for the year of participation; and
- Consent to abide by the duties and restrictions relating to practice before the IRS contained in subpart B and section 10.51 of Treasury Department Circular No. 230 for the entire period covered by the Record of Completion.

The AFSP also requires that tax return preparers have either 15 or 18 hours of continuing education from an IRS-approved continuing education provider.

Tax return preparers requiring 15 hours of continuing education include:

- Anyone who passed the Registered Tax Return Preparer test administered by the IRS between November 2011 and January 2013;
- Return preparers who are active registrants of the –
  - Oregon Board of Tax Practitioners,
  - California Tax Education Council (CTEC), and/or
  - Maryland State Board of Individual Tax Preparers;
- Tax practitioners who have passed the Special Enrollment Exam (SEE) Part I within the past two years;
- VITA volunteers; and
- Other accredited tax-focused credential-holders of –
  - The Accreditation Council for Accountancy and Taxation's Accredited Business Accountant/Advisor (ABA), and
  - Accredited Tax Preparer (ATP) programs.

All other Annual Filing Season Program participants must have 18 hours of continuing education.

The types of continuing education required for AFSP participants needing 15 or 18 hours of continuing education are as shown in the chart below:

Category	**15-Hour Continuing Education Requirement**	**18-Hour Continuing Education Requirement**
Federal Tax Law	10 hours	10 hours
Federal Tax Law Updates	3 hours	Not required
Annual Federal Tax Refresher	Not required	6 hours
Ethics	2 hours	2 hours
Total	15 hours	18 hours

Additional information concerning the Annual Filing Season Program may be obtained in IRS Publication 5227.

3.7.1. Consent to Adhere to Circular 230 Requirements

As part of the requirements that must be met to participate in the Annual Filing Season Program, a tax ***preparer must sign the Circular 230 Consent statement that can be accessed in the tax preparer's PTIN account*** at https://www.irs.gov/tax-professionals/annual-filing-season-program.

By signing the Circular 230 Consent statement, the participant consents to the following:

> I agree to abide by the duties and restrictions relating to practice before the IRS in subpart B and section 10.51 of Treasury Department Circular No. 230 for the entire period covered by the Record of Completion.
>
> I understand that failing to comply with the duties and restrictions relating to practice before the IRS in these sections may result in the revocation of my Annual Filing Season Program—Record of Completion, and I may be prohibited from participating in the Annual Filing Season Program in the future.

See the instructional video at https://www.irs.gov/tax-professionals/annual-filing-season-program for the steps to take to complete the consent.

3.7.1.1 Tax Return Preparer Duties and Restrictions

By signing the Circular 230 Consent statement, an AFSP participant agrees to abide by the duties and restrictions relating to:

Topic	Circular 230 Section Number
Required response to IRS request for information	§10.20
Knowledge of client omissions	§10.21
Requirement for practitioner accuracy	§10.22
Prompt disposition of pending matters	§10.23
Assistance from or to disbarred or suspended persons and former IRS employees	§10.24
Practice by former government employees, their partners and associates	§10.25
Prohibition against acting as a notary as to matters administered by the IRS	§10.26
Fees	§10.27
Return of client records	§10.28
Conflicting interests	§10.29
Solicitation of business	§10.30
Negotiation of checks issued to a taxpayer	§10.31
Unauthorized practice of law	§10.32
Adherence to best practices for tax advisors	§10.33
Maintaining standards with respect to tax returns and other documents	§10.34
Practitioner competence	§10.35
Adoption of and adherence to procedures to ensure compliance	§10.36
Requirements for written advice	§10.37
Incompetence and disreputable conduct	§10.51

3.7.2 AFSP Participants' Limited Representation Rights

A return preparer who is not an attorney, CPA, or enrolled agent and who does not participate in the Annual Filing Season Program will only be permitted to prepare tax returns. The return preparer will not be permitted to represent clients before the IRS except in regard to returns prepared by the return preparer before January 1, 2016.

Participants in the Annual Filing Season Program, however, have limited representation rights. Pursuant to those limited representation rights, AFSP participants may represent clients whose returns they prepared and signed:

- Involving initial audits;

- Regarding customer service matters; and
- Before the Taxpayer Advocate Service.

Note: To have limited representation rights for any return or claim for refund prepared and signed after December 31, 2015, return preparers must participate in the Annual Filing Season Program in both **the year of return preparation and the year of representation**.

Review #8 – Practices, Procedures and Professional Responsibility

1. Harriet, a tax return preparer, failed to comply with the EITC due diligence requirements in completing her client's income tax return. If the IRS determined that her failure was NOT due to reckless disregard for the EITC rules or maintaining an unreasonable position, to what dollar penalty is she subject?

   A. $100

   B. $545

   C. $1,000

   D. $5,000

2. Phil, a tax return preparer, charged his client $500 to prepare her income tax return that claimed a $5,000 refund based on an unreasonable position. To what penalty is Phil subject if Phil knew the position was unreasonable, but it was not determined to be the result of his willful and reckless conduct?

   A. $250

   B. $500

   C. $1,000

   D. $5,000

3. For how long is a tax return preparer required to make a client's e-file signature authorization available to the IRS?

   A. Until the end of the current calendar year

   B. For three years

   C. For five years

   D. For seven years

Answers to Review Quizzes

Review #1

Question 1 Feedback

A. Your answer is incorrect. Qualified long term care insurance benefits are includible in the recipient's income to the extent such benefits exceed the greater of a per diem amount which is $400/day in 2021 or the actual costs for the care. Since the amount of benefits received exceeds those limits, some benefits must be included.

B. Your answer is correct. Karl need include only $20 per day in his income. Benefits received under qualified long term care insurance policies that may be excluded from income are those benefits not exceeding the greater of:

- The applicable *per diem* limitation for the year; or
- The costs incurred for qualified long term care services provided for the insured.

The applicable *per diem* limitation for 2021 is $400.

C. Your answer is incorrect. It erroneously suggests that the difference between the per diem limitation and the actual expenses, if less, would be includible in income. In contrast, the amount includible is the amount of the benefit that exceeds the greater of the actual costs or the per diem amount.

D. Your answer is incorrect. The amount of the difference between the long term care insurance benefits received and the actual expenses incurred for the care is not necessarily includible in income. Only the amount by which such insurance benefits exceed the *greater* of the expenses or the applicable per diem amount needs to be recognized as income.

Question 2 Feedback

A. Your answer is correct. Hank qualifies for a 10% retirement savings contribution tax credit. Since the credit is based on his retirement savings contribution during the year, his saver's credit is $100. ($1,000 x 10% = $100)

B. Your answer is incorrect. The saver's credit for which Hank qualifies is based on his contribution to the 401(k) plan multiplied by the percentage credit to which he is entitled. However, the employer match is not considered in determining the credit.

C. Your answer is incorrect. Your answer indicates that Hank's saver's credit would be based on a 20% rate. Although he would qualify for a 20% saver's credit if he filed as head of household, the saver's credit rate for a single taxpayer is not 20%.

D. Your answer is incorrect. Although Hank would be eligible for a saver's credit equal to 50% of his $1,000 401(k) deferral if he were married and filed a joint tax return, the saver's credit to which he is entitled as a single taxpayer is less.

Question 3 Feedback

A. Your answer is incorrect. Sally's receipt of a saver's credit does not eliminate her deduction of a traditional IRA contribution.

B. Your answer is incorrect. The saver's tax credit for which Sally is eligible does not reduce the deductible portion of her traditional IRA contribution.

C. Your answer is incorrect. Sally's traditional IRA deduction is not netted by the saver's credit she receives.

D. Your answer is correct. Sally may deduct the entire traditional IRA contribution, provided she is otherwise eligible to take the deduction. The retirement savings contribution tax credit, if any, for which a taxpayer is eligible does not affect the tax treatment to which the contribution would normally be subject.

Review #2

Question 1 Feedback

A. Your answer is incorrect. Although not all charitable expenses may be deductible, such expenses are normally deductible.

B. Your answer is incorrect. Your answer identifies only the mileage as being deductible when using a personal vehicle for charitable purposes. However, more than just the mileage deduction is available.

C. Your answer is correct. Karl's unreimbursed charitable expense deduction is limited to $296. Taxpayers are permitted to deduct personal vehicle expenses when used for charitable purposes. Since Karl traveled 1,400 miles, paid $40 for parking and $60 for tolls and chooses to use the standard mileage deduction, he may deduct $296. The money spent on gas and oil is not deductible, however, since the standard mileage deduction was elected.

D. Your answer is incorrect. Not all charitable expenses associated with a taxpayer's use of his personal vehicle are deductible. In this case, Karl elected to use the standard mileage deduction rather than actual costs. Since he did not choose to deduct actual costs, his expenses for gas and oil are not deductible.

Question #2 Feedback

A. Your answer is incorrect. Your answer would be correct only if Phil had taken such a taxable distribution before he reached the eligibility age for Medicare.

B. Your answer is incorrect. The answer given is 15% of the taxable HSA distribution. The tax penalty, when such a penalty applies, is 20% of the taxable HSA distribution.

C. Your answer is incorrect. Since Phil has reached the age at which he is eligible for Medicare, the usual income tax penalty for using an HSA distribution for other than qualified medical expenses does not apply.

D. Your answer is correct. Phil is not liable for a tax penalty on account of the taxable HSA distribution because he has reached the age for Medicare. HSA distributions are includible in income ***and subject to income tax penalties*** of 20% when they are used for other than qualified medical expenses and fail to meet specific exceptions. The exceptions to the tax penalty apply to distributions received while the account holder is disabled, following the account holder's death or by the account holder after reaching the eligibility age for Medicare.

Review #3

Question #1 Feedback

A. Your answer is incorrect. Although a nonqualified distribution from a Roth IRA would not shield the gain from taxation, after-tax amounts consisting of Roth IRA contributions receive FIFO income tax treatment.

B. Your answer is incorrect. $10,000 of the distribution is gain, and the gain in a nonqualified Roth IRA distribution is includible in income.

C. Your answer is correct. Peter may exclude $40,000 of the distribution from his income, i.e., an amount equal to his total contributions. Because a Roth IRA receives FIFO tax treatment, all contributions to the IRA are deemed to be distributed *before any earnings are distributed*. Since Roth IRA contributions are made with after-tax dollars, they are withdrawn tax free, even though earnings withdrawn in a distribution that is not a "qualified distribution" would be subject to income tax and, possibly, to a premature distribution tax penalty.

D. Your answer is incorrect. If Peter's Roth IRA distribution had been a qualified distribution, all of the distribution would be tax free. However, since the distribution is a nonqualified distribution, earnings are includible in income and potentially subject to a tax penalty.

Question #2 Feedback

A. Your answer is incorrect. Bill's adjusted gross income of $200,000 in 2021 neither prohibits a traditional IRA contribution nor—given the facts of the question—affects his ability to take a tax deduction for the contribution.

B. Your answer is incorrect. It reflects the limits and rules applicable to IRA contributions in effect prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

C. Your answer is incorrect. Although Bill would certainly be able to contribute $6,000 to a regular traditional IRA in 2021 and deduct that amount, your answer does not account for Bill's age.

D. Your answer is correct. Bill may make and deduct a traditional IRA contribution in 2021 that is neither eliminated nor reduced by his relatively high adjusted gross income. Because he is age 50 or older, the maximum contribution allowable in 2021 includes both a *regular* IRA contribution of $6,000 and a *catch-up* contribution of an additional $1,000. Since he is not an active participant in an employer-sponsored qualified plan, his entire traditional IRA contribution is tax-deductible.

Review #4

Question #1 Feedback

A. Your answer is incorrect. Although the home-office deduction is limited to no more than $1,500, George's business expenses not related to the business use of his home continue to be deductible.

B. Your answer is incorrect. Since George's costs for business telephone and internet apply solely to the business, they are not subject to the business percentage use of the house.

C. Your answer is incorrect. The simplified method limits George's home-office deduction to the prescribed rate times no more than 300 square feet, and his business telephone and internet service expenses are deductible.

D. Your answer is correct. George's business deduction is $2,700, comprised of a $1,500 home-office deduction and business expenses not related to his home of $1,200.

Question #2 Feedback

A. Your answer is incorrect. Although the TCJA disallows a deduction for expenses incurred by a taxpayer after December 31, 2017 and before January 1, 2026, despite their being directly related to the taxpayer's trade or business, with respect to activities normally considered to be entertainment, amusement or recreation, the disallowance does not apply when the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

B. Your answer is incorrect. Expenses incurred for beverages are treated the same as food expenses for tax purposes.

C. Your answer is incorrect. Even though taxpayers are generally limited under the TCJA to a 50% deduction of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer's premises primarily for employees, the limitation does not apply when the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

D. Your answer is correct. Taxpayers are generally permitted to deduct 50% of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer's premises primarily for employees. However, the 50% limitation on the deduction of an employer's food and beverage expenses does not apply to any expenses if, among other exceptions, the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

Review #5

Question #1 Feedback

A. Your answer is correct. In the case of a military relocation, the taxpayer's move must be pursuant to a military order and involve a permanent change of station. In such a case, no paid or incurred moving and storage expenses:

- Furnished in kind, or
- For which reimbursement or allowance is provided to the service member, spouse or dependents

…are includible in gross income or reported.

In addition, if the moving expenses paid or incurred in connection with a military relocation are furnished or reimbursed (or an allowance is provided) to the service member's spouse and dependents to move:

- To a location other than the one to which the service member moves, or
- From a location other than the one from which the service member moves

…such expenses are likewise neither includible in gross income nor reported.

B. Your answer is incorrect. Moving reimbursements are treated, for tax purposes, in a manner identical to the treatment of allowances.

C. Your answer is incorrect. Allowances for moving expenses—whether civilian or military—are treated identically for tax purposes.

D. Your answer is incorrect. Although the exclusion of moving expenses is generally suspended under the TCJA for moves occurring in 2018 through 2025, military moves are an exception.

Question #2 Feedback

A. Your answer is incorrect. The TCJA made significant changes to the mortgage interest deduction; however, it did not eliminate the deduction.

B. Your answer is incorrect. While the TCJA reduced the mortgage interest that a taxpayer may deduct to the interest on no more than $750,000, interest paid on a mortgage to purchase a residence continues to be tax-deductible provided the aggregate mortgage debt doesn't exceed $750,000.

C. Your answer is incorrect. Although interest paid on home equity mortgages would appear, at first glance, to no longer be deductible, such interest ***would be deductible*** if used to buy, build or substantially improve the taxpayer's home securing the loan.

D. Your answer is correct. They may deduct the entire amount. The TCJA made the following changes to the existing home mortgage interest deduction for taxable years 2018 through 2025:

- Interest paid on home equity indebtedness—home equity loans and lines of credit, in other words—incurred after December 15, 2017 is not tax-deductible ***unless used to buy, build or substantially improve the taxpayer's home that secures the loan***;
- Interest paid on acquisition debt incurred after December 15, 2017, less any acquisition debt incurred on or before December 15, 2017, is limited to interest paid on total acquisition indebtedness but only if the total of such mortgages is $750,000 or less ($375,000 or less if married filing separately); and
- Interest paid on acquisition debt incurred on or before December 15, 2017 is limited to interest paid on acquisition indebtedness of $1,000,000 or less ($500,000 or less if married filing separately).

An exception to the new mortgage rules may apply to written binding contracts to purchase a residence entered into before December 15, 2017.

Review #6

Question 1 Feedback

A. Your answer is incorrect. Receiving investment income in 2021 does not necessarily make an otherwise eligible EIC recipient ineligible.

B. Your answer is incorrect. Although Tanya may be eligible for EIC if she had a $1,000 investment income in 2021, that is not the maximum amount she may receive and still be eligible.

C. Your answer is incorrect. The 2021 investment income of a taxpayer eligible for EIC cannot be greater than a specified amount. Although investment income greater than $3,650 was scheduled to apply in 2021, the passage of ARPA changed the amount of investment income considered excessive for EIC eligibility purposes.

D. Your answer is correct. Internal Revenue Code § 32(i) denies the earned income tax credit to those taxpayers having excessive investment income. For 2021, prior to the passage of ARPA, "excessive investment income" was investment income in excess of $3,650 ($2,200, increased by inflation after 2015). ARPA modifies § 32(i) and provides that, for 2021, excessive investment income is that income in excess of $10,000, subject to inflation adjustment for years beginning after 2021.

Question 2 Feedback

A. Your answer is incorrect. Your answer indicates that you used the CTC amounts applicable before passage of the American Rescue Plan Act (ARPA). The CTC amounts under ARPA are higher.

B. Your answer is correct. The credit is increased to $3,000 per qualifying child age 6 or older ($3,600 per qualifying child who has not attained age 6) for taxpayers whose MAGI does not exceed the applicable threshold amount which, for married taxpayers filing jointly, is $150,000. A qualifying child is one who, in addition to meeting other existing requirements, is under the age of 18 by the end of the year. The increased portion of the aggregate credit is reduced by $50 for each $1,000 (or fraction) of MAGI in excess of $150,000 for married taxpayers filing jointly. The ARPA-related CTC increase is $2,600, comprised of the $1,600 increase for the 5 year-old (from $2,000 to $3,600) and the $1,000 increase for the 8 year-old (From $2,000 to $3,000); the 18 year-old is not a qualifying child because of age. Because the reduction in the aggregate credit is $50 per $1,000 of MAGI in excess of $150,000 (and the taxpayer's MAGI is $160,000), the total reduction is $500. Since the taxpayer is entitled to a $6,600 CTC before the $500 reduction, the total credit is $6,100.

C. Your answer is incorrect. You have not considered the reduction in the credit resulting from the taxpayer's MAGI being in excess of the applicable $150,000 for their filing status.

D. Your answer is incorrect. You have remembered to reduce the credit by $500 to account for the taxpayer's MAGI in excess of the applicable amount, but you failed to eliminate the 18 year-old from the calculation who is too old to be a qualifying child.

Review #7

Question #1 Feedback

A. Your answer is incorrect. Although Arthur's AMTI exemption is reduced in 2021 because of his alternative taxable income, it is not eliminated.

B. Your answer is incorrect. You have identified the amount of the reduction in Arthur's AMTI exemption. The reduction must be subtracted from the unreduced AMTI exemption.

C. Your answer is correct. Arthur's reduced AMTI exemption is $48,600. The AMTI exemption amount is reduced (but not below zero) by 25 percent of the amount by which the taxpayer's alternative minimum taxable income exceeds:

- $1,047,200 for taxpayers whose filing status is "married filing jointly" or "qualifying widow(er)";
- $523,600 for taxpayers whose filing status is "single," "head of household," "married filing separately" and
- $85,650 for trusts and estates.

D. Your answer is incorrect. Arthur's AMTI exemption is reduced in 2021 because his alternative taxable income exceeds $523,600, the level at which the exemption begins to be reduced.

Question #2 Feedback

A. Your answer is correct. Audrey's § 199A deduction for 2021 is equal to $20,000, computed as the lesser of A and B where:

   A equals 20 percent of Audrey's QBI from the business, and
   B equals 20 percent of Audrey's total taxable income for the taxable year.

   Accordingly, the deduction for Audrey is the smaller of:

   $100,000 x 20 percent = $20,000; or
   $110,000 x 20 percent = $22,000.

   Since she has no REIT dividends or PTP income, her pass-through deduction is $20,000, i.e., the smaller number.

B. Your answer is incorrect. Although Audrey's pass-through deduction is limited to no more than 20 percent of QBI, it is also limited with respect to her taxable income.

C. Your answer is incorrect. The applicable threshold comes into play only if the individual's taxable income exceeds it. In this case, Audrey's taxable income is well below the applicable threshold.

D. Your answer is incorrect. Although you are correct with respect to Audrey's business being an SSTB, the SSTB limitation neither limits nor excludes the pass-through deduction in this case.

Review #8

Question #1 Feedback

A. Your answer is incorrect. Although the financial penalty was $100 for the failure to comply with EITC due diligence requirements, that penalty was increased for returns filed after December 31, 2011 and is subject to annual inflation adjustments.

B. Your answer is correct. Harriet is subject to a $545 penalty. IRC section 6695(g) imposes a financial penalty on any income tax return preparer failing to comply with the due diligence requirements related to determining a taxpayer's eligibility for the credit or its amount. The financial penalty was increased by subsequent legislation from $100 to $500 for returns filed after December 31, 2011 and is subject to annual inflation adjustments.

C. Your answer is incorrect. A minimum penalty of $1,000 may be assessed if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to an unreasonable position. In this case that condition, i.e. maintaining an unreasonable position, was not found.

D. Your answer is incorrect. A minimum penalty of $5,000 may be imposed if the tax return preparer prepares a client return and the IRS finds any part of the amount of taxes owed is due to a reckless or an intentional disregard of rules or regulations.

Question #2 Feedback

A. Your answer is incorrect. Although the IRS could levy a penalty equal to 50% of the income derived by the preparer for knowingly preparing a return based on an unreasonable position, the minimum penalty is greater.

B. Your answer is incorrect. While simply requiring the preparer to pay a penalty equal to his income from preparing the return could be reasonable, the minimum penalty is higher than $500.

C. Your answer is correct. In this case, the preparer is subject to a $1,000 penalty. If a tax return preparer prepares a tax return or claim of refund based on an unreasonable position and the preparer knew or reasonably should have known it was an unreasonable position, the preparer is subject to a penalty equal to the greater of a) $1,000, or b) 50% of the income derived, or to be derived, by the tax return preparer with respect to the return or claim.

D. Your answer is incorrect. A penalty of $5,000 in this case would have been levied only if Phil's actions were due to willful and reckless conduct.

Question #3 Feedback

A. Your answer is incorrect. Although a tax return preparer who originates the electronic submission of returns to the IRS must make various records easily available until the end of the calendar year, e-file signature authorizations have a longer retention requirement.

B. Your answer is correct. Forms 8878 and 8879, IRS e-file Signature Authorization forms, must be available to the IRS for three years from the due date of the return or the IRS received date, whichever is later.

C. Your answer is incorrect. E-file signature authorization forms must generally be retained for an extended period of time; however, the required period is not five years.

D. Your answer is incorrect. Despite the longer retention period applicable to E-file signature authorization forms they may be destroyed before the end of seven years.

Glossary

Adjustment to income	An adjustment to income is a deduction that reduces a taxpayer's income to arrive at the adjusted gross income. It is also called an "above the line" deduction, meaning it is taken above the line on the tax form for adjusted gross income.
American opportunity credit	The American opportunity credit is an education tax credit available only for the first four years of postsecondary education during which time the student must be pursuing a degree or other recognized credential.
Capital asset	A capital asset includes everything owned by a taxpayer and used for personal purposes, pleasure, or investment.
Capital gains and losses	A capital gain or loss is the gain or loss sustained by a taxpayer on a sale or trade of a capital asset.
Child and dependent care tax credit	The child and dependent care credit is a nonrefundable tax credit available to a taxpayer who pays someone for the care of a qualifying person while the taxpayer is working or looking for work.
Child tax credit	The child tax credit is a credit of up to $2,000 for each qualifying child.
Credit for Other Dependents	The Credit for Other Dependents is a credit a taxpayer may claim for dependent other than a child or for a qualifying child for whom a credit is disallowed solely because the taxpayer failed to include the child's Social Security number on the tax return for the taxable year.
Deduction	A dollar amount that reduces the taxpayer's taxable income.
Dependent	A dependent is a taxpayer's qualifying child or qualifying relative.
Dividend	A dividend is a distribution of money, stock, or other property paid to a taxpayer by a corporation or by a mutual fund.
Earned income tax credit	The earned income credit—usually referred to simply as "EIC" or "EITC"—is a refundable tax credit for certain lower-income working taxpayers who meet income, filing status and other requirements.
Estimated tax payment	Estimated tax payments are amounts paid quarterly by a taxpayer to the state and local governments to cover income taxes on amounts not subject to tax withholding.
Filing status	Filing status refers to one of the five statuses a taxpayer falls into and depends on whether the taxpayer is single or married and on the taxpayer's family situation. It is determined on the last day of the taxpayer's tax year, which is December 31 for most taxpayers.
Health insurance premium tax credit	A tax credit available to individuals who meet specified income, coverage and other criteria to enable them to purchase a qualified health plan through the Health Insurance Marketplace.
Interest	Interest is the fee paid by a borrower to a taxpayer for the use of money. Interest is normally taxable to the receiving taxpayer.
Lifetime learning credit	The lifetime learning credit is an education tax credit available for all years of postsecondary education as well as for courses to acquire or improve job skills.
Pass-through deduction	A deduction authorized by the Tax Cuts and Jobs Act of 2017 equal to 20% of qualified business income available to businesses organized as other than regular corporations

Pension	An income received from an employer-sponsored qualified retirement plan.
Roth IRA	A Roth IRA is a personal retirement savings plan, funded by an annuity or trust/custodial account, which provides income tax deferral and may provide tax-free distribution of earnings. It does not provide for contribution deductibility.
Self-employment income	Self-employment income is income earned by a taxpayer in business for himself or herself.
Standard deduction	The standard deduction is a dollar amount that reduces the taxpayer's taxable income. It is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A (Form 1040).
Student loan interest deduction	The student loan interest deduction is a special deduction allowed for interest payments made on a student loan used solely to pay higher education expenses up to a maximum deduction of $2,500.
Tax credit	A dollar amount that directly reduces the taxpayer's tax liability.
Tax Cuts and Jobs Act of 2017 (TCJA)	Tax reform legislation that, among other things, authorized a pass-through deduction, generally lowered taxes for individuals and businesses, temporarily suspended exemptions and increased standard deductions.
Tax withholding	Tax withholding is the employer's retention of funds from an employee's salary or wages and paid to the government to pay the Income tax due.
Traditional IRA	A traditional IRA is a personal retirement savings plan, funded by an annuity or a trust that meets certain requirements, which may permit tax-deductible contributions and tax-deferral of earnings.

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Appendix A

References to Applicable Standards and Best Practices for Safeguarding Taxpayer Data

Resource	Available at…
"Getting Noticed: Writing Effective Financial Privacy Notices"	https://iapp.org/resources/article/getting-noticed-writing-effective-financial-privacy-notices/
"Information Compromise and the Risk of Identity Theft: Guidance for Your Business"	https://www.ftc.gov/tips-advice/business-center/guidance/data-breach-response-guide-business.
"FTC Facts for Business: Financial Institutions and Customer Information: Complying with the Safeguards Rule"	https://www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying.
FTC Disposal Rule (2005) – "FTC Business Alert: Disposing of Consumer Report Information? Rule Tells How"	https://www.ftc.gov/tips-advice/business-center/guidance/disposing-consumer-report-information-rule-tells-how.
"Security Check: Reducing Risks to Your Computer Systems"	https://www.ftc.gov/tips-advice/business-center/guidance/security-check-reducing-risks-your-computer-systems.
NIST SP 800-18, Guide for Developing Security Plans for Federal Information Systems: Provides guidance on developing an Information Security Plan and includes a sample plan in Appendix A.	http://dx.doi.org/10.6028/NIST.SP.800-18r1.
NIST SP 800-53, Recommended Security Controls for Federal Information Systems and Organizations	http://dx.doi.org/10.6028/NIST.SP.800-53r4.
NIST SP 800-61 Revision 2, Computer Security Incident Handling Guide	https://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-61r2.pdf
NIST SP 800-30 Revision 1, Guide for Conducting Risk Assessments	http://dx.doi.org/10.6028/NIST.SP.800-30r1

Appendix B

Specified Service Trade or Business

The list of Specified Service Trades or Businesses, as amplified by IRS final regulations, includes trades or businesses involving the performance of services in one or more of the following fields:

- **Health** - the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such.

  The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient.

- **Law** - the performance of services in the field of law means the performance of legal services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such.

  The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law.

- **Accounting** - the performance of services in the field of accounting means the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such.
- **Actuarial science** - the performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such.

- **Performing arts** - the performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such.

  The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

- **Consulting** - the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such.

  The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided.

  Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Services within the fields of architecture and engineering are not treated as consulting services.

- **Athletics** - the performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing.

  The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

- **Financial services** - the performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, retirement advisors, and other similar professionals performing services in their capacity as such.

  Solely for purposes of section 199A, the performance of services in the field of financial services does not include taking deposits or making loans, but does include arranging lending transactions between a lender and borrower.

- **Brokerage services** - the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee.

  This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

- **Investing and investment managemen**t - the performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.

  The performance of services of investing and investment management does not include directly managing real property.

- **Trading** - the performance of services that consist of trading means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof.

- **Dealing in securities, partnership interests or commodities** – the performance of services that consist of –

  - dealing in securities means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

  - dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

  - dealing in commodities means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, gains and losses from qualified active sales* are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities.

- **Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners** - the term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following:
  - a trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
  - a trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual’s image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual’s identity, or
  - receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

*The term qualified active sale means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities if the trade or business is as an active producer, processor, merchant or handler of commodities. A hedging transaction is treated as a qualified active sale. The sale of commodities held by a trade or business other than in its capacity as an active producer, processor, merchant, or handler of commodities is not a qualified active sale. For example, the sale by a trade or business of commodities that were held for investment or speculation would not be a qualified active sale.